

MFA MORTGAGE INVESTMENTS
Form 10-Q
May 03, 2006

**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 March 31, 2006

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: 1-13991**

MFA MORTGAGE INVESTMENTS, INC.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

13-3974868
(I.R.S. Employer
Identification No.)

**350 Park Avenue, 21st Floor, New York, New
York**

(Address of principal executive offices)

10022
(Zip Code)
(212) 207-6400

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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

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

79,194,243 shares of the registrant's common stock, \$0.01 par value, were outstanding as of April 28, 2006.

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MFA MORTGAGE INVESTMENTS, INC.
CONSOLIDATED BALANCE SHEETS

| | March 31, 2006 | December 31, 2005 |
|---|---------------------------|------------------------------|
| <i>(In Thousands, Except Per Share Amounts)</i> | | |
| | (Unaudited) | |
| Assets: | | |
| Mortgage-backed securities (MBS), at fair value (including pledged MBS of \$4,198,147 and \$5,394,144 at March 31, 2006 and December 31, 2005, respectively) (Notes 4 and 7) | \$ 4,540,596 | \$ 5,714,906 |
| Cash and cash equivalents | 74,944 | 64,301 |
| Accrued interest receivable | 20,156 | 24,198 |
| Interest rate cap agreements, at fair value (Caps) (Note 5) | 2,364 | 2,402 |
| Swap agreements, at fair value (Swaps) (Note 5) | 3,088 | 3,092 |
| Real estate (Note 6) | 20,748 | 29,398 |
| Goodwill | 7,189 | 7,189 |
| Prepaid and other assets | 1,763 | 1,431 |
| | | |
| Total Assets | \$ 4,670,848 | \$ 5,846,917 |
| Liabilities: | | |
| Repurchase agreements (Note 7) | \$ 3,953,000 | \$ 5,099,532 |
| Accrued interest payable | 31,645 | 54,157 |
| Mortgages payable on real estate | 16,477 | 22,552 |
| Dividends payable | | 4,058 |
| Accrued expenses and other liabilities | 6,597 | 5,516 |
| | | |
| Total Liabilities | 4,007,719 | 5,185,815 |
| Commitments and contingencies (Note 8) | | |
| Stockholders Equity: | | |
| Preferred stock, \$.01 par value; series A 8.50% cumulative redeemable; 5,000 shares authorized; 3,840 shares issued and outstanding at March 31, 2006 and December 31, 2005 (\$96,000 aggregate liquidation preference) (Note 9) | 38 | 38 |
| Common stock, \$.01 par value; 370,000 shares authorized; 79,652 and 80,121 issued and outstanding at March 31, 2006 and December 31, 2005, respectively (Note 9) | 796 | 801 |
| Additional paid-in capital, in excess of par | 768,020 | 770,789 |
| Accumulated deficit | (39,392) | (52,315) |
| Accumulated other comprehensive loss (Note 11) | (66,333) | (58,211) |
| | | |
| Total Stockholders Equity | 663,129 | 661,102 |
| Total Liabilities and Stockholders Equity | \$ 4,670,848 | \$ 5,846,917 |

The accompanying notes are an integral part of the consolidated financial statements.

MFA MORTGAGE INVESTMENTS, INC.
CONSOLIDATED STATEMENTS OF INCOME

| | For the Three Months Ended March 31, | |
|--|---|------------------|
| | 2006 | 2005 |
| <i>(In Thousands, Except Per Share Amounts)</i> | (Unaudited) | |
| Interest Income: | | |
| MBS income | \$ 53,329 | \$ 60,942 |
| Interest income on temporary cash investments | 666 | 297 |
| | 53,995 | 61,239 |
| Total Interest Income | 53,995 | 61,239 |
| Interest Expense | 42,785 | 39,766 |
| | 11,210 | 21,473 |
| Net Interest Income | 11,210 | 21,473 |
| Other Income: | | |
| Gain on sale of MBS, net | 1,597 | |
| Revenue from operations of real estate | 694 | 648 |
| Miscellaneous other, net | 239 | 12 |
| | 2,530 | 660 |
| Total Other Income | 2,530 | 660 |
| Operating and Other Expense: | | |
| Compensation and benefits | 1,558 | 1,555 |
| Real estate operating expense | 473 | 476 |
| Mortgage interest on real estate | 297 | 300 |
| Other general and administrative | 1,117 | 959 |
| | 3,445 | 3,290 |
| Total Operating and Other Expense | 3,445 | 3,290 |
| Income before Discontinued Operations and Preferred Stock Dividends | 10,295 | 18,843 |
| Discontinued Operations: | | |
| (Loss)/income from discontinued operations, net | (37) | 38 |
| Gain on sale of real estate, net of tax of \$1,820 (See Note 6.) | 4,705 | |
| | 4,668 | 38 |
| Discontinued Operations, net | 4,668 | 38 |
| Income Before Preferred Stock Dividends | 14,963 | 18,881 |
| Less: Preferred Stock Dividends | 2,040 | 2,040 |
| | 12,923 | 16,841 |
| Net Income Available to Common Stockholders | \$ 12,923 | \$ 16,841 |

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Earnings Per Share of Common Stock:

| | | | | | |
|-------------------------------------|-------------------|----|--------|----|--------|
| Income from continuing operations | basic and diluted | \$ | 0.10 | \$ | 0.20 |
| Income from discontinued operations | basic and diluted | | 0.06 | | |
| | | | <hr/> | | <hr/> |
| Earnings per share | basic and diluted | \$ | 0.16 | \$ | 0.20 |
| | | | <hr/> | | <hr/> |
| Weighted average shares outstanding | basic | | 79,950 | | 82,243 |
| Weighted average shares outstanding | diluted | | 79,973 | | 82,285 |

The accompanying notes are an integral part of the consolidated financial statements.

MFA MORTGAGE INVESTMENTS, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY

| | For the Three Months Ended March 31, 2006 |
|--|--|
| | (Unaudited) |
| <i>(In Thousands, Except Per Share Amounts)</i> | |
| 8.50% Series A Cumulative Redeemable Preferred Stock Liquidation Preference \$25.00 per share: | |
| Balance at December 31, 2005 and March 31, 2006 | \$ 38 |
| | |
| Common Stock, Par Value \$0.01: | |
| Balance at December 31, 2005 (80,121 shares) | 801 |
| Repurchase of common stock (469 shares) | (5) |
| | |
| Balance at March 31, 2006 (79,652 shares) | 796 |
| | |
| Additional Paid-in Capital, in Excess of Par: | |
| Balance at December 31, 2005 | 770,789 |
| Repurchase of common stock | (2,889) |
| Compensation expense for common stock options | 120 |
| | |
| Balance at March 31, 2006 | 768,020 |
| | |
| Accumulated Deficit: | |
| Balance at December 31, 2005 | (52,315) |
| Net income | 14,963 |
| Dividends declared on preferred stock | (2,040) |
| | |
| Balance at March 31, 2006 | (39,392) |
| | |
| Accumulated Other Comprehensive Loss: | |
| Balance at December 31, 2005 | (58,211) |
| Unrealized losses on MBS, net | (8,464) |
| Unrealized gains on Caps, net | 345 |
| Unrealized losses on Swaps, net | (3) |
| | |
| Balance at March 31, 2006 | (66,333) |
| | |
| Total Stockholders Equity at March 31, 2006 | \$ 663,129 |

The accompanying notes are an integral part of the consolidated financial statements.

MFA MORTGAGE INVESTMENTS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Three Months Ended March 31, | |
|---|---|-------------|
| <i>(In Thousands)</i> | 2006 | 2005 |
| | (Unaudited) | |
| Cash Flows From Operating Activities: | | |
| Net income | \$ 14,963 | \$ 18,881 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Gain on sales of MBS | (2,094) | |
| Loss on sale of MBS | 497 | |
| Amortization of purchase premiums on MBS, net of accretion of discounts | 8,123 | 11,606 |
| Amortization of premium cost for Caps | 383 | 430 |
| Decrease (increase) in interest receivable | 4,042 | (979) |
| Decrease in receivable under the Dividend Reinvestment and Stock Repurchase Plan (DRSP) | | 985 |
| Depreciation and amortization on real estate (including discontinued operations) | 198 | 189 |
| Increase in other assets and other | (1,196) | (352) |
| Increase in accrued expenses and other liabilities | 1,066 | 155 |
| (Decrease) increase in accrued interest payable | (22,512) | 16,126 |
| Gain on sale of real estate | (4,705) | |
| Stock option expense | 120 | 126 |
| Negative amortization on MBS | (868) | |
| | (1,983) | 47,167 |
| | | |
| Cash Flows From Investing Activities: | | |
| Principal payments on MBS | 443,109 | 533,138 |
| Proceeds from sale of MBS | 788,490 | |
| Purchases of MBS | (71,412) | (752,682) |
| Proceeds from sale of real estate | 14,023 | |
| | 1,174,210 | (219,544) |
| | | |
| Cash Flows From Financing Activities: | | |
| Principal payments on repurchase agreements | (9,139,598) | (5,076,309) |
| Proceeds from borrowings on repurchase agreements | 7,993,066 | 5,275,151 |
| Proceeds from issuances of common stock | | 2,998 |
| Dividends paid on preferred stock | (2,040) | (2,040) |
| Common stock repurchased | (2,879) | |
| Dividends paid on common stock | (4,058) | (18,170) |
| Principal payments on mortgages | (6,075) | (47) |
| | (1,161,584) | 181,583 |
| | | |
| Net increase in cash and cash equivalents | 10,643 | 9,206 |
| Cash and cash equivalents at beginning of period | 64,301 | 68,341 |
| | \$ 74,944 | \$ 77,547 |
| | \$ 74,944 | \$ 77,547 |

The accompanying notes are an integral part of the consolidated financial statements.

MFA MORTGAGE INVESTMENTS, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| | Three Months Ended March 31, | |
|---|---|-------------|
| | 2006 | 2005 |
| <i>(In Thousands)</i> | | |
| | (Unaudited) | |
| Net Income available to common stockholders before preferred stock dividend | \$ 14,963 | \$ 18,881 |
| Other Comprehensive Income: | | |
| Unrealized (losses) on MBS, net | (8,464) | (49,388) |
| Unrealized gains on Caps, net | 345 | 1,344 |
| Unrealized (losses) gains on Swaps, net | (3) | 2,382 |
| | 6,841 | (26,781) |
| Comprehensive income (loss) before preferred stock dividends | 6,841 | (26,781) |
| Dividends on preferred stock | (2,040) | (2,040) |
| | 4,801 | (28,821) |
| Comprehensive Income (Loss) | \$ 4,801 | \$ (28,821) |

The accompanying notes are an integral part of the consolidated financial statements.

MFA MORTGAGE INVESTMENTS, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

1. Organization

MFA Mortgage Investments, Inc. (the Company) was incorporated in Maryland on July 24, 1997 and began operations on April 10, 1998. The Company has elected to be treated as a real estate investment trust (REIT) for federal income tax purposes. In order to maintain its qualification as a REIT, the Company must comply with a number of requirements under federal tax law, including that it must distribute at least 90% of its annual net taxable income to its stockholders, subject to certain adjustments.

2. Summary of Significant Accounting Policies

(a) Basis of Presentation

The accompanying interim unaudited financial statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) have been condensed or omitted according to such SEC rules and regulations. Management believes, however, that these disclosures are adequate to make the information presented therein not misleading. The accompanying financial statements should be read in conjunction with the financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. In the opinion of management, all normal and recurring adjustments necessary to present fairly the financial condition of the Company at March 31, 2006 and results of operations for all periods presented have been made. The results of operations for the three-month period ended March 31, 2006 should not be construed as indicative of the results to be expected for the full year.

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

(b) MBS

The Company accounts for its MBS in accordance with Statement of Financial Accounting Standards (FAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities, which requires that investments in securities be designated as either held-to-maturity, available-for-sale or trading at the time of acquisition. All of the Company's MBS are designated as available-for-sale and are carried at their estimated fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income, a component of Stockholder's Equity. On December 31, 2005, the Company early adopted the guidance prescribed in Financial Accounting Standards Board (FASB) Staff Position FAS 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments (FASB Impairment Position). The application of the FASB Impairment Position resulted in the Company recognizing an other-than-temporary impairment charge of \$20.7 million on December 31, 2005. (See Note 4.)

Although the Company generally intends to hold its MBS until maturity, it may, from time to time, sell any of its MBS as part of the overall management of its business. The available-for-sale designation provides the Company with the flexibility to sell its MBS in order to act on potential market opportunities or changes in economic conditions to ensure future liquidity and to meet other general corporate purposes as they arise. Amounts reclassified out of accumulated other comprehensive income into earnings, as realized gains and losses, upon the sale of MBS are based on the specific identification method. (See Note 4.)

The Company's adjustable-rate assets are comprised primarily of hybrid MBS and adjustable-rate MBS (collectively, ARM-MBS) that are issued or guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or the Federal Home Loan Mortgage Corporation (Freddie Mac), or an agency of the U.S. government, such as the Government National Mortgage Association (Ginnie Mae) (collectively, Agency MBS). Hybrid MBS have interest rates that are fixed for a specified period and, thereafter, generally reset annually.

Interest income is accrued based on the outstanding principal balance of the investment securities and their contractual terms. Premiums and discounts associated with the purchase of investment securities are amortized into interest income over the life of such securities using the effective yield method, adjusted for actual prepayment activity.

MFA MORTGAGE INVESTMENTS, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(c) Cash and Cash Equivalents

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

(d) Other-Than-Temporary Impairment/Credit Risk

The Company limits its exposure to credit losses on its investment portfolio by requiring that at least 50% of its investment portfolio consist of Agency MBS. Pursuant to its operating policies, the remainder of the Company's assets may consist of investments in: (i) residential mortgage loans; (ii) residential MBS; (iii) direct or indirect investments in multi-family apartment properties; (iv) investments in limited partnerships, REITs or closed-end funds; or (v) investments in other fixed income instruments (corporate or government). At March 31, 2006, 88.6% of the Company's assets consisted of Agency MBS and related receivables, 8.9% were MBS rated AAA by Standard & Poor's Corporation, a nationally recognized rating agency, and related receivables and 1.6% were cash and cash equivalents; combined these assets comprised 99.1% of the Company's total assets.

Other-than-temporary impairment losses related to changes in market interest rates or in the underlying credit of investment securities, as measured by the amount of decline in estimated fair value attributable to factors that are considered to be other-than-temporary, are charged against income resulting in an adjustment of the cost basis of such securities. The following are among, but not all of, the factors considered in determining whether and to what extent an other-than-temporary impairment related to credit exists: (i) the expected cash flow from the investment; (ii) whether there has been an other-than-temporary deterioration of the credit quality of the underlying mortgages, debtor or the company in which equity interests are held; (iii) the credit protection available to the related mortgage pool for MBS; (iv) any other market information available, including analysts assessments and statements, public statements and filings made by the debtor, counterparty or other relevant party issuing or otherwise collateralizing the particular security; (v) management's internal analysis of the security considering all known relevant information at the time of assessment; and (vi) the magnitude and duration of the historical decline in market value when available. Because management's assessments are based on factual information as well as subjective information available at the time of assessment, the determination as to whether an other-than-temporary decline exists and, if so, the amount considered impaired is also subjective and, therefore, constitutes material estimates that are susceptible to a significant change.

On November 3, 2005, the FASB Impairment Position was issued. The guidance in the FASB Impairment Position is required for reporting periods beginning after December 15, 2005, with earlier application permitted. The Company commenced the application of the FASB Impairment Position effective December 31, 2005. (See Note 2(l).)

(e) Goodwill

The Company accounts for its goodwill in accordance with FAS No. 142, "Goodwill and Other Intangible Assets" (FAS 142) which provides, among other things, how entities are to account for goodwill and other intangible assets that arise from business combinations or are otherwise acquired. FAS 142 requires that goodwill be tested for impairment at least annually, or more frequently under certain circumstances. At the time the Company adopted FAS 142, the Company had unamortized goodwill of approximately \$7.2 million, which represents the excess of the fair value of the common stock issued over the fair value of net assets acquired when the Company was formed in 1998 through a merger transaction. On an annual basis goodwill is tested for impairment at the entity level. Through March 31, 2006, the Company has not recognized any impairment on its goodwill.

(f) Real Estate

At March 31, 2006, the Company indirectly held 100% ownership interests in multi-family apartment properties known as Lealand Place (Lealand) and Cameron at Hickory Grove (Cameron), both of which are consolidated with the Company. These properties were acquired through tax-deferred exchanges under Section 1031 of the Internal Revenue Code of 1986, as amended (the Code). (See Note 6.)

The properties, capital improvements and other assets held in connection with these investments are carried at cost, net of accumulated depreciation and amortization. Maintenance, repairs and minor improvements are charged to expense in the period incurred, while capital improvements are capitalized and depreciated over their useful life. Depreciation and amortization are computed using the straight-line method over the estimated useful life of the related asset.

MFA MORTGAGE INVESTMENTS, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

(g) Repurchase Agreements

The Company finances the acquisition of its MBS through the use of repurchase agreements. Under these repurchase agreements, the Company sells securities to a lender and agrees to repurchase the same securities in the future for a price that is higher than the original sales price. The difference between the sale price that the Company receives and the repurchase price that the Company pays represents interest paid to the lender. A repurchase agreement is a financing under which the Company pledges its securities as collateral to secure a loan which is equal in value to a specified percentage of the estimated fair value of the pledged collateral, while the Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender or, with the consent of the lender, the Company may renew such agreement at the then prevailing financing rate. Margin calls, whereby a lender requires that the Company pledge additional collateral to secure borrowings under its repurchase agreements with such lender, are routinely experienced by the Company as the current face value (i.e., par value) of its MBS declines due to scheduled monthly amortization and prepayments of principal on such MBS. In addition, margin calls may also occur when the fair value of the MBS pledged as collateral declines due to increases in market interest rates or other market conditions. Through March 31, 2006, the Company had satisfied all of its margin calls.

Original terms to maturity of the Company's repurchase agreements generally range from one month to 36 months. Should a counterparty decide not to renew a repurchase agreement at maturity, the Company must either refinance elsewhere or be in a position to satisfy this obligation. If, during the term of a repurchase agreement, a lender should file for bankruptcy, the Company might experience difficulty recovering its pledged assets and may have an unsecured claim against the lender's assets for the difference between the amount loaned to the Company (plus interest due to the counterparty) and the estimated fair value of the collateral pledged to such lender. To reduce this risk, the Company enters into repurchase agreements only with institutions whose long-term debt rating is single A or better, or if applicable whose parent was rated single A or better, as determined by at least one nationally recognized rating agency, such as Moody's Investors Services, Inc., Standard & Poor's Corporation or Fitch, Inc. (collectively, the "Rating Agencies"), where applicable. If the minimum criterion is not met, the Company will not enter into repurchase agreements with a lender without the specific approval of the Company's Board of Directors (the "Board"). In the event an existing lender is downgraded below single A, the Company will seek the approval of the Board before entering into additional repurchase agreements with that lender. The Company generally seeks to diversify its exposure by entering into repurchase agreements with at least four separate lenders with a maximum loan from any lender of no more than three times the Company's Stockholders' Equity. At March 31, 2006, the Company had outstanding balances under repurchase agreements with 12 separate lenders with a maximum net exposure (the difference between the amount loaned to the Company including interest payable and the fair value of the security pledged by the Company as collateral) to a single lender of \$38.2 million. (See Note 7.)

In certain instances, the Company has purchased MBS from a counterparty and subsequently financed the acquisition of these MBS through repurchase agreements, which are also collateralized by these MBS, with the same counterparty (a "Same Party Transaction"). The Company records the acquisition of these MBS as assets and the related financings under repurchase agreements as liabilities gross on its consolidated balance sheets, with changes in the fair value of these MBS being recorded in other comprehensive income, a component of stockholders' equity. The corresponding interest income earned on these MBS and interest expense incurred on the related repurchase agreements are reported gross on the Company's consolidated statements of income. As of March 31, 2006, the Company had no Same Party Transactions and, at December 31, 2005, the Company had 25 Same Party Transactions aggregating approximately \$474.5 million in MBS and \$471.5 million in financings under repurchase agreements.

Based upon the Company's understanding of a technical interpretation of the provisions of FAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities" (FAS 140), Same Party Transactions may not qualify as a purchase by the Company because the MBS purchased by the Company in Same Party Transactions may not be determined to be legally isolated from the counterparty in such transactions. The result of this technical interpretation would be to preclude the Company from presenting (i) these MBS and the related financings under repurchase agreements on a gross basis on its balance sheet and (ii) the related interest income earned and interest expense incurred on a gross basis on its income statement. Instead, the Company would be required to present Same Party Transactions on a net basis, reporting derivatives on its balance sheet and the corresponding change in fair value of such derivatives on its income statement. The value of the derivatives

MFA MORTGAGE INVESTMENTS, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

created by these types of transactions would reflect the changes in the value of the underlying MBS and the changes in the value of the underlying credit provided by the applicable counterparty.

If the Company were to determine it was required to apply this technical interpretation of FAS 140, the potential change in its accounting treatment would not affect the economics of the Same Party Transactions, but would affect how these transactions were reported on its consolidated financial statements. This issue has been brought to the FASB for guidance, and the Company is awaiting further action by the FASB regarding Same Party Transactions.

(h) Earnings per Common Share (EPS)

Basic EPS is computed by dividing net income available to holders of common stock by the weighted average number of shares of common stock outstanding during the period. Diluted EPS is computed by dividing net income available to holders of common stock by the weighted-average shares of common stock and common equivalent shares outstanding during the period. For the diluted EPS calculation, common equivalent shares outstanding includes the weighted average number of shares of common stock outstanding adjusted for the effect of dilutive unexercised stock options using the treasury stock method. Under the treasury stock method, common equivalent shares are calculated assuming that all dilutive common stock equivalents are exercised and the proceeds are used to repurchase shares of the Company's outstanding common stock at the average market price during the reported period. No common share equivalents are included in the computation of any diluted per share amount for a period in which a net operating loss is reported. (See Note 10.)

(i) Comprehensive Income

Comprehensive income for the Company includes net income, the change in net unrealized gains and losses on investments and certain derivative instruments reduced by dividends on preferred stock. (See Note 11.)

(j) U.S. Federal Income Taxes

The Company has elected to be taxed as a REIT under the provisions of the Code and the corresponding provisions of state law. The Company expects to operate in a manner that will enable it to continue to be taxed as a REIT. As such, no provision for current or deferred income taxes has been made in the accompanying consolidated financial statements.

Under the Built-in Gain Rules of the Code, a REIT is subject to a corporate tax if it disposes of any assets acquired from a C Corporation during the ten-year period following the initial acquisition of such assets. Such built-in gain tax is imposed at the highest regular corporate tax rate on the lesser of (i) the amount of gain recognized by the REIT at the time of the sale or disposition of such asset or (ii) the amount of such asset's built-in gain at the time the asset was acquired from the non-REIT C corporation. On January 31, 2006, the Company was subject to a built-in gains tax of \$1.8 million in connection with the sale of real estate, which, net of such tax and selling expenses, resulted in a gain of \$4.7 million. (See Note 6.)

(k) Derivative Financial Instruments/Hedging Activity

The Company hedges a portion of its interest rate risk through the use of derivative financial instruments, comprised of Caps and Swaps (collectively, Hedging Instruments). The Company accounts for Hedging Instruments in accordance with FAS No. 133, Accounting for Derivative Instruments and Hedging Activities, (FAS 133) as amended by FAS No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, and FAS No. 149 Amendment of Statement 133 on Derivative Instrument and Hedging Activities. The Company's Hedging Instruments are carried on the balance sheet at their fair value, as assets, if their fair value is positive, or as liabilities, if their fair value is negative. Since the Company's derivatives are designated as cash flow hedges, the change in the fair value of any such derivative is recorded in other comprehensive income for hedges that qualify as effective and is transferred from other comprehensive income to earnings as the hedged liability affects earnings. 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 Hedging Instruments in earnings as a result of the hedge or a portion thereof being ineffective.

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

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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 FAS 133. The Company would discontinue 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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To date, the Company has not discontinued hedge accounting for any of its Hedging Instruments, as such instruments have remained highly effective.

The Company utilizes Hedging Instruments to manage a portion of its interest rate risk and does not anticipate entering into derivative transactions for speculative or trading purposes. (See Note 5.) In order to limit credit risk associated with the counterparties to derivative instruments, the Company's policy is to enter into derivative contracts with financial institutions rated single A or better, or if applicable whose parent was rated single A or better, by at least one of the Rating Agencies at the time of purchase.

Interest Rate Cap Agreements

In order for the Company's Caps to qualify for hedge accounting, upon entering into the Cap, the Company must anticipate that the hedge will be highly effective, as defined by FAS 133, in limiting the Company's cost beyond the Cap threshold on its matching (on an aggregate basis) anticipated repurchase agreements during the active period of the Cap. Provided that the hedge remains effective, changes in the estimated fair value of the Caps are included in other comprehensive income. Upon commencement of the Cap active period, the premium paid to enter into the Cap is amortized and reflected in interest expense. The periodic amortization of the premium expense is based on an allocation of the premium, determined at inception of the hedge, for the monthly components on an estimated fair value basis. Payments received in connection with Caps, if any, are reported as a reduction to interest expense. If it is determined that a Cap is not effective, the premium would be reduced and a corresponding charge made to interest expense, for the ineffective portion of the Cap. The maximum cost related to the Company's Caps is limited to the original price paid to enter into the Cap.

The Company purchases Caps by incurring a one-time fee or premium. Pursuant to the terms of the Caps, the Company will receive cash payments if the interest rate index specified in any such Cap increases above contractually specified levels. Therefore, Caps have the effect of capping the interest rate on a portion of the Company's borrowings above a level specified by the Cap. (See Note 5.)

Interest Rate Swaps

When the Company enters into a 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 Swaps are designated as cash flow hedges against the benchmark interest rate risk associated with the Company's borrowings.

All changes in the value of Swaps are recorded in accumulated other comprehensive income. 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, then the related gain or loss in accumulated other comprehensive income would be recognized through earnings.

Realized gains and losses resulting from the termination of a Swap are initially recorded in accumulated other comprehensive income as a separate component of equity. The gain or loss from a terminated Swap remains in accumulated other comprehensive income until the forecasted interest payments affect earnings. If it becomes probable that the forecasted interest payments will not occur, then the entire gain or loss would be recognized through earnings. (See Note 5.)

(l) Discontinued Operations

On January 31, 2006, the Company sold a real estate property resulting in a gain of \$4.7 million, net of a built-in gains tax of \$1.8 million and selling expenses. In accordance with the provisions of FASB Statement No. 144, Accounting for the Impairment or Disposal of Long Lived Assets (FAS 144), the gain on the sale of such property and, the operating results of such property are classified as discontinued operations for all periods presented net of tax, on the Company's consolidated statements of income. (See Note 6.)

(m) Adoption of New Accounting Standards

Equity Based Compensation

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On January 1, 2006, the Company adopted FAS 123(R) applying the modified prospective method. FAS 123(R), among other things, eliminated the alternative to use the intrinsic value method of accounting for stock based compensation and requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards (with limited exceptions). Prior to the adoption of FAS 123(R), the Company accounted for its stock based compensation in accordance with FAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure, which was adopted on January 1,

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2003. Based on the Company's analysis of its outstanding options under the provisions of FAS 123(R), the adoption of FAS 123(R) had no impact on the Company. The Company continues to value its stock-based compensation using the Black-Scholes method.

FASB Impairment Position

On December 31, 2005, the Company early adopted the FASB Impairment Position. Among other things, the FASB Impairment Position specifically addresses: the determination as to when an investment is considered impaired; whether that impairment is other-than-temporary; the measurement of an impairment loss; accounting considerations subsequent to the recognition of an other-than-temporary impairment; and certain required disclosures about unrealized losses that have not been recognized as other-than-temporary impairments.

The FASB Impairment Position specifically provides that when the fair value of an investment is less than its cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other-than-temporary - which does not mean permanent. If it is determined that impairment is other-than-temporary, then an impairment loss is recognized in earnings reflecting the entire difference between the investment's cost basis and its fair value at the balance sheet date of the reporting period for which the assessment is made. The measurement of the impairment is not permitted to include partial recoveries subsequent to the balance sheet date. Following the recognition of impairment as other-than-temporary, the fair value of the investment becomes the new cost basis of the investment and is not adjusted for subsequent recoveries in fair value.

Upon a decision to sell an impaired available-for-sale security on which the Company does not expect the fair value of the security to fully recover prior to the expected time of sale, the security shall be deemed other-than-temporarily impaired in the period in which the decision to sell is made, in addition, the Company recognizes an impairment loss when the impairment is deemed other-than-temporary even if a decision to sell has not been made. Upon the implementation of the FASB Impairment Position, the Company recorded an impairment charge of \$20.7 million related to impairments on MBS, such impairment related to changes in interest rates on MBS that the Company did not expect to hold until recovery of such impairment. At December 31, 2005 the Company had MBS of \$821.5 million on which an impairment charge had been made. During the three months ended March 31, 2006, the Company had sold each of the MBS on which it had recorded an impairment at December 31, 2005 and had no other MBS in the portfolio that were considered other-than-temporarily impaired. (See Note 4.)

(n) Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

3. Related Parties

On January 31, 2006, pursuant to a purchase and sale agreement, dated January 19, 2006, between Retirement Centers Corporation (RCC), a wholly owned subsidiary of the Company, and America First Apartment Investors, Inc. (AFAI), RCC sold its 100% membership interest (the Greenhouse Interest) in Greenhouse Holdings, LLC, which owns The Greenhouse, a 128-unit multi-family apartment property located in Omaha, Nebraska (Greenhouse), to AFAI for \$15.2 million. The terms of the purchase and sale agreement were determined through arms-length negotiations between the parties. Spartan I, LLC an indirect wholly-owned subsidiary of the Company, currently provides investment advisory services to AFAI for a negotiated fee and AFAI, through a wholly-owned subsidiary, currently provides property management services for a negotiated fee to the remaining multi-family properties in which the Company indirectly holds investment interests. George H. Krauss, who is one of the Company's directors as well as a member of the board of directors of AFAI, did not participate, on behalf of the Company or RCC, in the determination to enter into, or the negotiations relating to, the transaction. As a result of the transaction, the Company realized a gain on the sale of the Greenhouse Interest of \$4.7 million, which is reported as discontinued operations.

4. Mortgage-Backed Securities

At March 31, 2006 and December 31, 2005, all of the Company's MBS were classified as available-for-sale and, as such, were carried at their estimated fair value, based on prices obtained from a third-party pricing service or, if pricing was not available for an MBS from such pricing service, the average of broker quotes received for such MBS is used to determine the estimated fair value of such MBS. At March 31, 2006 and December 31, 2005, the Company's portfolio of MBS consisted of pools of ARM-MBS with carrying values of approximately \$4.540 billion

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and \$5.709 billion, respectively, and fixed-rate MBS with carrying values of approximately \$120,000 and \$6.2 million, respectively.

The following tables present certain information about the Company's MBS at March 31, 2006 and December 31, 2005.

| March 31, 2006 | | | | |
|--------------------------|----------------------|---------------------------------------|---|---|
| | Par Value | MBS Amortized Cost (1) | Carrying Value/ Estimated Fair Value (2) | Net Unrealized Gain/(Loss) |
| <i>(In Thousands)</i> | | | | |
| Agency MBS: | | | | |
| Fannie Mae Certificates | \$ 3,183,791 | \$ 3,249,143 | \$ 3,197,203 | \$ (51,940) |
| Ginnie Mae Certificates | 615,903 | 628,539 | 621,454 | (7,085) |
| Freddie Mac Certificates | 282,653 | 303,952 | 300,495 | (3,457) |
| Non-Agency MBS: | | | | |
| AAA rated | 418,027 | 423,251 | 415,574 | (7,677) |
| AA rated | 2,281 | 2,281 | 2,224 | (57) |
| Single A rated | 1,597 | 1,584 | 1,553 | (31) |
| BBB rated | 913 | 899 | 883 | (16) |
| BB and below rated | 1,255 | 1,055 | 1,125 | 70 |
| Non-rated | 229 | 84 | 85 | 1 |
| Total MBS | \$ 4,506,649 | \$ 4,610,788 | \$ 4,540,596 | \$ (70,192) |
| December 31, 2005 | | | | |
| | Par Value | MBS Amortized Cost (1) | Carrying Value/ Estimated Fair Value (2) | Net Unrealized Gain/(Loss) |
| <i>(In Thousands)</i> | | | | |
| Agency MBS: | | | | |
| Fannie Mae Certificates | \$ 3,882,393 | \$ 3,950,983 | \$ 3,906,821 | \$ (44,162) |
| Ginnie Mae Certificates | 866,361 | 879,105 | 870,234 | (8,871) |
| Freddie Mac Certificates | 328,494 | 354,708 | 351,592 | (3,116) |
| Non-Agency MBS: | | | | |
| AAA rated | 579,115 | 585,911 | 580,317 | (5,594) |
| AA rated | 2,290 | 2,290 | 2,271 | (19) |
| Single A rated | 1,603 | 1,604 | 1,582 | (22) |
| BBB rated | 916 | 890 | 871 | (19) |
| BB and below rated | 1,260 | 1,059 | 1,133 | 74 |
| Non-rated | 231 | 84 | 85 | 1 |
| Total MBS | \$ 5,662,663 | \$ 5,776,634 | \$ 5,714,906 | \$ (61,728) |

(1) Includes principal payments receivable.

(2) MBS with an estimated fair value of \$4.198 billion and \$5.394 billion were pledged as collateral against borrowings under repurchase agreements and Swaps at March 31, 2006 and December 31, 2005, respectively.

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Agency MBS: Although not rated, Agency MBS carry an implied AAA rating. Agency MBS are guaranteed as to principal and/or interest by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. government, such as Ginnie Mae. The payment of principal and/or interest on Fannie Mae and Freddie Mac MBS is guaranteed by those respective agencies and the payment of principal and/or interest on Ginnie Mae MBS is backed by the full faith and credit of the U.S. government.

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Non-Agency MBS: Non-Agency MBS are certificates that are backed by pools of single-family and multi-family mortgage loans, which are not guaranteed by the U.S. government or federal agency or any federally chartered corporation. Non-Agency MBS may be rated from AAA to B by one or more of the Rating Agencies. AAA is the highest bond rating given by a Rating Agency and indicates the credit worthiness of the investment. Certain Non-Agency MBS may also be non-rated.

The following table presents the amortized cost, gross unrealized gains, gross unrealized losses and fair value of the Company's MBS at March 31, 2006 and December 31, 2005:

| <i>(In Thousands)</i> | March 31, 2006 | December 31, 2005 |
|---|---------------------------|------------------------------|
| Principal balance (par value) | \$ 4,506,649 | \$ 5,662,663 |
| Principal payment receivable | 14,621 | 18,870 |
| | <u>4,521,270</u> | <u>5,681,533</u> |
| Unamortized premium | 89,891 | 98,689 |
| Unaccreted discount | (32) | (3,247) |
| Discount designated as a credit reserve | (341) | (341) |
| Gross unrealized gains | 1,628 | 3,988 |
| Gross unrealized losses | (71,820) | (65,716) |
| | <u>\$ 4,540,596</u> | <u>\$ 5,714,906</u> |

The table below presents information about the Company's MBS pledged as collateral under repurchase agreements and Swaps at March 31, 2006.

| MBS Pledged | MBS Pledged Under Repurchase Agreements | | MBS Pledged Under Swaps | | Total Fair Value of MBS Pledged |
|-----------------------|---|-----------------------|---|-----------------------|--|
| | Estimated Fair Value/ Carrying Value | Amortized Cost | Estimated Fair Value/ Carrying Value | Amortized Cost | |
| <i>(In Thousands)</i> | | | | | |
| Fannie Mae | \$ 3,018,482 | \$ 3,068,086 | \$ 771 | \$ 777 | \$ 3,019,253 |
| Freddie Mac | 251,422 | 254,436 | | | 251,422 |
| Ginnie Mae | 549,046 | 555,379 | | | 549,046 |
| AAA Rated | 378,426 | 385,035 | | | 378,426 |
| | <u>\$ 4,197,376</u> | <u>\$ 4,262,936</u> | <u>\$ 771</u> | <u>\$ 777</u> | <u>\$ 4,198,147</u> |

The Company's MBS are primarily comprised of Agency MBS, which have an implied AAA rating, or non-Agency MBS that were rated AAA by one or more of the Rating Agencies; accordingly, no unrealized losses associated with these MBS were considered to be credit related.

At March 31, 2006, the Company also held \$5.9 million (amortized cost) of non-Agency MBS rated below AAA. Approximately \$1.1 million of these MBS were rated below investment grade (i.e., BB and below), of which \$84,000 were not rated by a Rating Agency. The MBS rated below investment grade, including the non-rated MBS, were purchased at a discount, a portion of which was designated as credit protection against future credit losses. The initial credit protection (i.e., discount) of these MBS may be adjusted over time, based on review of the underlying collateral, economic conditions and other factors. If the performance of these securities is more favorable than initially forecasted, a portion of the amount designated as credit protection may be accreted into interest income over time. Conversely, if in the future the performance of these securities is less favorable than initially forecasted, additional reserves could be warranted, which would be charged

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against the Company's earnings. At March 31, 2006, the Company had 188 MBS, with an amortized cost of \$2.525 billion, that had unrealized losses for 12 months or more, all of which were Agency or AAA rated MBS. At March 31, 2006, these MBS had gross unrealized losses of \$53.4 million. The Company has the intent and the ability to hold the remaining MBS to their maturity and therefore the impairment on these MBS is deemed to be temporary.

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The following table presents the gross unrealized losses and estimated fair value of the Company's MBS, aggregated by investment category and length of time that such individual securities have been in a continuous unrealized loss position, at March 31, 2006.

| | Less than 12 Months | | 12 Months or more | | Total | |
|---------------------------------------|----------------------|-------------------|----------------------|-------------------|----------------------|-------------------|
| | Estimated Fair Value | Unrealized losses | Estimated Fair Value | Unrealized losses | Estimated Fair Value | Unrealized losses |
| <i>(In Thousands)</i> | | | | | | |
| Agency MBS: | | | | | | |
| Fannie Mae | \$ 735,975 | \$ 11,165 | \$ 1,783,363 | \$ 42,068 | \$ 2,519,338 | \$ 53,233 |
| Ginnie Mae | 145,446 | 515 | 433,452 | 6,745 | 578,898 | 7,260 |
| Freddie Mac | 97,102 | 717 | 173,766 | 2,827 | 270,868 | 3,544 |
| Non-Agency AAA rated MBS | 334,041 | 5,907 | 81,472 | 1,771 | 415,513 | 7,678 |
| Non-Agency AA and below | 4,660 | 105 | | | 4,660 | 105 |
| Total temporarily impaired securities | \$ 1,317,224 | \$ 18,409 | \$ 2,472,053 | \$ 53,411 | \$ 3,789,277 | \$ 71,820 |

During the fourth quarter of 2005, the Company engaged in a reassessment and repositioning of its MBS portfolio, which, among other things, resulted in the recognition of an other-than-temporary impairment charge of \$20.7 million on specifically identified MBS in the Company's portfolio, with an aggregate estimated market value of \$821.5 million. The Company had determined to discontinue its previous strategy of holding certain MBS until such time that the unrealized losses, all of which resulted from increases in interest rates, were recovered. All of the MBS on which an impairment was recognized at December 31, 2005 were sold during the first quarter of 2006, resulting in a net gain of \$1.6 million, comprised of gross gains of \$2.1 million and gross losses of \$497,000.

The following table presents interest income and premium amortization on the Company's MBS portfolio for the three months ended March 31, 2006 and 2005:

| | Three Months Ended March 31, | |
|-----------------------------|---------------------------------|-----------|
| | 2006 | 2005 |
| <i>(In Thousands)</i> | | |
| Coupon interest on MBS | \$ 61,452 | \$ 72,547 |
| Premium amortization | (8,233) | (11,616) |
| Discount accretion | 110 | 11 |
| Interest income on MBS, net | \$ 53,329 | \$ 60,942 |

5. Hedging Instruments/Hedging Activity

In connection with the Company's interest rate risk management process, the Company periodically hedges a portion of its interest rate risk by entering into derivative financial instrument contracts. Through March 31, 2006, such instruments have been comprised of Caps and Swaps, which in effect modify the repricing characteristics of the Company's repurchase agreements and cash flows for such liabilities. The use of Hedging Instruments 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 order to mitigate its exposure to any counterparty-related risk associated with its Hedging Instruments, the Company's policy is to enter into derivative transactions only with financial institutions that have a long-term debt rating of, or, to the extent applicable, have a holding or parent company with a long-term debt rating of, single A or better as determined by at least one of the Rating Agencies at the time any such transaction is entered into. In the event of a default by the counterparty, the Company would not receive payments provided for under the terms of the Hedging Instrument, could incur a loss for the remaining unamortized premium cost of the Cap and could have difficulty obtaining its assets pledged as collateral for Swaps.

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The following table sets forth the impact of the Company's Hedging Instruments on the Company's other comprehensive income for the three months ended March 31, 2006 and 2005.

| | For the Three Months Ended March 31, | |
|--|---|------------|
| | 2006 | 2005 |
| <i>(In Thousands)</i> | | |
| Accumulated Other Comprehensive | | |
| Income/(Loss) from Hedging Instruments: | | |
| Balance at beginning of year | \$ 3,517 | \$ (1,989) |
| Unrealized gains on Hedging Instruments, net | 342 | 3,726 |
| | \$ 3,859 | \$ 1,737 |

(a) Interest Rate Caps

The Company's Caps are designated as cash flow hedges against interest rate risk associated with the Company's existing and forecasted repurchase agreements. At March 31, 2006, the Company had five Caps with an aggregate notional amount of \$300.0 million purchased to hedge against increases in interest rates on \$300.0 million of its current and/or anticipated 30-day term repurchase agreements. The Caps had an amortized cost of approximately \$1.6 million and an estimated fair value of approximately \$2.4 million at March 31, 2006, resulting in a net unrealized gain of approximately \$770,000, which is included as a component of accumulated other comprehensive income or loss. The Company incurred premium amortization expense on its Caps, which is recorded as interest expense on the Company's repurchase agreements that such Caps hedge, of \$383,000 and \$430,000 for the three months ended March 31, 2006 and 2005, respectively. If the 30-day LIBOR were to increase above the rate specified in the Cap during the effective term of the Cap, the Company would receive monthly payments from its Cap counterparty. For the three months ended March 31, 2006 and March 31, 2005, the Company received \$576,000 and \$0 in payments related to its Caps, respectively.

The following table presents the impact on the Company's interest expense related to its Caps for the three months ended March 31, 2006 and 2005.

| | For the Three Months Ended March 31, | |
|------------------------------|---|--------|
| | 2006 | 2005 |
| <i>(In Thousands)</i> | | |
| Premium amortization on Caps | \$ 383 | \$ 430 |
| Payments earned on Caps | (576) | |
| | \$ (193) | \$ 430 |

The table below presents information about the Company's Caps at March 31, 2006, all of which were active:

| | Weighted Average Remaining Active Period | Weighted Average LIBOR Strike Rate (1) | Notional Amount | Unamortized Premium | Estimated Fair Value/Carrying Value | Gross Unrealized Gain |
|-------------------------------|---|--|--------------------|------------------------|---|-----------------------------|
| <i>(Dollars in Thousands)</i> | | | | | | |
| Currently active | 7 Months | 3.79% | \$ 300,000 | \$ 1,594 | \$ 2,364 | \$ 770 |

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(1) The 30-day LIBOR strike rate at which payments would become due to the Company under the terms of the Cap. At March 31, 2006, the 30-day LIBOR was 4.83%.

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(b) Interest Rate Swaps

The Company's Swaps are used to lock-in the fixed interest rate related to a portion of its current and anticipated future 30-day term repurchase agreements. For the three months ended March 31, 2006, the Company's Swaps reduced the cost of the Company's borrowings by \$783,000; for the three months ended March 31, 2005, the Company's Swaps increased the cost of the Company's borrowings by \$403,000.

The table below presents information about the Company's Swaps at March 31, 2006, all of which were active:

| | <u>Weighted Average Remaining Active Period</u> | <u>Notional Amount</u> | <u>Weighted Average Swap Rate</u> | <u>Estimated Fair Value/Carrying Value</u> | <u>Gross Unrealized Gain</u> |
|-------------------------------|---|----------------------------|---|--|--------------------------------------|
| <i>(Dollars in Thousands)</i> | | | | | |
| Currently Active | 9 Months | \$ 315,000 | 3.53% | \$ 3,089 | \$ 3,089 |

6. Real Estate Investments and Discontinued Operations

At March 31, 2006, the Company indirectly held 100% of the ownership interests in two multi-family apartment properties: (i) Lealand Place, a 191-unit apartment property located in Lawrenceville, Georgia; and (ii) Cameron, a 201-unit multi-family apartment complex in Charlotte, North Carolina.

The Company's investments in real estate, which are consolidated with the Company, were as follows at March 31, 2006 and December 31, 2005:

| | <u>March 31, 2006</u> | <u>December 31, 2005(1)</u> |
|--------------------------------|-----------------------|---------------------------------|
| <i>(In Thousands)</i> | | |
| Real Estate: | | |
| Land and buildings | \$ 20,748 | \$ 29,398 |
| Cash | 723 | 749 |
| Prepaid and other assets | 212 | 406 |
| Mortgages payable | (16,477)(2) | (22,552) |
| Accrued interest payable | (7) | (51) |
| Other payables | (277) | (339) |
| | <u>\$ 4,922</u> | <u>\$ 7,611</u> |
| Net real estate related assets | | |

(1) Included in Real Estate at December 31, 2005 was Greenhouse, a 128-unit multi-family apartment located in Omaha, Nebraska. At December 31, 2005, Greenhouse, which did not meet the criteria for designation as held-for-sale, had assets primarily comprised of land and buildings carried at \$8.5 million and liabilities, primarily comprised of a \$6.0 million mortgage secured by such real estate. The sale of Greenhouse on January 31, 2006, resulted in a gain of \$4.7 million, net of a built-in gains tax of \$1.8 million and direct selling expenses. Greenhouses operations have been reclassified to discontinued operations for the prior periods presented in accordance with FAS 144.

(2) Each of these two properties serves as collateral for their respective mortgages. The mortgage collateralized by Lealand Place is non-recourse, subject to customary non-recourse exceptions, which generally means that the lender's final source of prepayment in the event of default is foreclosure of the property securing such loan. The mortgage collateralized by Cameron, which had a balance of \$6.8 million at March 31, 2006, is under certain limited circumstances guaranteed by the Company. At March 31, 2006, the mortgages on Lealand Place and Cameron had fixed interest rates of 6.87% and 7.39%, respectively, and mature on February 1, 2011 and December 1, 2010, respectively. In January 2005, the Company loaned Lealand Place \$150,000 to fund operations; this loan is eliminated in consolidation.

The following table presents the summary results of operations for the Company's consolidated real estate operations, for the three months ended March 31, 2006 and 2005:

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| | Three Months Ended March 31, | |
|---|---------------------------------|-----------------|
| | 2006 | 2005 |
| <i>(In Thousands)</i> | | |
| Revenue from operations of real estate | \$ 694 | \$ 648 |
| Interest expense for mortgages on real estate | (297) | (300) |
| Other real estate operations expense | (473) | (476) |
| | <u>\$ (76)</u> | <u>\$ (128)</u> |

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7. Repurchase Agreements

The Company's repurchase agreements are collateralized by the Company's MBS and typically bear interest at rates that are LIBOR-based. At March 31, 2006, the Company had outstanding balances of \$3.953 billion under 350 repurchase agreements with a weighted average borrowing rate of 4.15% and a weighted average remaining contractual maturity of 3.7 months, including the impact of related hedging instruments. At December 31, 2005, the Company had outstanding balances of \$5.100 billion under 415 repurchase agreements with a weighted average borrowing rate of 3.56% and a weighted average remaining contractual maturity of 3.7 months, including the related hedging instruments. At March 31, 2006 and December 31, 2005, the repurchase agreements had the following remaining contractual maturities:

| | March 31, 2006 | December 31, 2005 |
|-------------------------|---------------------|----------------------|
| <i>(In Thousands)</i> | | |
| Within 30 days | \$ 1,270,600 | \$ 1,606,500 |
| >30 days to 3 months | 1,451,400 | 1,806,832 |
| >3 months to 6 months | 414,400 | 709,000 |
| >6 months to 12 months | 779,400 | 774,600 |
| >12 months to 24 months | 37,200 | 202,600 |
| | <u>\$ 3,953,000</u> | <u>\$ 5,099,532</u> |

The table below presents information about the Company's MBS that are pledged as collateral under repurchase agreements based upon the term to maturity of the repurchase agreements at March 31, 2006.

| Collateral Pledged | Fair Value of MBS Pledged as Collateral | Term to Maturity of Repurchase Agreement | | | |
|-----------------------|--|--|---------------------|---------------------|---------------------|
| | | Up to 30 Days | 30 to 90 Days | Over 90 Days | Total |
| MBS Pledged | | | | | |
| <i>(In Thousands)</i> | | | | | |
| Fannie Mae | \$ 3,018,482 | \$ 1,016,100 | \$ 877,945 | \$ 995,859 | \$ 2,889,904 |
| Freddie Mac | 251,422 | 72,600 | 134,885 | 29,065 | 236,550 |
| Ginnie Mae | 549,046 | 126,200 | 226,570 | 119,476 | 472,246 |
| AAA Rated | 378,426 | 55,700 | 212,000 | 86,600 | 354,300 |
| | <u>\$ 4,197,376</u> | <u>\$ 1,270,600</u> | <u>\$ 1,451,400</u> | <u>\$ 1,231,000</u> | <u>\$ 3,953,000</u> |

8. Commitments and Contingencies*(a) Lease Commitments*

The Company has a lease through August 31, 2012 for its corporate headquarters, located at 350 Park Avenue, New York, New York. This lease provides for, among other things, monthly payments based on annual rent of: (i) \$348,000 through November 30, 2008 and (ii) \$358,000 from December 1, 2008 through August 31, 2012. The Company also has a lease for additional space at its corporate headquarters, which commenced in March 2005 and will run through July 31, 2007. This lease provides for, among other things, monthly payments based on annual rent of \$152,000. The Company believes that its current leased space is adequate to meet its foreseeable operating needs. In addition, the Company has a lease through December 2007 for its off-site back-up facilities located in Rockville Centre, New York. This lease provides for, among other things, annual rent of \$25,000.

9. Stockholders' Equity

(a) Stock Repurchase Program

On August 11, 2005, the Company announced the implementation of a stock repurchase program (the Repurchase Program) to repurchase up to 4.0 million shares of its outstanding common stock. Subject to applicable securities laws, repurchases of common stock under the Repurchase Program will be made at times and in amounts as the Company deems appropriate. Repurchases of common stock will be made using the Company's available cash resources. The Repurchase Program may be suspended or discontinued by the Company at any time and without prior notice. From inception of the Repurchase Program through March 31, 2006, the Company

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repurchased 2,733,800 shares of common stock at an average cost per share of \$5.86. At March 31, 2006, 1,266,200 shares remained authorized for repurchase.

Repurchased shares of common stock by the Company under the Repurchase Program, are cancelled and, until reissued by the Company, are deemed to be the authorized but unissued shares of the Company's capital stock classified as common stock. (See Note 13(b).)

(b) Dividends on Preferred Stock

The following table presents cash dividends declared by the Company on its Preferred Stock, since January 2005.

| <u>Declaration Date</u> | <u>Record Date</u> | <u>Payment Date</u> | <u>Dividend Per share</u> |
|-------------------------|--------------------|---------------------|-------------------------------|
| 2006 | | | |
| February 17, 2006 | March 1, 2006 | March 31, 2006 | \$ 0.53125 |
| 2005 | | | |
| February 18, 2005 | March 1, 2005 | March 31, 2005 | \$ 0.53125 |
| May 20, 2005 | June 1, 2005 | June 30, 2005 | 0.53125 |
| August 19, 2005 | September 1, 2005 | September 30, 2005 | 0.53125 |
| November 18, 2005 | December 1, 2005 | December 30, 2005 | 0.53125 |

(c) Dividends/Distributions on Common Stock

The following table presents common dividends declared by the Company on its common stock from January 1, 2005 through March 31, 2006:

| <u>Declaration Date</u> | <u>Record Date</u> | <u>Payment Date</u> | <u>Dividend per Share</u> |
|-------------------------|--------------------|---------------------|-------------------------------|
| 2005 | | | |
| April 1, 2005 | April 12, 2005 | April 29, 2005 | \$ 0.180 |
| July 1, 2005 | July 12, 2005 | July 29, 2005 | 0.125 |
| October 3, 2005 | October 14, 2005 | October 28, 2005 | 0.050 |
| December 15, 2005 | December 27, 2005 | January 31, 2006 | 0.050 |

On April 3, 2006, the Company declared its 2006 first quarter common stock dividend of \$0.05, payable on April 28, 2006, to stockholders of record on April 17, 2006. (See Note 13.)

(d) Shelf Registrations

On September 25, 2001, the Company filed a shelf registration statement on Form S-3 with the SEC under the Securities Act of 1933, as amended (the "Act"), with respect to an aggregate of \$300.0 million of common stock and/or preferred stock that may be sold by the Company from time to time pursuant to Rule 415 of the Act. On October 5, 2001, the Commission declared this shelf registration statement effective. At March 31, 2006, the Company had \$8.7 million remaining on this shelf registration statement.

On June 27, 2003, the Company filed a shelf registration statement on Form S-3 with the SEC under the Act with respect to an aggregate of \$500.0 million of common stock and/or preferred stock that may be sold by the Company from time to time pursuant to Rule 415 of the Act. On July 8, 2003, the SEC declared this registration statement effective. On July 21, 2004, the Company filed a post-effective amendment to this shelf registration statement, which was declared effective by the SEC on August 12, 2004. At March 31, 2006, the Company had \$244.1 million available under this shelf registration statement.

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On December 17, 2004, the Company filed a shelf registration statement on Form S-3 with the SEC under the Act for the purpose of registering additional common stock for sale through the DRSP. This shelf registration statement was declared effective by the SEC on January 4, 2005 and, when combined with the unused portion of the Company's previous DRSP shelf registration statement, registered an aggregate of 10 million shares of common stock. At March 31, 2006, 9.5 million shares of common stock remained available for issuance pursuant to the prior DRSP shelf registration statement.

On December 17, 2004, the Company filed a registration statement on Form S-8 with the SEC under the Act for the purpose of registering additional common stock for issuance in connection with the exercise of awards under the Company's 2004 Equity Compensation Plan (the 2004 Plan), which amended and restated the Company's

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Second Amended and Restated 1997 Stock Option Plan (the "1997 Plan"). This registration statement became effective automatically upon filing and, when combined with the previously registered, but unissued, portions of the Company's prior registration statements on Form S-8 relating to awards under the 1997 Plan, related to an aggregate of 3.3 million shares of common stock.

(e) DRSP

Beginning in September 2003, the Company's DRSP, which is designed to provide existing stockholders and new investors with a convenient and economical way to purchase shares of common stock (through the automatic reinvestment of dividends and/or optional monthly cash investments), became operational. During the three months ended March 31, 2006, the Company did not issue any shares through the DRSP. Since the inception of the DRSP, through March 31, 2006, the Company issued 12,060,123 shares pursuant to the DRSP raising net proceeds of \$110.8 million.

(f) Controlled Equity Offering Program

On August 20, 2004, the Company initiated a controlled equity offering program (the "CEO Program") through which it may publicly offer and sell, from time to time, shares of common stock through Cantor Fitzgerald & Co. ("Cantor") in privately negotiated and/or at-the-market transactions. From inception of the CEO Program through March 31, 2006, the Company issued 1,833,215 shares of common stock in at-the-market transactions through such program raising net proceeds of \$16,481,652 and, in connection with such transactions, Cantor received aggregate fees and commissions of \$419,942. The Company did not issue any shares through the CEO Program during the quarter ended March 31, 2006.

10. EPS Calculation

The following table presents the reconciliation between basic and diluted shares of common stock outstanding used in calculating basic and diluted EPS for the three months ended March 31, 2006 and 2005:

| | Three Months Ended | |
|---|---------------------------|---------------|
| | March 31, | |
| | 2006 | 2005 |
| <i>(In Thousands)</i> | | |
| Weighted average shares outstanding - basic | 79,950 | 82,243 |
| Add effect of assumed shares issued under treasury stock method for stock options | 23 | 42 |
| Weighted average shares outstanding - diluted | <u>79,973</u> | <u>82,285</u> |

11. Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss at March 31, 2006 and December 31, 2005 was as follows:

| | March 31, | December 31, |
|-------------------------|------------------|---------------------|
| | 2006 | 2005 |
| <i>(In Thousands)</i> | | |
| Available-for-sale MBS: | | |
| Unrealized gains | \$ 1,628 | \$ 3,988 |
| Unrealized (losses) | (71,820) | (65,716) |
| | <u>(70,192)</u> | <u>(61,728)</u> |
| Hedging Instruments: | | |

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| | | |
|--|--------------|--------------|
| Unrealized gains on Caps | 770 | 425 |
| Unrealized gains on Swaps | 3,089 | 3,092 |
| | <u>3,859</u> | <u>3,517</u> |
| Accumulated other comprehensive (loss) | \$ (66,333) | \$ (58,211) |

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12. Equity Compensation, Employment Agreements and Other Benefit Plans

(a) 2004 Equity Compensation Plan

In accordance with the terms of the 2004 Plan, directors, officers and employees of the Company and any of its subsidiaries and other persons expected to provide significant services (of a type expressly approved by the Compensation Committee of the Board as covered services for these purposes) for the Company and any of its subsidiaries are eligible to be granted stock options (Options), restricted stock, phantom shares, dividend equivalent rights (DERs) and other stock-based awards under the 2004 Plan.

In general, subject to certain exceptions, stock-based awards relating to a maximum of 3,500,000 shares of common stock may be granted under the 2004 Plan; forfeitures and/or awards that expire unexercised do not count towards such limit. At March 31, 2006, 2.3 million shares of common stock remained available for grant to eligible participants under the 2004 Plan. Subject to certain exceptions, a participant may not receive stock-based awards relating to greater than 500,000 shares of common stock in any one-year and no award may be granted to any person who, assuming exercise of all Options and payment of all awards held by such person, would own or be deemed to own more than 9.8% of the outstanding shares of the Company's capital stock. At March 31, 2006, an aggregate of 962,000 shares were subject to outstanding awards under the 2004 Plan, of which 836,500 were exercisable. Unless previously terminated by the Board, awards may be granted under the 2004 Plan until the tenth anniversary of the date that the Company's stockholders approved such plan.

Pursuant to Section 422(b) of the Code, in order for stock options granted under the 2004 Plan and vesting in any one calendar year to qualify as an incentive stock option (ISO) for tax purposes, the market value of the common stock, as determined on the date of grant, shall not exceed \$100,000 during a calendar year. The exercise price of an ISO may not be lower than 100% (110% in the case of an ISO granted to a 10% stockholder) of the fair market value of the common stock on the date of grant. The exercise price for any other type of Option so issued may not be less than the fair market value on the date of grant. Each Option is exercisable after the period or periods specified in the award agreement, which will generally not exceed ten years from the date of grant. Options will be exercisable at such times and subject to such terms as determined by the Compensation Committee.

At March 31, 2006, the Company had 125,500 Options outstanding that were not yet vested. These unvested Options, which are scheduled to vest through February 1, 2007, had a weighted average vesting period of seven months. During the quarter ended March 31, 2006, no Options were granted, exercised or expired unexercised.

(b) Employment Agreements

The Company has an employment agreement with each of its five senior officers, with varying terms that provide for, among other things, base salary, bonuses and change-in-control provisions, subject to certain events.

(c) Deferred Compensation Plans

The Company administers the MFA Mortgage Investments, Inc. 2003 Non-employee Directors' Deferred Compensation Plan and the MFA Mortgage Investments, Inc. Senior Officers Deferred Bonus Plan (collectively, the Deferred Plans). Pursuant to the Deferred Plans, Directors and senior officers of the Company may elect to defer a certain percentage of their compensation. The Deferred Plans are intended to provide non-employee Directors and senior officers of the Company with an opportunity to defer up to 100% of certain compensation, as defined in the Deferred Plans, while at the same time aligning their interests with the interests of the Company's stockholders. Amounts deferred are considered to be converted into stock units of the Company, which do not represent stock of the Company, but rather the right to receive a cash payment equal to the fair market value of an equivalent number of shares of the common stock. Deferred accounts increase or decrease in value as would equivalent shares of the common stock and are settled in cash at the termination of the deferral period, based on the value of the stock units at that time. The Deferred Plans are non-qualified plans under the Employee Retirement Income Security Act and are not funded. Prior to the time that the deferred accounts are settled, participants are unsecured creditors of the Company.

At the time a participant's deferral of compensation is made, it is intended that such participant will not recognize income for federal income tax purposes, nor will the Company receive a deduction until such time that the compensation is actually distributed to the participant.

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At March 31, 2006 and December 31, 2005, the Company had the following liability under the Deferred Plans, which included amounts deferred by participants, as well as the market value adjustments for the equivalent stock units:

| <i>(In Thousands)</i> | March 31, 2006 | December 31, 2005 |
|-----------------------|---------------------------|------------------------------|
| Directors deferred | \$ 381 | \$ 337 |
| Officers deferred | 224 | 200 |
| | \$ 605 | \$ 537 |

(d) Savings Plan

The Company sponsors a tax-qualified employee savings plan (the Savings Plan), which was established during 2002. Pursuant to Section 401(k) of the Code, eligible employees of the Company are able to make deferral contributions, subject to limitations under applicable law. Participant's accounts are self-directed and the Company bears all costs associated with administering the Savings Plan. The Company matches 100% of the first 3% of eligible compensation deferred by employees and 50% of the next 2%, subject to a maximum as provided by the Code. Substantially all of the Company's employees are eligible to participate in the Savings Plan. The Company has elected to operate the Savings Plan under applicable safe harbor provisions of the Code, whereby among other things, the Company must make contributions for all eligible employees and all matches contributed by the Company immediately vest 100%. For the quarters ended March 31, 2006 and 2005, the Company recognized expenses for matching contributions of \$23,000 and \$19,000, respectively.

13. Subsequent Events

(a) Common Stock Dividend Declared

On April 3, 2006, the Company declared a first quarter 2006 dividend of \$0.05 per share on common stock to stockholders of record on April 17, 2006. Dividend payments totaling \$4.0 million were paid on April 28, 2006.

(b) Stock Repurchase Program

On May 2, 2006, the Company announced an increase in the size of the Repurchase Program, by an additional 3,191,200 shares of common stock, resetting the number of shares of common stock that the Company is authorized to repurchase at 4.0 million shares. Subject to applicable securities laws, repurchases of common stock under the Repurchase Program will be made at times and in amounts as the Company deems appropriate. (See Note 9(a).)

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

The following discussion should be read in conjunction with the financial statements and notes thereto included in Item 1 of this Quarterly Report on Form 10-Q as well as in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

GENERAL

The Company, a self-advised mortgage REIT, is primarily engaged in the business of investing, on a leveraged basis, in Agency MBS and, to a lesser extent, high quality ARM-MBS rated in one of the two highest rating categories by at least one of the Rating Agencies. The Company's operating policies also permit investments in residential mortgage loans, residential MBS, direct or indirect investments in multi-family apartment properties, investments in limited partnerships, REITs or closed-end funds and investments in other corporate or government fixed income instruments. The Company's principal business objective is to generate net income for distribution to its stockholders resulting from the spread between the interest and other income it earns on its investments and the interest expense on its borrowings used to finance such investments and its operating costs.

The Company has elected to be treated as a REIT for U.S. federal income tax purposes. One of the requirements of maintaining its qualification as a REIT is that the Company must distribute at least 90% of its annual net taxable income to its stockholders, subject to certain adjustments.

At March 31, 2006, 99.1% of the Company's assets consisted of Agency MBS, AAA-rated MBS, MBS-related receivables and cash. In addition, the Company also had indirect interests in two multi-family apartment properties, containing a total of 392 rental units, located in Georgia and North Carolina and \$5.9 million of Non-Agency MBS rated below AAA. During the quarter ended March 31, 2006, the Company had income of \$4.7 million from discontinued operations for the quarter ended March 31, 2006, which primarily reflects the sale of its indirect interest in Greenhouse Holdings, LLC, which owns Greenhouse, a 128-unit multi-family apartment property located in Omaha, Nebraska, for \$15.2 million. The operations of the Company's indirect interests in real estate have not been, and are not expected to be in the future, material to the results of operations of Company.

The results of the Company's business operations are affected by a number of factors, many of which are beyond its control, and primarily depend on, among other things, the level of its net interest income, the market value of its assets and the supply of, and demand for, MBS in the market place. The Company's net interest income varies primarily as a result of changes in interest rates, the slope of the yield curve, borrowing costs (i.e., interest expense) and prepayment speeds on the MBS portfolio, the behavior of which involves various risks and uncertainties. Interest rates and prepayment speeds, as measured by the constant prepayment rate (CPR), vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty. With respect to the Company's business operations, increases in interest rates, in general, may over time cause: (i) the interest expense associated with its borrowings (i.e., repurchase agreements) to increase; (ii) the value of its MBS portfolio and, correspondingly, its stockholders' equity to decline; (iii) prepayments on its MBS portfolio to slow, thereby reducing the cost of premium amortization; and (iv) coupons on its MBS to reset, although on a delayed basis, to higher interest rates. Conversely, decreases in interest rates, in general, may over time cause: (i) prepayments on its MBS portfolio to increase, thereby increasing the cost of premium amortization; (ii) coupons on its MBS assets to reset, although on a delayed basis, to lower interest rates; (iii) the interest expense associated with its borrowings to decrease; and (iv) the value of its MBS portfolio and, correspondingly, its stockholders' equity to increase. In addition, borrowing costs and credit lines are further affected by the Company's perceived credit worthiness.

Interest rates on the Company's liabilities reset faster than do interest rates on its assets. The 15 consecutive increases in the target federal funds rate, from 1.00% to 4.75%, have increased, and are expected to continue to increase, the cost of the Company's liabilities at a more rapid pace than the yield on its assets, negatively impacting spreads in 2006. The Company anticipates a 16th consecutive 25 basis point increase in the fed funds rate to 5.0% at the upcoming May 10, 2006 meeting of the Federal Open Market Committee. After this meeting, future Federal Reserve actions will be dependent upon the flow of new data regarding inflation and economic activity. Based on recent Consumer Price Index data, it is difficult to rule out the possibility of additional monetary tightening in 2006. As a result of the Federal Reserve's efforts to tighten monetary policy and the fact that, in general, the yields on MFA's assets reset annually, but only after an initial fixed rate period, the Company currently projects that it will approximately breakeven during the second quarter ignoring the impact of any potential asset sales. Additional

increases in the target federal funds rate in 2006 could have a further negative impact on spreads and earnings in 2006. In addition, due to the shape of the yield curve, which has recently been flat and even inverted, cash-out refinancing opportunities and the availability of lower monthly payment interest-only mortgages, the Company's prepayment rates may be elevated, further negatively impacting spreads and income. Applying a 25% CPR, the Company MBS portfolio had an estimated weighted average term to repricing of 10 months, while its interest-bearing liabilities had an estimated weighted average term to repricing of four months at March 31, 2006.

In response to the continued rising interest rate environment and relatively flat yield curve in 2005 and the first quarter of 2006, the Company undertook a number of strategic steps to reposition its MBS portfolio. During this period, the Company reduced its asset base through a strategy under which it, among other things, determined not to fully reinvest principal repayments on its ARM-MBS as the underlying ARMs on such assets amortized and were prepaid, sold higher duration and lower yielding ARM-MBS and repurchased shares of its common stock. The Company's MBS portfolio was \$4.541 billion at March 31, 2006, compared to \$5.715 billion at December 31, 2005 and \$7.029 billion at its peak in February 2005. Leverage as measured by debt-to-equity was 6.0 times at March 31, 2006, compared to debt-to-equity ranging from approximately 7.8 times to 9.0 times during the year ended December 31, 2005. As a result of the actions taken, MFA is positioned to take advantage of investment opportunities as they may arise.

The Company believes 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.

The Company's weighted average contractual maturities on repurchase agreements was 3.1 months at March 31, 2006, compared to 7.5 months at March 31, 2005; however, the Company's Swaps in effect extended the fixed pricing period on the Company's repurchase agreements to 3.7 months at March 31, 2006.

The Company, through wholly-owned subsidiaries, provides third-party investment advisory services for which it generates fee income. In addition, the Company continues to explore alternative business strategies, investments and financing sources and other strategic initiatives, including, without limitation, the acquisition and securitization of ARMs, the expansion of third-party advisory services, the creation of new Company-managed investment vehicles and the creation and/or acquisition of a third-party asset management business to complement the Company's core business strategy of investing, on a leveraged basis, in high quality ARM-MBS. No assurance, however, can be provided that any such strategic initiatives will or will not be implemented in the future or, if undertaken, that any such strategic initiatives will favorably impact the Company.

The Company continues to explore alternative business strategies, investments and financing sources and other strategic initiatives, including, without limitation, the acquisition and securitization of ARMs, the expansion of third-party advisory services, and the creation and/or acquisition of a third-party asset management business to complement the Company's core business strategy of investing, on a leveraged basis, in high quality ARM-MBS. No assurance, however, can be provided that any such strategic initiatives will or will not be implemented in the future or, if undertaken, that any such strategic initiatives will favorably impact the Company.

RESULTS OF OPERATIONS

Quarter Ended March 31, 2006 Compared to the Quarter Ended March 31, 2005

For the first quarter of 2006, the Company had net income available to common stockholders of \$12.9 million, or \$0.16 per share, which included a gain of \$4.7 million realized on the sale of real estate reported as discontinued operations and net gains of \$1.6 million realized on the sale of MBS. During the fourth quarter of 2005, the Company recognized an impairment charge against certain MBS, all of which were sold during the first quarter of 2006. For the first quarter of 2005, the Company had net income available to common stockholders of \$16.8 million, or \$0.20 per share.

Interest income for the first quarter of 2006 decreased by \$7.2 million, or 11.8%, to \$54.0 million compared to \$61.2 million earned during the first quarter of 2005. The Company's average investment in MBS, excluding changes in market value of the MBS portfolio, decreased by \$1.668 billion, or 24.0%, to \$5.277 billion for the first quarter of 2006 from \$6.945 billion for the first quarter of 2005. The reduced size of the MBS portfolio reflects: (i) the repositioning of the MBS portfolio, which was achieved through sales of MBS with an amortized cost basis of \$786.9 million and \$583.2 million, during the fourth quarter of 2005 and the first quarter of 2006, respectively and

(ii) the partial reinvestment of proceeds from MBS principal prepayments and amortization. While the net yield on the MBS portfolio increased to 4.04% for the first quarter of 2006, from 3.51% for the first quarter for 2005, the reduced size of the MBS portfolio caused interest income on the MBS portfolio to decrease. The increase in the net yield on the MBS portfolio primarily reflects an increase in the gross yield (i.e., stated coupon) on the MBS portfolio of 50 basis points to 4.86% for the first quarter of 2006 from 4.36% for the first quarter of 2005. The cost of net premium amortization for the first quarter of 2006 decreased to 64 basis points, compared to 70 basis points for the first quarter of 2005, while the CPR experienced for the first quarter of 2006 was relatively unchanged from the first quarter of 2005. This decrease in the cost of premium amortization reflects the temporary decrease in the average premium (i.e., the amount paid in excess of the par value of MBS at the time of acquisition) on the MBS portfolio resulting from the impairment charge taken on certain MBS during the fourth quarter of 2005. All of the MBS on which an impairment charge was taken at December 31, 2005 were sold during the first quarter of 2006.

The following table presents the components of the net yield earned on the Company's MBS portfolio for the quarterly periods presented:

| Quarter Ended | Stated Coupon | Cost of Premium | Net Premium Amortization | Cost of Delay for Principal Receivable | Net Yield |
|--------------------|---------------|-----------------|--------------------------|--|-----------|
| March 31, 2006 | 4.86% | (0.09)% | (0.64)% | (0.09)% | 4.04% |
| December 31, 2005 | 4.70 | (0.09) | (0.90) | (0.09) | 3.62 |
| September 30, 2005 | 4.55 | (0.10) | (1.05) | (0.09) | 3.31 |
| June 30, 2005 | 4.48 | (0.09) | (0.86) | (0.08) | 3.45 |
| March 31, 2005 | 4.36 | (0.09) | (0.70) | (0.06) | 3.51 |

The Company expects that over time its ARM-MBS experience higher prepayment rates than fixed-rate MBS. This is based on the assumption that homeowners with adjustable-rate and hybrid mortgages are generally self-selected borrowers and are expected to exhibit more rapid housing turnover levels or refinancing activity compared to fixed-rate borrowers. In addition, the Company believes that prepayments on ARM-MBS accelerate significantly as the coupon reset date approaches. Over the last consecutive eight quarters, ending with March 31, 2006, the CPR on the Company's MBS portfolio ranged from a low of 24.1% to a high of 34.9%, with an average quarterly CPR of 28.9%. At March 31, 2006, the Company had net purchase premiums of \$89.9 million, or 2.0% of current par value, compared to \$95.4 million of net purchase premiums, or 1.7% of principal balance, at December 31, 2005. The net purchase premium on the MBS portfolio at December 31, 2005 was reduced by the \$20.7 million impairment charge taken at December 31, 2005. This impairment charge resulted in a new cost basis for the MBS on which the impairment charge was taken, all of which were sold during the first quarter of 2006.

The following table presents the historical CPR experienced on the Company's MBS portfolio, on an annualized basis, for the quarterly periods presented:

| Quarter Ended | CPR |
|--------------------|-------|
| March 31, 2006 | 24.4% |
| December 31, 2005 | 31.2 |
| September 30, 2005 | 34.9 |
| June 30, 2005 | 29.1 |
| March 31, 2005 | 24.1 |

Interest income from short-term cash investments (i.e., money market/sweep accounts) increased by \$369,000 to \$666,000 for the first quarter of 2006 from \$297,000 for the first quarter of 2005. The Company's average cash investments increased by \$3.2 million, to \$61.1 million for the first quarter of 2006 compared to \$57.9 million for the first quarter of 2005. As a result of rising interest rates, cash investments yielded 4.42% for the first quarter of 2006, compared to 2.08% for the first quarter of 2005. In general, the Company manages its cash investments to meet the needs of its investing, financing and operating requirements.

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The following table presents historical information regarding the Company's average balances, interest income, interest expense, yield on assets, cost of funds and net interest income for the quarterly periods presented.

| For the Quarter Ended | Average Amortized Cost of MBS (1) | Interest Income on MBS | Average Cash and Cash Equivalents | Total Interest Income | Yield on Average Interest- Earning Assets | Average Balance of Repurchase Agreements | Interest Expense | Average Cost of Funds | Net Interest Income |
|-------------------------------|--|------------------------------|--|-----------------------------|---|---|---------------------|-----------------------------|---------------------------|
| <i>(Dollars in Thousands)</i> | | | | | | | | | |
| March 31, 2006 | \$ 5,276,973 | \$ 53,329 | \$ 61,126 | \$ 53,995 | 4.05% | \$ 4,605,790 | \$ 42,785 | 3.77% | \$ 11,210 |
| December 31, 2005 | 6,378,629 | 57,708 | 115,619 | 58,806 | 3.62 | 5,718,634 | 48,498 | 3.36 | 10,308 |
| September 30, 2005 | 6,806,005 | 56,396 | 136,274 | 57,531 | 3.31 | 6,150,582 | 49,060 | 3.16 | 8,471 |
| June 30, 2005 | 7,035,784 | 60,752 | 57,180 | 61,142 | 3.45 | 6,312,122 | 46,508 | 2.96 | 14,634 |
| March 31, 2005 | 6,945,280 | 60,942 | 57,935 | 61,239 | 3.50 | 6,234,969 | 39,766 | 2.59 | 21,473 |

(1) Does not reflect unrealized gains and losses.

Interest expense for the first quarter of 2006 increased by 7.6% to \$42.8 million, from \$39.8 million for the first quarter of 2005, while the average balance of repurchase agreements for the first quarter of 2006 decreased by \$1.629 billion, or 26.1%, to \$4.606 billion, from \$6.235 billion for the first quarter of 2005. The Company's cost of borrowings, which includes the cost of its Hedging Instruments, increased to 3.77% for the first quarter of 2006, compared to 2.59% for the first quarter of 2005. Hedging Instruments decreased the cost of borrowings by \$976,000, or nine basis points, during the first quarter of 2006, while such instruments increased the cost of the Company's borrowings by \$833,000, or five basis points, during the first quarter of 2005. The Company's Hedging Instruments may from time to time result in additional interest expense or a reduction to interest expense, depending on the rates specified in such instruments relative to each instrument's benchmark market rate. At March 31, 2006, the Company had Swaps with an aggregate notional amount of \$315.0 million and a weighted average maturity of nine months and Caps with an aggregate notional amount of \$300.0 million and a weighted average remaining active period of seven months. (See Notes 2(k) and 5 to the accompanying consolidated financial statements, included under Item 1.) The Company expects that the recent and anticipated increases in market interest rates will cause the Company's cost of funding to continue to increase during the remainder of 2006.

For the quarter ended March 31, 2006, other income of \$2.5 million included a net gain of \$1.6 million on the sale of MBS. The MBS sold during the first quarter of 2006 were comprised entirely of the MBS on which the Company had taken a \$20.7 million impairment charge against at December 31, 2005 as part of the MBS portfolio repositioning the commenced during the fourth quarter of 2005. During the first quarter of 2006, the Company's two remaining real estate interests generated revenue of \$694,000, compared to \$648,000 for the first quarter of 2005. The Company does not consider the results from operations from its real estate investments to be material to the Company, nor does it anticipate that they will be significant in the future. These properties, net of operating expenses and mortgage interest, generated net losses of \$76,000 and \$128,000 for the three months ended March 31, 2006 and 2005, respectively. (See Note 6 to the accompanying consolidated financial statements, included under Item 1.)

For the first quarter of 2006, the Company incurred operating and other expense of \$3.4 million, which included an aggregate of \$770,000 related to real estate operating expenses and mortgage interest with respect to its two remaining real estate investments discussed above. The Company's costs for compensation and benefits and other general and administrative items were \$2.7 million for the first quarter of 2006, or 0.20% of average assets, compared to \$2.5 million, or 0.14% of average assets, for the first quarter of 2005. The increase in these expenses as a percentage of average assets, reflects the decrease in average assets as a result of the reduced size of the MBS portfolio. Other general and administrative expense are comprised primarily of fees for professional services, including general legal and accounting, the cost of complying with the provisions of the Sarbanes-Oxley Act of 2002, as amended, corporate insurance, office lease expense, Board fees and miscellaneous other operating overhead.

During the quarter ended March 31, 2006, the Company reported income from discontinued operations of \$4.7 million (net of built-in gains taxes of \$1.8 million), or \$0.06 per common share, primarily comprised of a gain on the sale of the Company's interest in Greenhouse. While the gain on the sale of Greenhouse was beneficial to the Company's for the first quarter of 2006, this property, along with the Company's remaining two real estate investments, have not been a significant component of the Company's operating results. Greenhouse generated a loss of \$37,000 and income of \$38,000 for the quarterly periods ended March 31, 2006 and 2005, respectively.

Liquidity and Capital Resources

The Company's principal sources of liquidity consist of borrowings under repurchase agreements, payments of principal and interest received on its portfolio of MBS, and, from time to time, proceeds from capital market transactions. The Company's most significant uses of cash include purchases of MBS, dividend payments on its capital stock and repayments of principal and interest on its repurchase agreements. In addition, the Company also uses cash to fund operations, enter into Hedging Instruments, repurchase shares of its common stock pursuant to the Repurchase Program and make such other investments that it considers appropriate.

Borrowings under repurchase agreements were \$3.953 billion at March 31, 2006 compared to \$5.100 billion at December 31, 2005. This decrease in borrowings reflects the reduced size of the Company's MBS portfolio. At March 31, 2006, the Company's repurchase agreements had a weighted average borrowing rate of 4.15%, on loan balances ranging from \$55,000 to \$138.0 million. These repurchase agreements generally have original terms to maturity ranging from one to 36 months at inception of the loan and fixed interest rates that are typically based off of LIBOR.

During the quarter ended March 31, 2006, the Company, as part of the repositioning of its portfolio, sold 30 MBS which generated cash proceeds of \$788.5 million and resulted in a realized net gain of \$1.6 million. Prepayments and amortization on MBS generated cash of \$443.1 million. During the first quarter of 2006, the Company acquired \$71.4 million of MBS, all of which were either Agency MBS or AAA rated ARM-MBS. While the Company generally intends to hold its MBS as long-term investments, certain MBS may be sold as part of managing the Company's interest rate risk, liquidity needs and other operating objectives. As such, all of the Company's MBS are designated as available-for-sale. The timing and impact of future sales of MBS, if any, cannot be predicted with any certainty. In addition, during the first quarter of 2006, the Company received proceeds, net of selling expenses, of \$14.0 million on the sale of Greenhouse, of which \$6.1 million was used to satisfy the mortgage on such property and \$1.8 million of which will be used in the future for payment of the built-in gains tax due on such sale.

During the first quarter of 2006, the Company declared and paid dividends of \$2.0 million on its preferred stock and paid dividends of \$4.1 million declared on its common stock in December 2005. On April 3, 2006, the Company declared its first quarter 2006 dividend on its common stock, which totaled \$4.0 million and was paid on April 28, 2006 to stockholders of record on April 17, 2006. The Company used cash of \$2.9 million to repurchase 469,100 shares of its common stock during the first quarter of 2006 pursuant to its Repurchase Program. (See Note 13(b) to the accompanying consolidated financial statements, included under Item 1.)

At March 31, 2006, the Company had an aggregate of \$252.8 million available under its two effective shelf registration statements on Form S-3. The Company may, as market conditions permit, issue additional shares of common stock and/or preferred stock pursuant to these registration statements. In addition, at March 31, 2006, the Company had approximately 9.5 million shares of common stock available under its DRSPS shelf registration statement on Form S-3 for issuance in connection with the DRSPS.

To the extent the Company raises additional equity capital from future capital market transactions, the Company currently anticipates using the net proceeds for general corporate purposes, including, without limitation, the acquisition of additional MBS consistent with its investment policy and the repayment of its repurchase agreements. The Company may also consider acquiring additional interests in residential ARMs, multi-family apartment properties and/or other investments consistent with its investment strategies and operating policies. There can be no assurance, however, that the Company will be able to raise additional equity capital at any particular time or on any particular terms.

In order to reduce interest rate risk exposure, the Company may enter into derivative financial instruments, such as Caps and Swaps. The Company's Caps and Swaps are designated as cash-flow hedges against the Company's current and anticipated 30-day LIBOR term repurchase agreements. During the quarter ended March 31, 2006, the Company did not purchase any Caps or Swaps. The Company's Caps, which had an aggregate notional amount of \$300.0 million at March 31, 2006, will generate future cash payments to the Company if interest rates are above the rate specified in any of the individual Cap Agreements. During the quarter ended March 31, 2006, the Company received or was due payments of \$576,000 on its Caps. At March 31, 2006, the Company had Swaps with an aggregate notional amount of \$315.0 million, with maturities extending through February 2, 2007. Pursuant to the Swaps outstanding at March 31, 2006, the Company was required to pay a weighted average fixed rate of 3.53% and receive a variable rate based on 30-day LIBOR. (See Note 5 to the accompanying consolidated financial statements, included under Item 1.)

Under its repurchase agreements, the Company may be required to pledge additional assets to its 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 (i.e., a margin call), which may take the form of additional securities or cash. Specifically, margin calls result from a decline in the value of the Company's MBS collateralizing its repurchase agreements, generally due to changes in the estimated fair value of such MBS resulting from changes in market interest rates and other market factors and principal reduction of such MBS from scheduled amortization and prepayments on the mortgages securing such MBS. From time to time, the Company may have restricted cash which represents cash held on deposit as collateral with lenders and, at the time a repurchase agreement rolls (i.e., matures), generally will be applied against the repurchase agreement, thereby reducing the borrowing. The Company believes it has adequate financial resources to meet its obligations as they come due, including margin calls, and to fund dividends declared as well as to actively pursue its investment strategies. Through March 31, 2006, the Company had satisfied all of its margin calls with either cash or additional collateral. In addition, at March 31, 2006, the Company had MBS with a fair value of \$342.4 million that were not pledged as collateral and \$74.9 million of cash. Should market interest rates and/or prepayment speeds on the mortgages underlying the Company's MBS suddenly increase, margin calls on the Company's repurchase agreements could result, causing an adverse change in the Company's liquidity position.

INFLATION

Substantially all of the Company's assets and liabilities are financial in nature. As a result, changes in interest rates and other factors impact the Company's performance far more than does inflation. The Company's financial statements are prepared in accordance with GAAP and its dividends are based upon net income as calculated for tax purposes; in each case, the Company's results of operations and reported assets, liabilities and equity are measured with reference to historical cost or fair market value without considering inflation.

OTHER MATTERS

The Company intends to conduct its business so as to maintain its exempt status under, and not to become regulated as an investment company for purposes of, the Investment Company Act of 1940, as amended (the Investment Company Act). If the Company failed to maintain its exempt status under the Investment Company Act and became regulated as an investment company, the Company's ability to, among other things, use leverage would be substantially reduced and, as a result, the Company would be unable to conduct its business as described in the Company's annual report on Form 10-K for the year ended December 31, 2005 and this quarterly report on Form 10-Q for the quarter ended March 31, 2006. 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 the current interpretation of the staff of the SEC, in order to qualify for this exemption, the Company must maintain (i) at least 55% of its assets in Qualifying Interests (the 55% Test) and (ii) at least 80% of its assets in real estate related assets (including Qualifying Interests) (the 80% Test). MBS that do not represent all of the certificates issued (i.e., an undivided interest) with respect to the entire pool of mortgages (i.e., a whole pool) underlying such MBS may be treated as securities separate from such underlying mortgage loans and, thus, may not be considered Qualifying Interests for purposes of the 55% Test; however, such MBS would be considered real estate related assets for purposes of the 80% Test. Therefore, for purposes of the 55% Test, the Company's ownership of these types of MBS is limited by the provisions of the Investment Company Act. In meeting the 55% Test, the Company treats as Qualifying Interests those MBS issued with respect to an underlying pool as to which it owns all of the issued certificates. If the SEC or its staff were to adopt a contrary interpretation, the Company could be required to sell a substantial amount of its MBS under potentially adverse market conditions. Further, in order to insure that it at all times qualifies for this exemption from the Investment Company Act, the Company may be precluded from acquiring MBS whose yield is higher than the yield on MBS that could be otherwise purchased in a manner consistent with this exemption. Accordingly, the Company monitors its compliance with both of the 55% Test and the 80% Test in order to maintain its exempt status under the Investment Company Act. As of March 31, 2006, the Company had determined that it was in and had maintained compliance with both of the 55% Test and the 80% Test.

FORWARD LOOKING STATEMENTS

When used in this quarterly report on Form 10-Q, in future filings with the SEC or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as anticipate, estimate, should, expect, believe, intend, similar expressions, are intended to identify forward-looking statements within the meaning of Section 27A of the Act and Section 21E of the Securities Exchange Act of 1934 (1934 Act) and, as such, may involve known and unknown risks, uncertainties and assumptions.

These forward-looking statements are subject to various risks and uncertainties, including, but not limited to, those relating to: changes in interest rates and the market value of the Company's MBS; changes in the prepayment rates on the mortgage loans collateralizing the Company's MBS; the Company's ability to use borrowings to finance its assets; changes in government regulations affecting the Company's business; the Company's ability to maintain its qualification as a REIT for U.S. federal income tax purposes; and risks associated with investing in real estate, including changes in business conditions and the general economy. These and other risks, uncertainties and factors, including those described in reports that the Company files from time to time with the SEC, could cause the Company's actual results to differ materially from those projected in any forward-looking statements it makes. All forward-looking statements speak only as of the date they are made and the Company does not undertake, and specifically disclaims, any obligation to update or revise any forward-looking statements to reflect events or circumstances occurring after the date of such statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

The Company seeks to manage the interest rate, market value, liquidity, prepayment and credit risks inherent in all financial institutions in a prudent manner designed to insure the longevity of the Company while, at the same time, seeking to provide an opportunity to stockholders to realize attractive total rates of return through stock ownership of the Company. While the Company does not seek to avoid risk, it does seek to assume risk that can be quantified from historical experience, to actively manage such risk, to earn sufficient returns to justify the taking of such risks and to maintain capital levels consistent with the risks it does undertake.

INTEREST RATE RISK

The Company primarily invests in ARM-MBS. The Company expects that over time its ARM-MBS will experience higher prepayment rates than would fixed-rate MBS. This is based on the assumption that homeowners with adjustable-rate and hybrid mortgages are generally self-selected borrowers and are expected to exhibit more rapid housing turnover levels or refinancing activity compared to fixed-rate borrowers. In addition, the Company believes that prepayments on ARM-MBS accelerate significantly as the coupon reset date approaches. Over the last consecutive eight quarters ending on March 31, 2006, the CPR on the Company's MBS portfolio ranged from a low of 24.1% to a high of 34.9%, with an average quarterly CPR of 28.9%.

The Company takes into account both anticipated coupon resets and expected prepayments when measuring sensitivity of its ARM-MBS portfolio to changes in interest rates. In measuring its assets-to-borrowings repricing gap (the Repricing Gap), the Company measures the difference between: (a) the weighted average months until coupon adjustment or projected prepayment on the ARM-MBS portfolio; and (b) the months remaining on its repurchase agreements applying the same projected prepayment rate and including the impact of Swaps. Assuming a 25% CPR, the weighted average term to repricing or assumed prepayment for the Company's ARM-MBS portfolio, as of March 31, 2006, was approximately ten months and the average term remaining on the Company's repurchase agreements, including the impact of Swaps, was approximately four months, resulting in Repricing Gap of six months. The CPR is applied in order to reflect, to a certain extent, the prepayment characteristics inherent in the Company's interest-earning assets and interest-bearing liabilities. As of March 31, 2006, based on contractual terms (i.e., assuming no prepayments), the Company's ARM-MBS portfolio had a weighted average term to repricing of approximately 14 months and its repurchase agreements, including the impact of Swaps, had a weighted average term remaining of approximately four months, resulting in a Repricing Gap of approximately ten months. Based on historical results, the Company believes that applying a 25% CPR assumption provides a reasonable approximation of the Repricing Gap for the Company's ARM-MBS portfolio over time.

At March 31, 2006, the Company's financing obligations under repurchase agreements had remaining terms of one year or less. Upon contractual maturity or an interest reset date, these borrowings are refinanced at then prevailing market rates.

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The interest rates for most of the Company's adjustable-rate assets are primarily dependent on the LIBOR, one-year constant maturity treasury (CMT) rate, or the 12-month CMT moving average (MTA), while its repurchase agreements, are generally priced off of LIBOR. While LIBOR and CMT generally move together and the (while MTA is a lagging index to CMT) there can be no assurance that such movements will be parallel, such that the magnitude of the movement of one index will match that of the other index. At March 31, 2006, the Company had 42.3% repricing from the one-year LIBOR index, 36.4% of its ARM-MBS portfolio repricing from the one-year CMT index, 19.8% repricing from the MTA and 1.5% repricing from the 11th District Cost of Funds Index (COFI).

The Company's adjustable-rate assets reset on various dates that are not matched to the reset dates on the Company's borrowings (i.e., repurchase agreements). In general, the repricing of the Company's debt obligations occurs more quickly than the repricing of its assets. Therefore, on average, the Company's cost of borrowings may rise or fall more quickly in response to changes in market interest rates than does the yield on its interest-earning assets.

The mismatch between repricings or maturities within a time period is commonly referred to as the gap for that period. A positive gap, where repricing of interest-rate sensitive assets exceeds the maturity of interest-rate sensitive liabilities, generally will result in the net interest margin increasing in a rising interest rate environment and decreasing in a falling interest rate environment. At March 31, 2006, the Company had a negative gap, which will generally have the opposite results on the net interest margin. As discussed above, the gap analysis is prepared assuming a CPR of 25%; however, actual prepayment speeds could vary significantly. The gap analysis does not reflect the constraints on the repricing of ARM-MBS in a given period resulting from interim and lifetime cap features on these securities or the behavior of various indexes applicable to the Company's assets and liabilities. The gap methodology does not assess the relative sensitivity of assets and liabilities to changes in interest rates and also fails to account for interest rate caps and floors imbedded in the Company's MBS or include assets and liabilities that are not interest rate sensitive.

The following table presents the Company's interest rate risk using the gap methodology applying a 25% CPR at March 31, 2006.

| | At March 31, 2006 | | | | | |
|--|-----------------------|--------------------------------|--------------------------|----------------------------|-----------------------|--------------|
| | Less than 3 Months | Three Months to One Year | One Year to Two Years | Two Years to Year Three | Beyond Three Years | Total |
| Interest-Earning Assets: | | | | | | |
| Adjustable Rate - MBS | \$ 1,786,125 | \$ 1,535,066 | \$ 712,356 | \$ 184,709 | \$ 322,220 | \$ 4,540,476 |
| Fixed-Rate - MBS | | | | | 120 | 120 |
| Cash | 74,944 | | | | | 74,944 |
| | | | | | | |
| Total interest-earning assets | \$ 1,861,069 | \$ 1,535,066 | \$ 712,356 | \$ 184,709 | \$ 322,340 | \$ 4,615,540 |
| Interest-Bearing Liabilities: | | | | | | |
| Repurchase agreements | \$ 2,722,000 | \$ 1,193,800 | \$ 37,200 | \$ - | \$ - | \$ 3,953,000 |
| Mortgage loans | | | | | 16,477 | 16,477 |
| | | | | | | |
| Total interest-bearing liabilities | \$ 2,722,000 | \$ 1,193,800 | \$ 37,200 | \$ - | \$ 16,477 | \$ 3,969,477 |
| Gap before Hedging Instruments | \$ (860,931) | \$ 341,266 | \$ 675,156 | \$ 184,709 | \$ 305,863 | 646,063 |
| Notional Amounts of Swaps | 315,000 | | | | | 315,000 |
| Cumulative Difference Between Interest-Earnings Assets and Interest Bearing Liabilities after Hedging Instruments | \$ (545,931) | \$ (204,665) | \$ 470,491 | \$ 655,200 | \$ 961,063 | |

As part of its overall interest rate risk management strategy, the Company periodically uses Hedging Instruments to mitigate the impact of significant unplanned fluctuations in earnings and cash flows caused by interest rate volatility. The interest rate risk management strategy at times involves modifying the repricing characteristics of certain assets and liabilities utilizing derivatives. At March 31, 2006, the Company had Caps with an aggregate notional amount of \$300.0 million and Swaps with a notional amount of \$315.0 million, all of which

were active. During the quarter ended March 31, 2006, the Company received or was due payments of \$576,000 from counterparties on its Caps and \$783,000 related to its Swaps. The notional amount of the Swap is presented in the table above, as it impacts the cost of a portion of the Company's repurchase agreements. The notional amounts of the Company's Caps, which hedge against increases in interest rates on the Company's LIBOR-based repurchase agreements, are not considered in the gap analysis, as they do not effect the timing of the repricing of the instruments they hedge, but rather, to the extent of the notional amount, cap the limit on the amount of interest rate change that can occur relative to the hedged liability. In addition, the notional amounts of the Company's Hedging Instruments are not reflected in the Company's consolidated balance sheets. The Company's Caps, at the time of purchase, are intended to serve as a hedge against future interest rate increases on the Company's repurchase agreements, which are typically priced off of LIBOR.

MARKET VALUE RISK

Substantially all of the Company's investment securities are designated as available-for-sale assets. As such, they are carried at their estimated fair value, with the difference between amortized cost and estimated fair value reflected in accumulated other comprehensive income or loss, a component of stockholders' equity. (See Note 11 to the accompanying consolidated financial statements, included under Item 1.) The estimated fair value of the Company's MBS fluctuate primarily due to changes in interest rates and other factors; however, given that at March 31, 2006, these securities were primarily Agency MBS or AAA rated MBS, such changes in the estimated fair value of the Company's MBS are generally not credit-related. To a limited extent the Company is exposed to credit-related market value risk as the Company at March 31, 2006 held \$5.9 million of non-Agency MBS that were rated below AAA, of which \$85,000 were non-rated securities. Generally, in a rising interest rate environment, the estimated fair value of the Company's MBS would be expected to decrease; conversely, in a decreasing interest rate environment, the estimated fair value of such MBS would be expected to increase. If the estimated fair value of the Company's MBS collateralizing its repurchase agreements decreases, the Company may receive margin calls from its repurchase agreement counterparties for additional collateral or cash due to such decline. If such margin calls were not met, the lender could liquidate the securities collateralizing the Company's repurchase agreements with such lender, resulting in a loss to the Company. In such a scenario, the Company could apply a strategy of reducing borrowings and assets, by selling assets or not replacing securities as they amortize and/or prepay, thereby shrinking the balance sheet. Such an action would likely reduce interest income, interest expense and net income, the extent of which would be dependent on the level of reduction in assets and liabilities as well as the sale price of the assets sold. Further, such a decrease in the Company's net interest income could negatively impact cash available for distributions, which in turn could reduce the market price of the Company's issued and outstanding common stock and preferred stock.

LIQUIDITY RISK

The primary liquidity risk for the Company arises from financing long-maturity assets, which have interim and lifetime interest rate adjustment caps, with shorter-term borrowings in the form of repurchase agreements. Although the interest rate adjustments of these assets and liabilities are matched within the guidelines established by the Company's operating policies, maturities are not required to be, nor are they matched.

The Company's assets which are pledged to secure repurchase agreements are high-quality, liquid assets. As a result, the Company has not had difficulty rolling over (i.e., renewing) these agreements as they mature. However, there can be no assurances that the Company will always be able to roll over its repurchase agreements. At March 31, 2006, the Company had cash and cash equivalents of \$74.9 million and unpledged securities of \$342.4 million available to meet margin calls on its repurchase agreements and for other corporate purposes. However, should market interest rates and/or prepayment speeds on the mortgage loans underlying the Company's MBS suddenly increase, margin calls on the Company's repurchase agreements could result, causing an adverse change in the Company's liquidity position.

PREPAYMENT AND REINVESTMENT RISK

As the Company receives repayments of principal on its MBS, premiums paid on such securities are amortized against interest income and discounts, other than credit related discounts, on MBS are accreted to interest income. Premiums arise when the Company acquires a MBS at a price in excess of the principal balance of the mortgages securing such MBS or the par value of such MBS if purchased at the original issue. Conversely, discounts arise

when the Company acquires a MBS at a price below the principal balance of the mortgages securing such MBS, or the par value of such MBS, if purchased at the original issue. For financial accounting purposes, interest income is accrued based on the outstanding principal balance of the investment securities and their contractual terms. Purchase premiums on the Company's investment securities, currently comprised of MBS, are amortized against interest income over the lives of the securities using the effective yield method, adjusted for actual prepayment activity. In general, an increase in the prepayment rate, as measured by the CPR, will accelerate the amortization of purchase premiums, thereby reducing the yield/interest income earned on such assets.

For tax accounting purposes, the purchase premiums and discounts are amortized based on the constant effective yield at the purchase date. Therefore, on a tax basis, amortization of premiums will differ from those reported for financial purposes under GAAP. At March 31, 2006, the gross unamortized premium for ARM-MBS for financial accounting purposes was \$89.9 million (2.0% of the principal balance of MBS) while the gross unamortized premium for federal tax purposes was estimated at \$88.0 million.

In general, the Company believes that it will be able to reinvest proceeds from scheduled principal payments and prepayments at acceptable yields; however, no assurances can be given that, should significant prepayments occur, market conditions would be such that acceptable investments could be identified and the proceeds timely reinvested.

TABULAR PRESENTATION

The information presented in the following table projects the potential impact of sudden parallel changes in interest rates on net interest income and portfolio value, including the impact of Hedging Instruments, over the next twelve months based on the assets in the Company's investment portfolio on March 31, 2006. The Company acquires interest-rate sensitive assets and funds them with interest-rate sensitive liabilities. The Company generally plans to retain such assets and the associated interest rate risk to maturity. All changes in income and value are measured as percentage change from the projected net interest income and portfolio value at the base interest rate scenario.

| Change in Interest Rates | Percentage Change in Net Interest Income | Percentage Change in Portfolio Value |
|-----------------------------|---|---|
| +1.00% | (43.61%) | (1.15%) |
| +0.50% | (13.29%) | (0.53%) |
| -0.50% | 29.99% | 0.44% |
| -1.00% | 58.97% | 0.80% |

Certain assumptions have been made in connection with the calculation of the information set forth in the above table and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. The base interest rate scenario assumes interest rates at March 31, 2006. The analysis presented utilizes assumptions and estimates based on management's judgment and experience. Furthermore, future sales, acquisitions and restructuring could materially change the Company's interest rate risk profile. It should be specifically noted that the information set forth in the above table and all related disclosure constitutes forward-looking statements within the meaning of Section 27A of the Act and Section 21E of the Exchange Act. Actual results could differ significantly from those estimated in the table and changes in interest rates over any period could be greater than the changes in interest rates shown in the above table.

The table quantifies the potential changes in net interest income and portfolio value should interest rates immediately change (Shock). The table presents the estimated impact of interest rates instantaneously rising 50 and 100 basis points, and falling 50 and 100 basis points. The cash flows associated with the portfolio of MBS for each rate Shock are calculated based on assumptions, including, but not limited to, prepayment speeds, yield on future acquisitions, slope of the yield curve and size of the portfolio. Assumptions made on the interest rate sensitive liabilities, which are assumed to be repurchase agreements, include anticipated interest rates, collateral requirements as a percent of the repurchase agreement, amount and term of borrowing.

The impact on portfolio value is approximated using the calculated effective duration (i.e., the price sensitivity to changes in interest rates) of 0.97 and effective convexity (i.e., approximates the change in duration relative to the change in interest rates) of (0.35). Duration and convexity can change significantly over time, the timing and severity of which are primarily driven and by changes and volatility in the interest rate environment. The impact on net interest income is driven mainly by the difference between portfolio yield and cost of funding of the Company's

repurchase agreements, which includes the cost and/or benefit from Hedging Instruments that hedge such repurchase agreements. The Company's asset/liability structure is generally such that an increase in interest rates would be expected to result in a decrease in net interest income, as the Company's repurchase agreements are generally shorter term than the Company's interest-earning assets. When interest rates are Shocked, prepayment assumptions are adjusted based on management's expectations along with the results from the prepayment model. For example, under current market conditions, a 100 basis point increase in interest rates is estimated to result in a 37.5% decrease in the CPR of the MBS portfolio.

Item 4. Controls and Procedures

A review and evaluation was performed by the Company's management, including the Company's Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the 1934 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 the Company's current disclosure controls and procedures, as designed and implemented, were effective. Notwithstanding the foregoing, a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that it will detect or uncover failures within the Company to disclose material information otherwise required to be set forth in the Company's periodic reports.

There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2006 that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

PART II. OTHER INFORMATION**Item 1. Legal Proceedings**

There are no material pending legal proceedings to which the Company is a party or any of its assets are subject.

Item 1a. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A Risk Factors of the Company's Annual Report on Form 10-K for the year ended December 31, 2005 (the Form 10-K). The materialization of any risks and uncertainties identified in the Company's Forward Looking Statements contained herein together with those previously disclosed in the Form 10-K or those that are presently unforeseen could result in significant adverse effects on the Company's financial condition, results of operations and cash flows. See Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations Forward Looking Statements in this Quarterly Report on Form 10-Q.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table presents information regarding the shares of common stock repurchased under the Company's Repurchase Program during the three months ended March 31, 2006.

| 2006 Monthly Period | Total Number of Shares Purchased | Weighted Average Price Paid per Share (1) | Total Number of Shares Purchased as Part of Publicly Announced Repurchase Program (2) | Maximum Number of Shares that May Yet be Purchased Under the Repurchase Program |
|--------------------------------|--|--|---|--|
| January 1 through January 31 | 46,300 | \$ 5.82 | 46,300 | 1,689,000 |
| February 1 through February 28 | 133,700 | 6.15 | 133,700 | 1,555,300 |
| March 1 through March 31 | 289,100 | 6.24 | 289,100 | 1,266,200 |
| Total | 469,100 | \$ 6.17 | 469,100 | |

(1) Includes brokerage commissions.

(2) On August 11, 2005, the Company publicly announced the implementation of the Repurchase Program to repurchase up to 4.0 million shares of its outstanding common stock.

Item 6. Exhibits and Reports on Form 8-K**(a) Exhibits**

3.1 Amended and Restated Articles of Incorporation of the Registrant (incorporated herein by reference to Form 8-K dated April 10, 1998, filed by the Registrant pursuant to the Securities Exchange Act of 1934 (Commission File No. 1-13991)).

3.2 Articles of Amendment to the Amended and Restated Articles of Incorporation of the Registrant, dated August 6, 2002 (incorporated herein by reference to Form 8-K, dated August 13, 2002, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

3.3 Articles of Amendment to the Amended and Restated Articles of Incorporation of the Registrant, dated August 16, 2002 (incorporated herein by reference to Exhibit 3.3 of the Form 10-Q, for the quarter ended September 30, 2002, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

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3.4 Articles Supplementary of the Registrant, dated April 22, 2004, designating the Registrant's 8.50% Series A Cumulative Redeemable Preferred Stock (incorporated herein by reference to Exhibit 3.4 of the Form 8-A, dated April 23, 2004, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

3.5 Amended and Restated Bylaws of Registrant (incorporated herein by reference to Form 8-K dated August 13, 2002, filed by the Registrant pursuant to the Securities Exchange Act of 1934 (Commission File No. 1-13991)).

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4.1 Specimen of Common Stock Certificate of the Registrant (incorporated herein by reference to Exhibit 4.1 of the Registration Statement on Form S-4, dated February 12, 1998, filed by the Registrant pursuant to the Securities Act of 1933 (Commission File No. 333-46179)).

4.2 Specimen of Stock Certificate representing the 8.50% Series A Cumulative Redeemable Preferred Stock of the Registrant (incorporated herein by reference to Exhibit 4 of the Form 8-A, dated April 23, 2004, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

10.1 Amended and Restated Employment Agreement of Stewart Zimmerman, dated as of April 16, 2006 (incorporated herein by reference to Exhibit 10.1 of the Form 8-K, dated April 25, 2006, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

10.2 Amended and Restated Employment Agreement of William S. Gorin, dated as of April 16, 2006 (incorporated herein by reference to Exhibit 10.3 of the Form 8-K, dated April 25, 2006, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

10.3 Amended and Restated Employment Agreement of Ronald A. Freyberg, dated as of April 16, 2006 (incorporated herein by reference to Exhibit 10.2 of the Form 8-K, dated April 25, 2006, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

10.4 Amended and Restated Employment Agreement of Teresa D. Covello, dated as of January 1, 2006 (incorporated herein by reference to Exhibit 10.5 of the Form 8-K, dated April 25, 2006, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

10.5 Amended and Restated Employment Agreement of Timothy W. Korth II, dated as of January 1, 2006 (incorporated herein by reference to Exhibit 10.4 of the Form 8-K, dated April 25, 2006, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

10.6 2004 Equity Compensation Plan of the Company (incorporated herein by reference to Exhibit 10.1 of the Post-Effective Amendment No. 1 to the Registration Statement on Form S-3, dated July 21, 2004, filed by the Registrant pursuant to the 33 Act (Commission File No. 333-106606)).

10.7 MFA Mortgage Investments, Inc. Senior Officers Deferred Compensation Plan, adopted December 19, 2002 (incorporated herein by reference to Exhibit 10.7 of the Form 10-K, dated December 31, 2002, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

10.8 MFA Mortgage Investments, Inc. 2003 Non-Employee Directors Deferred Compensation Plan, adopted December 19, 2002 (incorporated herein by reference to Exhibit 10.8 of the Form 10-K, dated December 31, 2002, filed by the Registrant pursuant to the 1934 Act (Commission File No. 1-13991)).

10.9 Form of Incentive Stock Option Award Agreement relating to the Registrant's 2004 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.9 of the Form 10-Q, dated September 30, 2004, filed by the Registrant pursuant to the Exchange Act (Commission File No. 1-13991)).

10.10 Form of Non-Qualified Stock Option Award Agreement relating to the Registrant's 2004 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.10 of the Form 10-Q, dated September 30, 2004, filed by the Registrant pursuant to the Exchange Act (Commission File No. 1-13991)).

10.11 Form of Restricted Stock Award Agreement relating to the Registrant's 2004 Equity Compensation Plan (incorporated herein by reference to Exhibit 10.11 of the Form 10-Q, dated September 30, 2004, filed by the Registrant pursuant to the Exchange Act (Commission File No. 1-13991)). 31.1 Certification of the Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.1 Certification of the Chief Executive Officer, 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 the Chief Financial Officer, 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 the Chief Executive Officer, 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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32.2 Certification of the Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements 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.

Date: May 1, 2006

MFA MORTGAGE INVESTMENTS, INC.

By: /s/ Stewart Zimmerman

Stewart Zimmerman
President and Chief Executive Officer

By: /s/ William S. Gorin

William S. Gorin
Executive Vice President
Chief Financial Officer
(Principal Financial Officer)

By: /s/ Teresa D. Covello

Teresa D. Covello
Senior Vice President
Chief Accounting Officer
(Principal Accounting Officer)