

LUMINENT MORTGAGE CAPITAL INC

Form S-3

January 03, 2005

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As filed with the Securities and Exchange Commission on January 3, 2005

Registration No. 333-

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM S-3
REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

LUMINENT MORTGAGE CAPITAL, INC.
(Exact name of registrant as specified in its Charter)

Maryland
(State or other jurisdiction of incorporation
or organization)

06-1694835
(I.R.S. Employer Identification No.)

909 Montgomery Street, Suite 500
San Francisco, California 94133
(415) 486-2110
(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Albert J. Gutierrez, CFA
President
Luminent Mortgage Capital, Inc.
909 Montgomery Street, Suite 500
San Francisco, California 94133
(415) 486-2110
(Name, address, including zip code, and telephone number, including area code, of agent for service)

copy to:
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4200 One Liberty Place
Philadelphia, PA 19103-7396
(215) 979-1234

Approximate date of commencement of proposed sale to the public:
From time to time or at one time after the effective date of this registration
statement as the registrant shall determine.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box.

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box.

If this form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act of 1933, check the following box and list the Securities Act registration statement number of earlier effective registration statement for the same offering.

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box.

CALCULATION OF REGISTRATION FEE

| Title of each class of securities to be registered(1) | Proposed maximum aggregate offering price(1)(2) | Amount of registration fee(3) |
|--|--|--------------------------------------|
| Common Stock, par value \$0.001 per share (2) | | |
| Preferred Stock, par value \$0.001 per share (2) | | |
| Warrants | | |
| Debt securities(4) | | |
| Total | \$500,000,000 | \$ 58,850 |

- (1) Includes such indeterminate number or amount of shares of common stock, preferred stock, warrants to purchase common stock or preferred stock, debt securities and such indeterminate number of shares of common stock and preferred stock as may be issued upon the exercise of warrants to purchase common stock or preferred stock. Any securities registered hereunder may be sold separately or as units with other securities registered hereunder as may from time to time be issued at indeterminate prices by the registrant or as may be issuable upon conversion of, or in exchange for, or upon exercise of, convertible or exchangeable securities as may be offered pursuant to this registration statement. In no event will the maximum aggregate offering price of all securities issued pursuant to this registration statement exceed \$500,000,000.
- (2) The aggregate amount of common stock registered hereunder is limited, solely for the purpose of any at-the-market offering, to that which is permissible under Rule 415(a)(4)(ii) under the Securities Act.
- (3) Calculated pursuant to Rule 457(o) under the Securities Act.
- (4) If any debt securities are issued at an original issue discount, then the offering price shall be in such greater principal amount as shall result in an aggregate initial offering price not to exceed \$500,000,000.

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of

1933 or until the registration statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

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The information in this preliminary prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This preliminary prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

PRELIMINARY PROSPECTUS SUBJECT TO COMPLETION, DATED JANUARY 3, 2005

PROSPECTUS

\$500,000,000

**Common Stock
Preferred Stock
Warrants to Purchase Common Stock or Preferred Stock
Debt Securities**

By this prospectus, we may offer, from time to time:

shares of our common stock;

shares of our preferred stock;

warrants to purchase shares of our common stock or preferred stock;

debt securities; or

any combination of the foregoing

in one or more series with an aggregate initial public offering price of up to \$500,000,000. We will provide specific terms of each issuance of these securities in supplements to this prospectus. You should read this prospectus and any prospectus supplement carefully before you decide to invest.

This prospectus may not be used to consummate sales of these securities unless it is accompanied by a prospectus supplement.

Our common stock is listed on the New York Stock Exchange under the symbol LUM.

To ensure we qualify as a real estate investment trust, no person may own more than 9.8% of the outstanding shares of any class of our common stock or our preferred stock, unless our board of directors waives this limitation.

See **Risk Factors** beginning on page 5 of this prospectus for a description of risks that should be considered by purchasers of these securities.

We may offer these securities in amounts, at prices and on terms to be set forth in one or more prospectus supplements. We may sell these securities to or through underwriters, dealers or agents or we may sell these securities directly to investors on our own behalf.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to

the contrary is a criminal offense.

The date of this prospectus is , 2005

You should rely only on the information contained in or incorporated by reference into this prospectus and any related prospectus supplement. We have not authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus, the related prospectus supplement and the documents incorporated by reference herein is accurate only as of its respective date or dates or on the date or dates specified in these documents. Our business, financial condition, results of operations and prospects may have changed since those dates.

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This prospectus, including any prospectus supplement, and the documents incorporated by reference herein contain certain forward-looking statements. Forward-looking statements are those that are not historical in nature. They can often be identified by the inclusion of words such as will, anticipate, estimate, should, expect, believe, similar expressions. Any projection of revenues, earnings or losses, distributions, capital structure or other financial terms is a forward-looking statement. inten

Our forward-looking statements are based upon our management's beliefs, assumptions and expectations of our future operations and economic performance, taking into account the information currently available to us. Forward-looking statements involve risks and uncertainties, some of which are not currently known to us, that might cause our actual results, performance or financial condition to be materially different from the expectations of future results, performance or financial condition we express or imply in any forward-looking statement. Some of the important factors that could cause our actual results, performance or financial condition to differ materially from our expectations are:

interest rate mismatches between our mortgage-backed securities and the borrowings we use to fund our purchases of such securities;

changes in interest rates and mortgage prepayment rates;

our ability to obtain or renew sufficient funding to maintain our leverage strategies;

potential impacts of our leveraging policies on our net income and cash available for distribution;

our limited operating history and the limited experience of Seneca Capital Management LLC, our management company, in managing a real estate investment trust, or REIT;

the ability of our board of directors to change our operating policies and strategies without stockholder approval or notice to you;

effects of interest rate caps on our adjustable-rate and hybrid adjustable-rate mortgage-backed securities;

the degree to which our hedging strategies may or may not protect us from interest rate volatility;

the fact that Seneca could be motivated to recommend riskier investments in an effort to maximize its incentive compensation under its management agreement with us;

potential conflicts of interest arising out of our relationship with Seneca, on the one hand, and Seneca's relationships with other third parties, on the other hand; and

our ability to invest up to 10% of our investment portfolio in lower-credit quality mortgage-backed securities that carry an increased likelihood of default or rating downgrade relative to investment-grade securities;

your inability to review the assets that we will acquire with the net proceeds of any securities we offer;

the other important factors described in this prospectus, including under the caption Risk Factors, in any prospectus supplement and in the documents incorporated herein by reference.

We undertake no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the events described in our forward-looking statements might not occur. We qualify all of our forward-looking statements by these cautionary factors. Please keep this cautionary note in mind as you read this prospectus, any prospectus supplement and the documents incorporated herein by reference.

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission, or SEC, using a shelf registration process. Under this process, we may offer and sell any combination of common stock, preferred stock, warrants to purchase common stock or preferred stock and debt securities in one or more offerings for total proceeds of up to \$500,000,000. This prospectus provides you with a general description of the securities we may offer. Each time we offer to sell securities, we will provide a supplement to this prospectus that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. We encourage you to read, in their entirety, this prospectus and any related prospectus supplement, as well as the information that is incorporated by reference herein. You should read this entire prospectus carefully, including the section titled Risk Factors before making an investment in our securities. As used in this prospectus, Luminent, company, we, our and us refer to Luminent Mortgage Capital, Inc. and Seneca, our M and the Manager refer to Seneca Capital Management LLC, except where the context otherwise requires.

LUMINENT MORTGAGE CAPITAL, INC.

General

We were incorporated in April 2003 to invest primarily in U.S. agency and other highly-rated, single-family, adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage-backed securities, which we acquire in the secondary market. Our strategy is to acquire mortgage-related assets, finance these purchases in the capital markets and use leverage in order to provide an attractive return on stockholders' equity. Through this strategy, we seek to earn income, which is generated from the spread between the yield on our earning assets and our costs, including the interest cost of the funds we borrow. We operate as a REIT, and generally do not pay federal corporate income taxes on our income that is distributed to our stockholders.

We commenced operations in June 2003, following the completion of a private placement of our common stock, in which we raised net proceeds of approximately \$159.7 million. On December 18, 2003, we completed an initial public offering of our common stock in which we raised net proceeds of approximately \$157.0 million. On December 19, 2003, our common stock began trading on the New York Stock Exchange, or NYSE, under the trading symbol LUM. On March 29, 2004, we completed a follow-on public offering of our common stock in which we raised net proceeds of approximately \$157.5 million.

We invest primarily in adjustable-rate and hybrid adjustable-rate mortgage-backed securities. Adjustable-rate mortgage-backed securities have interest rates that reset periodically, typically every six months or on an annual basis. Hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan typically three, five, seven or 10 years and thereafter reset periodically in a manner similar to adjustable-rate mortgage-backed securities.

Unless otherwise indicated in an accompanying prospectus supplement, we intend to use the net proceeds from the sale of the securities offered by this prospectus and the related accompanying prospectus supplement and other borrowed funds to invest in mortgage-backed securities similar to those currently in our portfolio. We will seek to acquire mortgage-backed securities that will produce competitive returns, taking into consideration the amount and nature of the anticipated returns from the investment, our ability to pledge the investment for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments. As of the date of this prospectus, we have not identified any specific mortgage-backed securities that we intend to acquire with the net proceeds of this offering. All of the mortgage-backed securities that we acquired with the net proceeds of our initial public offering and our follow-on offering are agency-backed or have AAA credit ratings from at least one

nationally-recognized statistical rating agency, and all of the securities are either adjustable-rate or hybrid adjustable-rate mortgage-backed securities. We expect that the substantial majority, or perhaps all of the mortgage-backed securities that we acquire with the net proceeds of this offering will be agency-backed or have AAA credit ratings. Such securities are readily available in the market. As of June 30, 2004, the market for residential mortgage debt that had been securitized into mortgage-backed securities was approximately \$4.2 trillion, approximately \$3.4 trillion of which was agency-backed and, therefore, generally consistent with our investment guidelines. As of June 30, 2004, approximately \$69.8 billion of all available mortgage-backed securities were held by REITs.

We have financed our acquisition of mortgage-related assets by investing our equity and by borrowing at short-term rates under repurchase agreements. We intend to continue to finance our acquisitions in this manner. We generally seek to borrow between eight and 12 times the amount of our equity. We actively manage the adjustment periods and the selection of the interest rate indices of our borrowings against the adjustment periods and the selection of indices on our mortgage-related assets in order to manage our liquidity

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and interest rate-related risks. We may also choose to engage in various hedging activities designed to match more closely the terms of our assets and liabilities.

As a long-term holder of mortgage-backed securities, we focus on acquiring, financing and managing a diverse portfolio of mortgage-backed securities with a variety of characteristics that we believe will provide attractive returns in a multitude of interest rate and prepayment environments. We do not construct our overall investment portfolio in order to express a directional expectation for interest rates or mortgage prepayment rates.

We review the credit risk associated with each potential investment and may diversify our portfolio to avoid undue geographic, guarantor, industry and other types of concentrations. By maintaining a large percentage of our assets in high-quality and highly-rated assets, many of which are guaranteed under limited circumstances as to payment of a limited amount of principal and interest by federal agencies or federally-chartered entities such as Fannie Mae, Freddie Mac or Ginnie Mae, we believe we can mitigate our exposure to losses from credit risk.

In addition to the strategies described above, we intend to use other strategies to seek to generate earnings and distributions to our stockholders, which may include the following:

increasing the size of our balance sheet at a rate faster than the rate of increase in our operating expenses;

using leverage to increase the size of our balance sheet; and

lowering our effective borrowing costs over time by seeking direct funding with collateralized lenders.

We are externally managed and advised by Seneca pursuant to a management agreement between Seneca and us. We have a full-time chief financial officer who is not employed by Seneca, and who provides us with dedicated financial management, analysis and investor relations capability.

We have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended. As such, we will routinely distribute substantially all of the income generated from our operations to our stockholders. As long as we retain our REIT status, we generally will not be subject to U.S. federal or state corporate taxes on our income to the extent that we distribute our net income to our stockholders.

Our principal offices are located at 909 Montgomery Street, Suite 500, San Francisco, California 94133. Our telephone number is (415) 486-2110 and our website is www.luminentcapital.com. Information contained on our website does not constitute a part of this prospectus.

Seneca and Executive Officers

Our day-to-day operations are externally managed and advised by Seneca, subject to the direction and oversight of our board of directors. Seneca was established in 1989, and is an investment adviser registered under the Investment Advisers Act of 1940, as amended. Seneca, whose sole business is investment management, manages fixed-income and equity assets for pension and profit-sharing plans, financial institutions, such as banking and insurance companies, and mutual funds for retail and institutional investors. Seneca had over 100 full-time employees and approximately \$13 billion of institutional and private investment accounts on September 30, 2004.

From time to time, we will assess whether we should be internally managed. In May 2004, our board of directors formed a committee of independent directors to assess the advisability of internalization. We believe this on-going assessment will consider a number of factors, including, without limitation, our ability to attract and retain full-time employees, and the costs, expenses and potential efficiencies related to becoming internally managed.

A majority of Seneca's outstanding equity interests are owned by Phoenix Investment Partners, Ltd., or Phoenix. Phoenix is a wholly owned subsidiary of The Phoenix Companies, Inc. (NYSE: PNX). Our board of directors consists of seven members, five of whom are not affiliated with Seneca or Phoenix. Neither this prospectus nor any offering or sale of securities made through this prospectus and a related prospectus supplement are endorsed or guaranteed in any way by Seneca or Phoenix.

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Our executive officers have significant experience in providing investment advisory services, with an average of 17 years of experience. Prior to founding Seneca in 1989, Gail P. Seneca, our chief executive officer, spent two years as senior vice president of the Asset Management Division of Wells Fargo Bank, where she managed fixed-income assets in excess of \$10 billion. Before joining Seneca as its fixed income chief investment officer, Albert J. Gutierrez, our president, spent two years as head of portfolio management, trading and investment systems at American General Investment Management, where he was responsible for approximately \$75 billion in client assets, and 12 years with Conseco Capital Management as a senior vice president in charge of fixed income research and trading as well as insurance asset portfolio management. Other than our full-time chief financial officer, all of our executive officers are also employees and/or officers of Seneca, as described in the following table:

| Name | Position with Seneca | Position with Us |
|--------------------------|--|--|
| Gail P. Seneca, Ph.D. | President/Chief Executive Officer and Chief Investment Officer | Chairman of the Board of Directors and Chief Executive Officer |
| Albert J. Gutierrez, CFA | Fixed Income Chief Investment Officer and Principal | President and Director |
| Christopher J. Zyda | None | Senior Vice President and Chief Financial Officer |
| Andrew S. Chow, CFA | Fixed Income Portfolio Manager | Senior Vice President |
| Troy A. Grande, CFA | Fixed Income Portfolio Manager | Senior Vice President |

The Management Agreement

Pursuant to our management agreement, Seneca, as our sole manager, generally implements our business strategy, is responsible for our day-to-day operations and performs services and activities relating to our assets and operations in accordance with the terms of the management agreement. The management agreement will remain in effect until terminated. Seneca's services for us can be divided into the following three principal activities:

Asset Management Seneca advises us with respect to, arranges for and manages the acquisition, financing, management and disposition of, our investments.

Liability Management Seneca evaluates the credit risk and prepayment risk of our investments and arranges borrowing and hedging strategies.

Capital Management Seneca coordinates our capital raising activities.

In conducting these activities, Seneca advises us on the formulation of, and implements, our operating strategies and policies, arranges for our acquisition of assets, monitors the performance of our assets, arranges for various types of financing and hedging strategies and provides administrative and managerial services in connection with our operations. At all times in the performance of these activities, Seneca is subject to the direction and oversight of our board of directors.

Pursuant to the management agreement and a cost-sharing agreement between Seneca and us, Seneca may earn or be entitled to receive the following compensation, fees and other benefits:

Base management fee 1% per annum of the first \$300 million of our average net worth, plus 0.8% per annum of our average net worth in excess of \$300 million during such fiscal year, calculated on a quarterly basis.

Incentive compensation a specified percentage of our REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) in excess of a threshold amount of taxable income, calculated on a quarterly basis and subject to annual reconciliation.

Out-of-pocket expense reimbursements reimbursement of actual out-of-pocket expenses incurred in connection with our administration on an ongoing basis.

Reimbursement of overhead expenses reimbursement of actual costs attributable to our use of services rendered by Seneca pursuant to the cost-sharing agreement. Our portion of such costs is allocated to us as determined by Seneca, subject to reasonable approval by a majority of our independent directors.

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Termination fee payable only upon termination by us without cause or by Seneca upon our change of control. Actual amount of fee depends on the circumstances of the termination.

For a more detailed discussion of the compensation and other fees payable to Seneca, as well as our and Seneca's right to terminate the management agreement, see the management agreement and cost-sharing agreement incorporated by reference as exhibits to the registration statement of which this prospectus is a part.

Conflicts of Interest

We are subject to potential conflicts of interest involving Seneca because, among other reasons:

the incentive compensation, which is based on our net income, may create an incentive for Seneca to recommend investments with greater income potential, which may be relatively more risky than would be the case if its compensation from us did not include an incentive-based component;

Seneca is permitted to purchase mortgage-backed securities for its own account and to advise accounts of other clients, and certain investment opportunities appropriate for us also will be appropriate for these accounts; and

two of our directors, and all but one of our executive officers, are managers or employees of, or otherwise affiliated with, Seneca.

The management agreement does not limit or restrict the right of Seneca from engaging in any business or rendering services to any other person, including, without limitation, the purchase of, or rendering advice to others purchasing, mortgage-backed securities that meet our investment guidelines. However, Seneca has agreed that for as long as Seneca is our exclusive manager pursuant to the management agreement, it will not sponsor any other mortgage REIT that invests primarily in high-quality, residential mortgage-backed securities, without first obtaining the approval of a majority of our independent directors.

SUMMARY OF THE SECURITIES OFFERED BY THIS PROSPECTUS

We may offer any of the following securities from time to time:

common stock;

preferred stock;

warrants to purchase common stock or preferred stock; and

debt securities.

When we use the term "securities" in this prospectus, we mean any of the securities we may offer with this prospectus, unless we indicate otherwise. The total dollar amount of all securities that we may issue will not exceed \$500,000,000. This prospectus, including the following summary of the securities we may issue, describes the general terms of such securities. The specific terms of any particular securities we may offer will be described in a separate prospectus supplement.

Common Stock

We may offer shares of our common stock, which is currently traded on the New York Stock Exchange under the symbol "LUM". See "Description of Capital Stock" beginning on page 21 of this prospectus.

Preferred Stock

We may offer our preferred stock in one or more series. For any particular series we offer, the applicable prospectus supplement will describe the specific designation; the aggregate number of shares offered; the rate and periods, or the method of calculating the rate and periods for dividends, if any; the stated value and liquidation preference, if any; the voting rights, if any; the terms on which

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the series will be convertible into or exchangeable for other securities or property, if any; the redemption terms, if any and any other specific terms of the particular series of preferred stock. See Description of Capital Stock beginning on page 21 of this prospectus.

Warrants

We may offer warrants to purchase our common stock or preferred stock. For any warrants we offer, the applicable prospectus supplement will describe the security underlying the warrant; the expiration date of the warrant; the exercise price or other method of determining the exercise price; the amount and kind, or the method of determining the amount and kind, of the security to be issued upon the exercise of the warrant and any other specific terms. See Description of Capital Stock Warrants beginning on page 27 of this prospectus.

Debt Securities

We may offer debt securities in one or more series. The debt securities will be our direct unsecured general obligations and may include debentures, notes, bonds or other evidences of indebtedness. The applicable prospectus supplement will describe the terms of any debt securities. See Description of Debt Securities beginning on page 30 of this prospectus.

RISK FACTORS

An investment in our securities involves various risks. Before you decide to invest in our securities, you should consider carefully the following risk factors in connection with the other information in this prospectus, the prospectus supplement accompanying this prospectus and the documents incorporated herein by reference. Our business, financial condition or results of operations could be harmed if any of these risks or uncertainties actually occurs. In that event, the price of our securities could decline and you might lose all or part of your investment. Our actual results could differ materially from those anticipated by our forward-looking statements as a result of the risk factors described below, in any prospectus supplement and the documents incorporated herein by reference. These risks are not the only ones that may affect us. Additional risks not presently known to us or that we currently deem immaterial might also impair our business operations.

Risks Related to Our Business

Interest rate mismatches between our mortgage-backed securities and the borrowings used to fund our purchases of mortgage-backed securities might reduce our net income or result in losses during periods of changing interest rates.

We invest primarily in adjustable-rate and hybrid adjustable-rate mortgage-backed securities. The mortgages underlying these adjustable-rate mortgage-backed securities have interest rates that reset periodically, typically every six months or on an annual basis, based upon market-based indices of interest rates such as U.S. Treasury bonds or LIBOR, the interest rate that banks in London offer for deposits in London of U.S. dollars. The mortgages underlying hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan typically three, five, seven or 10 years and thereafter their interest rates reset periodically similar to the mortgages underlying adjustable-rate mortgage-backed securities. We have funded our acquisitions, and expect to fund our future acquisitions, of adjustable-rate and hybrid adjustable-rate mortgage-backed securities in part with borrowings that have interest rates based on indices and repricing terms similar to, but with shorter maturities than, the interest rate indices and repricing terms of our adjustable-rate and hybrid adjustable-rate mortgage-backed securities. During periods of changing interest rates, this interest rate mismatch between our assets and liabilities could reduce or

eliminate our net income and distributions to our stockholders and could cause us to suffer a loss.

Accordingly, in a period of rising interest rates, we could experience a decrease in, or elimination of, our net income or a net loss because the interest rates on our borrowings could increase faster than the interest rates on our adjustable-rate mortgage-backed securities. Conversely, in a period of declining interest rates, we could experience a decrease in, or elimination of, our net income or a net loss because our amortization of premiums could increase.

Increased levels of prepayments on the mortgages underlying our mortgage-backed securities might decrease our net interest income or result in a net loss.

The mortgage-backed securities that we acquire generally represent interests in pools of mortgage loans. The principal and interest payments we receive from our mortgage-backed securities are generally funded by the payments that mortgage borrowers

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make on those underlying mortgage loans. When borrowers prepay their mortgage loans sooner than expected, corresponding prepayments on the mortgage-backed securities occur sooner than expected by the marketplace. Sooner-than-expected prepayments could harm our results of operations in the following ways, among others:

We seek to purchase mortgage-backed securities that we believe to have favorable risk-adjusted expected returns relative to market interest rates at the time of purchase. If the coupon interest rate for a mortgage-backed security is higher than the market interest rate at the time it is purchased, then that mortgage-backed security will be acquired at a premium to its par value.

In accordance with applicable accounting rules, we are required to amortize any premiums or accrete discounts related to our mortgage-backed securities over their expected terms. The amortization of a premium reduces interest income, while the accretion of a discount increases interest income. The expected terms for mortgage-backed securities are a function of the prepayment rates for the mortgages underlying the mortgage-backed securities. Mortgage-backed securities that are at a premium to their par value are more likely to experience prepayment of some or all of their principal through refinancings. If the mortgages underlying our mortgage-backed securities purchased at a premium are prepaid in whole or in part more quickly than their respective maturity dates, then we must also amortize their respective premiums more quickly, which would decrease our net interest income and harm our profitability.

A substantial portion of our adjustable-rate mortgage-backed securities may bear interest at rates that are lower than their fully-indexed rates, which refers to their applicable index rates plus a margin. If an adjustable-rate mortgage-backed security is prepaid prior to or soon after the time of adjustment to a fully-indexed rate, we will have held that mortgage-backed security while it was less profitable and lost the opportunity to receive interest at the fully-indexed rate over the remainder of its expected life.

If we are unable to acquire new mortgage-backed securities to replace the prepaid mortgage-backed securities, our financial condition, results of operations and cash flow may suffer and we could incur losses.

Prepayment rates generally increase when interest rates decline and decrease when interest rates rise; however, changes in prepayment rates may lag behind changes in interest rates and are difficult to predict. Prepayment rates also may be affected by other factors, including, without limitation, conditions in the housing and financial markets, general economic conditions and the relative interest rates on adjustable-rate and fixed-rate mortgage loans. While we seek to minimize prepayment risk, we must balance prepayment risk against other risks and the potential returns of each investment when selecting investments. No strategy can completely insulate us from prepayment or other such risks.

We depend on short-term borrowings to purchase mortgage-related assets and reach our desired amount of leverage. If we fail to obtain or renew sufficient funding on favorable terms or at all, we will be limited in our ability to acquire mortgage-related assets, which will harm our results of operations.

We depend on short-term borrowings to fund acquisitions of mortgage-related assets and reach our desired amount of leverage. Accordingly, our ability to achieve our investment and leverage objectives depends on our ability to borrow money in sufficient amounts and on favorable terms. In addition, we must be able to renew or replace our maturing short-term borrowings on a continuous basis. We depend on a few lenders to provide the primary credit facilities for our purchases of mortgage-related assets. In addition, our existing indebtedness may limit our ability to make additional borrowings. If our lenders do not allow us to renew our borrowings or we cannot replace maturing borrowings on favorable terms or at all, we might have to sell our mortgage-related assets under adverse market conditions, which would harm our results of operations and may result in losses.

Our leverage strategy increases the risks of our operations, which could reduce our net income and the amount available for distributions or cause us to suffer a loss.

We generally seek to borrow between eight and 12 times the amount of our equity, although at times our borrowings may be above or below this amount. We incur this indebtedness by borrowing against a substantial portion of the market value of our mortgage-backed securities. Our total indebtedness, however, is not expressly limited by our policies and depends on our and our prospective lender's estimate of the stability of our portfolio's cash flow. We face the risk that we might not be able to meet our debt service obligations or a lender's margin requirements from our income and, to the extent we cannot, we might be forced to liquidate some of our assets at disadvantageous prices. Our use of leverage amplifies the risks associated with other risk factors, which could reduce our net income and the amount available for distributions or cause us to suffer a loss. For example:

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A majority of our borrowings are secured by our mortgage-backed securities, generally under repurchase agreements. A decline in the market value of our mortgage-backed securities used to secure these debt obligations could limit our ability to borrow or result in lenders requiring us to pledge additional collateral to secure our borrowings. In that situation, we could be required to sell mortgage-backed securities under adverse market conditions in order to obtain the additional collateral required by the lender. If these sales are made at prices lower than the carrying value of our mortgage-backed securities, we would experience losses.

A default under a mortgage-related asset that constitutes collateral for a loan could also result in an involuntary liquidation of the mortgage-related asset, including any cross-collateralized mortgage-backed securities. This circumstance would result in a loss to us to the extent that the value of our mortgage-related asset upon liquidation is less than the amount we borrowed against the mortgage-related asset.

To the extent we are compelled to liquidate qualified REIT assets to repay our debts or further collateralize them, our compliance with the REIT rules regarding our assets and our sources of income could be negatively affected, which could jeopardize our status as a REIT. Losing our REIT status would cause us to lose tax advantages applicable to REITs and would decrease our overall profitability and our distributions to our stockholders.

If we experience losses as a result of our leverage policy, such losses would reduce the amounts available for distribution to our stockholders.

We may incur increased borrowing costs related to repurchase agreements that would harm our results of operations.

Our borrowing costs under repurchase agreements are generally adjustable and correspond to short-term interest rates, such as LIBOR or a short-term Treasury index, plus or minus a margin. The margins on these borrowings over or under short-term interest rates may vary depending upon a number of factors, including, without limitation, the following:

the movement of interest rates;

the availability of financing in the market; and

the value and liquidity of our mortgage-backed securities.

Most of our borrowings are collateralized borrowings in the form of repurchase agreements. If the interest rates on these repurchase agreements increases, our results of operations will be harmed and we may have losses.

We have only been in business since June 2003 and our implementation of our operating policies and strategies may not continue to be successful.

We began operations in June 2003, and therefore have a limited operating history. Our results of operations depend on many factors, including the availability of opportunities to acquire mortgage-related assets, the level and volatility of interest rates, readily accessible short- and long-term funding alternatives in the financial markets and economic conditions. Moreover, delays in fully leveraging and investing the net proceeds of our public offerings may cause our performance to be weaker than other fully leveraged and invested mortgage REITs pursuing comparable investment strategies. Furthermore, we face the risk that our implementation of our operating policies and strategies may not continue to be successful.

Our board of directors may change our operating policies and strategies without stockholder approval or prior notice and such changes could harm our business and results of operations and the value of our stock.

Our board of directors has the authority to modify or waive our current operating policies and our strategies, including our election to operate as a REIT, without prior notice and without stockholder approval. We cannot predict the effect any changes to our current operating policies and strategies would have on our business, operating results and value of our stock. However, the effects might be adverse.

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We depend on our key personnel, and the loss of any of our key personnel could severely and detrimentally affect our operations.

We depend on the diligence, experience and skill of our officers and the Seneca personnel who provide management services to us for the selection, acquisition, structuring, monitoring and sale of our mortgage-related assets and the borrowings used to acquire these assets. Our key officers include Gail P. Seneca, Albert J. Gutierrez, Christopher J. Zyda, Andrew S. Chow and Troy A. Grande. We have not entered into employment agreements with our key officers other than Mr. Zyda, who is our Senior Vice President and Chief Financial Officer. With the exception of Mr. Zyda, none of our senior officers, including Ms. Seneca and Messrs. Gutierrez, Chow and Grande, devote all of their business time to our business and are free to engage in competitive activities in our industry. In addition, our management agreement with Seneca pursuant to which Ms. Seneca and Messrs. Gutierrez, Chow and Grande provide management services to us is terminable by Seneca at any time upon 60 days' notice. The loss of our key officers or the termination of our management agreement with Seneca could harm our business, financial condition, cash flow and results of operations.

Competition might prevent us from acquiring mortgage-backed securities at favorable yields, which would harm our results of operations.

Our net income depends on our ability to acquire mortgage-backed securities at favorable spreads over our borrowing costs. In acquiring mortgage-backed securities, we compete with other REITs, investment banking firms, savings and loan associations, banks, insurance companies, mutual funds, other lenders and other entities that purchase mortgage-backed securities, many of which have greater financial resources than we do. As a result, we may not be able to acquire sufficient mortgage-backed securities at favorable spreads over our borrowing costs, which would harm our results of operations.

Interest rate caps related to our mortgage-backed securities may reduce our net income or cause us to suffer a loss during periods of rising interest rates.

The mortgages underlying our mortgage-backed securities are typically subject to periodic and lifetime interest rate caps. Periodic interest rate caps limit the amount that the interest rate of a mortgage can increase during any given period. Lifetime interest rate caps limit the amount an interest rate can increase through the maturity of a mortgage.

Our borrowings are not subject to similar restrictions. The periodic adjustments to the interest rates of the mortgages underlying our mortgage-backed securities are based on changes in an objective index. Substantially all of the mortgages underlying our mortgage-backed securities adjust their interest rates based on one of two main indices, the U.S. Treasury index, which is a monthly or weekly average yield of benchmark U.S. Treasury securities published by the Federal Reserve Board, or LIBOR.

Accordingly, in a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while interest rate caps could limit the increases in the yields on our mortgage-backed securities. This problem is magnified for mortgage-backed securities that are not fully indexed. Further, some of the mortgages underlying our mortgage-backed securities may be subject to periodic payment caps that result in a portion of the interest being deferred and added to the principal outstanding. As a result, we may receive less cash income on our mortgage-backed securities than we need to pay interest on our related borrowings. These factors could reduce our net interest income or cause us to suffer a net loss.

We might experience reduced net interest income or a loss from holding fixed-rate investments during periods of rising interest rates.

A significant portion of our investment portfolio consists of hybrid adjustable-rate mortgage-backed securities. We may also invest in fixed-rate mortgage-backed securities from time to time. We fund our acquisition of fixed-rate mortgage-backed securities, including those based on balloon maturity and hybrid adjustable-rate mortgages, in part with short-term repurchase agreements and term loans. During periods of rising interest rates, our costs associated with borrowings used to fund the acquisition of fixed-rate mortgage-backed securities are subject to increases, while the income we earn from these assets remains substantially fixed. The reduction or elimination of the net interest spread between the fixed-rate mortgage-backed securities that we purchase and our borrowings used to purchase them would reduce our net interest income and could cause us to suffer a loss.

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We might not be able to use derivatives to mitigate our interest rate and prepayment risks.

Our policies permit us to enter into interest rate swaps, caps and floors and other derivative transactions in an effort to reduce our interest rate and prepayment risks. These transactions might mitigate our interest rate and prepayment risks, but cannot eliminate these risks. Moreover, the use of derivative transactions could have a negative impact on our net income and our status as a REIT and, therefore, our use of such derivatives could be limited.

We may enter into ineffective derivative transactions or other hedging activities that may reduce our net interest rate spread or cause us to suffer losses.

Our policies permit us, but we are not required, to enter into derivative transactions such as interest rate swaps, caps and floors and other derivative transactions to help us seek to reduce our interest rate and prepayment risks. The effectiveness of any derivative transaction will depend significantly upon whether we correctly quantify the interest rate or prepayment risks being hedged, our execution of and ongoing monitoring of our hedging activities and the treatment of such hedging activities under generally accepted accounting principles in the United States, or GAAP.

In the case of these hedges, and any other efforts to mitigate the effects of interest rate changes on our liability costs, if we enter into hedging instruments that have higher interest rates embedded in them as a result of the forward yield curve, and at the end of the term of these hedging instruments the spot market interest rates for the liabilities that we hedged are actually lower, then we will have locked in higher interest rates for our liabilities than would be available in the spot market at the time which could result in a narrowing of our net interest rate spread or result in losses. In some situations, we may sell assets or hedging instruments at a loss in order to maintain adequate liquidity.

In addition, we apply Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted, and record derivatives at fair value. If the derivatives meet the criteria to be accounted for as hedging transactions, the effects of the transactions could be materially different as to timing than if they do not qualify as hedges, which may cause a narrowing of our net interest rate spread or result in losses.

An increase in interest rates might adversely affect our book value.

We use changes in 10-year U.S. Treasury yields as a reference indicator for changes in interest rates because it is a common market benchmark. Increases in the general level of interest rates can cause the fair market value of our assets to decline, particularly those mortgage-backed securities whose underlying mortgages have fixed-rate components. Our fixed-rate mortgage-backed securities and our hybrid adjustable-rate mortgage-backed securities (during the fixed-rate component of the mortgages underlying such securities) will generally be more negatively affected by such increases than our adjustable-rate mortgage-backed securities. In accordance with GAAP, we will be required to reduce the carrying value of our mortgage-backed securities by the amount of any decrease in the fair value of our mortgage-backed securities compared to their respective amortized costs. If unrealized losses in fair value occur, we will have to either reduce current earnings or reduce stockholders' equity without immediately affecting current earnings, depending on how we classify such mortgage-backed securities under GAAP. In either case, our net book value will decrease to the extent of any realized or unrealized losses in fair value.

We may invest in leveraged mortgage derivative securities that generally experience greater volatility in market prices, and thus expose us to greater risk with respect to their rate of return.

We may acquire leveraged mortgage derivative securities that expose us to a high level of interest rate risk. The characteristics of leveraged mortgage derivative securities cause those securities to experience greater volatility in their market prices. Thus, acquisition of leveraged mortgage derivative securities will expose us to the risk of greater

volatility in our portfolio, which could reduce our net income and harm our overall results of operations.

Possible market developments could cause our lenders to require us to pledge additional assets as collateral. If our assets are insufficient to meet the collateral requirements, we might be compelled to liquidate particular assets at inopportune times and at disadvantageous prices.

Possible market developments, including a sharp or prolonged rise in interest rates, an increase in prepayment rates or increasing market concern about the value or liquidity of one or more types of mortgage-backed securities in which our portfolio is concentrated, might reduce the market value of our portfolio, which might cause our lenders to require additional collateral. Any requirement for

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additional collateral might compel us to liquidate our assets at inopportune times and at disadvantageous prices, thereby harming our operating results. If we sell our mortgage-backed securities at prices lower than their carrying value, we would experience losses.

Because the assets that we acquire might experience periods of illiquidity, we might be prevented from selling our mortgage-related assets at opportune times and prices.

We bear the risk of being unable to dispose of our mortgage-related assets at advantageous times and prices or in a timely manner because mortgage-related assets generally experience periods of illiquidity. The lack of liquidity might result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale. If we are unable to sell our mortgage-related assets at opportune times, we might suffer a loss and/or reduce our distributions.

We remain subject to losses despite our strategy of investing in highly-rated mortgage-backed securities.

Our investment guidelines provide that at least 90% of our assets must be invested in mortgage-backed securities that are either agency-backed or are rated at least investment grade by at least one nationally recognized statistical rating agency. While highly-rated mortgage-backed securities are generally subject to a lower risk of default than lower credit quality mortgage-backed securities and may benefit from third-party credit enhancements such as insurance or corporate guarantees, there is no assurance that such mortgage-backed securities will not be subject to credit losses. Furthermore, ratings are subject to change over time as a result of a number of factors, including greater than expected delinquencies, defaults or credit losses or a deterioration in the financial strength of corporate guarantors, any of which may reduce the market value of such securities. Furthermore, ratings do not take into account the reasonableness of the issue price, interest risks, prepayment risks, extension risks or other risks associated with such mortgage-backed securities. As a result, while we attempt to mitigate our exposure to credit risk on a relative basis by focusing on highly-rated mortgage-backed securities, we cannot eliminate such credit risks and remain subject to other risks to our investment portfolio and may suffer losses, which may harm the market price of our common stock.

Our investment guidelines permit us to invest up to 10% of our assets in unrated mortgage-related assets and mortgage-backed securities rated below investment-grade, which carry a greater likelihood of default or rating downgrade than investments in investment-grade mortgage-backed securities and may cause us to suffer losses.

Our investment guidelines allow us to invest up to 10% of our assets in lower credit quality mortgage-related assets, including mortgage-backed securities that are not rated at least investment grade by at least one nationally-recognized statistical rating organization, and other investments such as leveraged mortgage derivative securities, shares of other REITs, mortgage loans or other mortgage-related investments. If we acquire non-investment-grade mortgage-backed securities, which may include residual mortgage-backed securities, we are more likely to incur losses because the mortgages underlying those securities are made to borrowers possessing lower-quality credit. While all mortgage-backed securities are subject to a risk of default, that risk is greater with non-investment grade mortgage-backed securities. In addition, the rating agencies are more likely to downgrade the credit quality of those securities, which would reduce the value of those securities.

Our use of repurchase agreements to borrow funds may give our lenders greater rights in the event that either we or any of our lenders file for bankruptcy.

Our borrowings under repurchase agreements may qualify for special treatment under the bankruptcy code, giving our lenders the ability to avoid the automatic stay provisions of the bankruptcy code and to take possession of and liquidate our collateral under the repurchase agreements without delay if we file for bankruptcy. Furthermore, the

special treatment of repurchase agreements under the bankruptcy code may make it difficult for us to recover our pledged assets in the event that any of our lenders files for bankruptcy. Thus, the use of repurchase agreements exposes our pledged assets to risk in the event of a bankruptcy filing by any of our lenders or us.

Defaults on the mortgage loans underlying our mortgage-backed securities may reduce the value of our investment portfolio and may harm our results of operations.

We bear the risk of any losses resulting from any defaults on the mortgage loans underlying the mortgage-backed securities in our investment portfolio. Many of the mortgage-backed securities that we acquire have one or more forms of credit enhancement provided by third parties, such as insurance against risk of loss due to default on the underlying mortgage loans or bankruptcy, fraud and special hazard losses. To the extent that third parties have agreed to insure against these types of losses, the value of such insurance will depend in part on the creditworthiness and claims-paying ability of the insurer and the timeliness of reimbursement in

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the event of a default on the underlying obligations. Further, the insurance coverage for various types of losses is limited in amount, and we would bear losses in excess of these limitations.

Other mortgage-backed securities that we purchase are subject to limited guarantees of the payment of limited amounts of principal and interest on mortgage loans underlying such mortgage-backed securities, either by federal government agencies, including Ginnie Mae, by federally-chartered corporations, including Fannie Mae and Freddie Mac, or by other corporate guarantors. While Ginnie Mae's obligations are backed by the full faith and credit of the United States, the obligations of Fannie Mae and Freddie Mac and other corporate guarantors are solely their own. As a result, a substantial deterioration in the financial strength of Fannie Mae, Freddie Mac or other corporate guarantors could increase our exposure to future delinquencies, defaults or credit losses on our holdings of Fannie Mae or Freddie Mac-backed mortgage-backed securities or other corporate-backed mortgage-backed securities, and could harm our results of operations. In addition, while Freddie Mac guarantees the eventual payment of principal, it does not guarantee the timely payment thereof, and our results of operations may be harmed if borrowers are late or delinquent in their payments on mortgages underlying Freddie Mac-backed mortgage-backed securities. Moreover, Fannie Mae, Freddie Mac, Ginnie Mae and other corporate guarantees relate only to payments of limited amounts of principal and interest on the mortgages underlying such agency-backed or corporate-backed securities, and do not guarantee the market value of such mortgage-backed securities or the yields on such mortgage-backed securities. As a result, we remain subject to interest rate risks, prepayment risks, extension risks and other risks associated with our investment in such mortgage-backed securities and may experience losses in our investment portfolio.

Decreases in the value of the property underlying our mortgage-backed securities might decrease the value of our assets.

The mortgage-backed securities in which we invest are secured by underlying real property interests. To the extent that the value of the property underlying our mortgage-backed securities decreases, our security might be impaired, which might decrease the value of our assets.

Insurance will not cover all potential losses on the underlying real property and the absence thereof may harm the value of our assets.

Under our asset acquisition policy, we are permitted to invest up to a maximum of 10% of our total assets in assets other than agency-backed securities, or rated as at least investment grade by a nationally recognized statistical rating agency. Mortgage loans that fall outside of this category of investments under our investment guidelines are subject to the 10% limitation. If we elect to purchase mortgage loans, we may require that each of the mortgage loans that we purchase include comprehensive insurance covering the underlying real property, including liability, fire and extended coverage. Certain types of losses, however, generally of a catastrophic nature, such as earthquakes, floods and hurricanes, may be uninsurable or not economically insurable. Inflation, changes in building codes and ordinances, environmental considerations and other factors might also make it infeasible to use insurance proceeds to replace a property if it is damaged or destroyed. Under such circumstances, the insurance proceeds, if any, might not be adequate to restore the economic value of the underlying real property, which might impair our security and decrease the value of our assets.

Distressed mortgage loans have a higher risk of future default.

If we elect to purchase mortgage loans, we may purchase distressed mortgage loans as well as mortgage loans that have had a history of delinquencies. These distressed mortgage loans may be in default or may have a greater than normal risk of future defaults and delinquencies, compared to a pool of newly-originated, high quality loans of comparable type, size and geographic concentration. Returns on an investment of this type depend on accurate pricing of such investment, the borrower's ability to make required payments or, in the event of default, the ability of the loan's

servicer to foreclose and liquidate the mortgage loan. We cannot assure you that the servicer will be able to liquidate a defaulted mortgage loan in a cost-effective manner, at an advantageous price or in a timely manner.

Subordinated loans on real estate are subject to higher risks.

If we elect to purchase mortgage loans, we may acquire loans secured by commercial properties, including loans that are subordinated to first liens on the underlying commercial real estate. Subordinated mortgage loans are subject to greater risks of loss than first lien mortgage loans. An overall decline in the real estate market could reduce the value of the real property securing such loans such that the aggregate outstanding balance of the second-lien loan and the outstanding balance of the more senior loan on the real property exceed the value of the real property.

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Risks Related to Seneca

We pay Seneca incentive compensation based on our portfolio's performance. This arrangement may lead Seneca to recommend riskier or more speculative investments in an effort to maximize its incentive compensation.

In addition to its base management fee, Seneca earns incentive compensation for each fiscal quarter equal to a specified percentage of the amount by which our taxable income, before deducting incentive compensation, exceeds a return on equity based on the 10-year U.S. Treasury rate plus 2%. The percentage for this calculation is the weighted-average of the following percentages based on our average net invested assets for the fiscal quarter:

20% for the first \$400 million of our average net invested assets; and

10% of our average net invested assets in excess of \$400 million.

Pursuant to the formula for calculating Seneca's incentive compensation, Seneca shares in our profits but not in our losses. Consequently, as Seneca evaluates different mortgage-backed securities and other investments for our account, there is a risk that Seneca will cause us to assume more risk than is prudent in an attempt to increase its incentive compensation. Other key criteria related to determining appropriate investments and investment strategies, including the preservation of capital, might be under-weighted if Seneca focuses exclusively or disproportionately on maximizing its incentive income from us.

We may be obligated to pay Seneca incentive compensation even if we incur a loss.

Pursuant to the management agreement, Seneca is entitled to receive incentive compensation for each fiscal quarter in an amount equal to a tiered percentage of the excess of our taxable income for that quarter (before deducting incentive compensation, net operating losses and certain other items) above a threshold return for that quarter. In addition, the management agreement further provides that our taxable income for incentive compensation purposes excludes net capital losses that we may incur in the fiscal quarter, even if such capital losses result in us incurring net loss for that quarter. Thus, we may be required to pay Seneca incentive compensation for a fiscal quarter even if there is a decline in the value of our portfolio or we incur a net loss for that quarter.

Because Seneca is entitled to a significant fee if we terminate the management agreement, economic considerations might preclude us from terminating the management agreement in the event that Seneca fails to meet our expectations.

From time to time, we will assess whether we should be internally managed. In May 2004, our board of directors formed a committee of independent directors to assess the advisability of internalization and this assessment is currently ongoing. If we terminate the management agreement without cause or because we decide to manage our company internally or if Seneca terminates the management in the event of a change of control, then we will have to pay a significant fee to Seneca. The amount of the fee depends on whether:

we terminate the management agreement without cause in connection with a decision to manage our portfolio internally, in which case we will be obligated to pay to Seneca a fee equal to the highest amount of management fee incurred in a particular year during the then three most recent years; or

our decision to terminate the management agreement without cause is for a reason other than our decision to manage our portfolio internally, in which case we will be obligated to pay Seneca an amount equal to two times the highest amount of management fee incurred in a particular year during the then three most recent years.

In each of the above cases, Seneca will also receive accelerated vesting of the stock component of its incentive compensation. The actual amount of such fee cannot be known at this time because it is based in part on the performance of our portfolio of mortgage-backed securities. Paying this fee would reduce significantly the cash available for distribution to our stockholders and might cause us to suffer a net operating loss. Consequently, terminating the management agreement might not be advisable even if we determine that it would be more efficient to operate with an internal management structure or if we are otherwise dissatisfied with Seneca's performance.

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Seneca's liability is limited under the management agreement, and we have agreed to indemnify Seneca against certain liabilities.

Seneca has not assumed any responsibility to us other than to render the services described in the management agreement, and is not responsible for any action of our board of directors in declining to follow Seneca's advice or recommendations. Seneca and its directors, officers and employees will not be liable to us for acts performed by its officers, directors or employees in accordance with and pursuant to the management agreement, except for acts constituting gross negligence, recklessness, willful misconduct or active fraud in connection with their duties under the management agreement. We have agreed to indemnify Seneca and its directors, officers and employees with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from acts of Seneca not constituting gross negligence, recklessness, willful misconduct or active fraud.

Seneca might allocate mortgage-related opportunities to other entities, and thus might divert attractive investment opportunities away from us.

Our operations and assets are managed by specified individuals at Seneca. Seneca and those individuals, including some of our officers, manage mortgage and other portfolios for parties unrelated to us. These multiple responsibilities might create conflicts of interest for Seneca and these individuals if they are presented with opportunities that might benefit us and Seneca's other clients. Seneca and these individuals must allocate investments among our portfolio and their other clients by determining the entity or account for which the investment is most suitable. In making this determination, Seneca and these individuals consider the investment strategy and guidelines of each entity or account with respect to the acquisition of assets, leverage, liquidity and other factors that Seneca and these individuals determine to be appropriate. However, Seneca and those working on its behalf have no obligation to make any specific investment opportunities available to us and the above-mentioned conflicts of interest might result in decisions or allocations of investments that are not in our or our stockholders' best interests.

Seneca may render services to other mortgage investors, which could reduce the amount of time and effort that Seneca devotes to us.

Our management agreement with Seneca does not restrict the right of Seneca or any persons working on its behalf to carry on their respective businesses, including the rendering of advice to others regarding the purchase of mortgage-backed securities that would meet our investment criteria. In addition, the management agreement does not specify a minimum time period that Seneca and its personnel must devote to managing our investments. The ability of Seneca to engage in these other business activities, and specifically to manage mortgage-related assets for third parties, could reduce the time and effort it spends managing our portfolio to the detriment of our investment returns.

Seneca has significant influence over our affairs, and might cause us to engage in transactions that are not in our or our stockholders' best interests.

In addition to managing us and having two of its officers as members of our board, Seneca provides advice on our operating policies and strategies. Seneca may also cause us to engage in future transactions with Seneca and its affiliates, subject to the approval of, or guidelines approved by, the independent members of our board of directors. Our directors, however, rely primarily on information supplied by Seneca in reaching their determinations. Accordingly, Seneca has significant influence over our affairs, and may cause us to engage in transactions that are not in our or our stockholders' best interests.

Seneca has limited experience managing a REIT and we cannot assure you that Seneca's past experience will be sufficient to manage our business as a REIT successfully.

Seneca has limited experience managing a REIT, and limited experience in complying with the income, asset and other limitations imposed by the REIT provisions of the Internal Revenue Code. Those provisions are complex and the failure to comply with those provisions in a timely manner could cause us to lose our qualification as a REIT or could force us to pay unexpected taxes and penalties. In such event, our net income would be reduced and we could incur a loss.

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During periods of declining market prices for our common stock, we may be required to issue greater numbers of shares to Seneca for the same amount of incentive compensation arising under the management agreement, which will have a dilutive effect on our stockholders that may harm the market price of our common stock.

Pursuant to the terms of the management agreement, the incentive compensation payable to Seneca for each fiscal quarter is paid one-half in cash and one-half in restricted shares of our common stock. The number of shares to be issued to Seneca is based on (a) one-half of the total incentive compensation for the period, divided by (b) the average of the closing prices of our common stock over the 30-day period ending three calendar days prior to the grant date, less a fair market value discount determined by our board of directors on a quarterly basis. During periods of declining market prices of our common stock, we may be required to issue more shares to Seneca for the same amount of incentive compensation. Although these shares are subject to restrictions on transfer that lapse ratably over a three-year period, the issuance of these shares will have a dilutive effect on our stockholders that may harm the market price of our common stock.

Investors may not be able to estimate with certainty the aggregate fees and expense reimbursements that will be paid to Seneca under the management agreement and the cost-sharing agreement due to the time and manner in which Seneca's incentive compensation and expense reimbursements are determined.

Seneca may be entitled to substantial fees pursuant to the management agreement. Seneca's base management fee is calculated as a percentage of our average net worth. Seneca's incentive compensation is calculated as a tiered percentage of our taxable income, before deducting certain items, in excess of a threshold amount of taxable income and is indeterminable in advance of a particular period. Since future payments of base management fees, incentive compensation and expense reimbursements are determined at future dates based upon our then-applicable average net worth, results of operations and actual expenses incurred by Seneca, such fees and expense reimbursements cannot be estimated with mathematical certainty. Any base management fees, incentive compensation or expense reimbursements payable to Seneca may be materially greater or less than the historical amounts and we can provide no assurance at this time as to the amount of any such base management fee, incentive compensation or expense reimbursements that may be payable to Seneca in the future.

Legal and Tax Risks

If we are disqualified as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability.

Qualification as a REIT involves the application of highly technical and complex U.S. federal income tax code provisions for which only a limited number of judicial or administrative interpretations exist. Accordingly, it is not certain we will be able to remain qualified as a REIT for U.S. federal income tax purposes. Even a technical or inadvertent mistake could jeopardize our REIT status. Furthermore, Congress or the Internal Revenue Service (the IRS), might change tax laws or regulations and the courts might issue new rulings, in each case potentially having retroactive effect, that could make it more difficult or impossible for us to qualify as a REIT in a particular tax year. If we fail to qualify as a REIT in any tax year, then:

we would be taxed as a regular domestic corporation, which, among other things, means that we would be unable to deduct distributions to our stockholders in computing taxable income and we would be subject to U.S. federal income tax on our taxable income at regular corporate rates;

any resulting tax liability could be substantial, would reduce the amount of cash available for distribution to our stockholders and could force us to liquidate assets at inopportune times, causing lower income or higher losses than would result if these assets were not liquidated; and

unless we were entitled to relief under applicable statutory provisions, we would be disqualified from treatment as a REIT for the subsequent four taxable years following the year during which we lost our qualification and, thus, our cash available for distribution to our stockholders would be reduced for each of the years during which we did not qualify as a REIT.

Even if we remain qualified as a REIT, we might face other tax liabilities that reduce our cash flow. Further, we might be subject to federal, state and local taxes on our income and property. Any of these taxes would decrease cash available for distribution to our stockholders.

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Complying with the REIT requirements might cause us to forego otherwise attractive opportunities.

In order to qualify as a REIT for U.S. federal income tax purposes, we must satisfy tests concerning, among other things, our sources of income, the nature and diversification of our mortgage-backed securities, the amounts we distribute to our stockholders and the ownership of our stock. We may also be required to make distributions to our stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may cause us to forego opportunities we would otherwise pursue.

In addition, the REIT provisions of the Internal Revenue Code impose a 100% tax on income from prohibited transactions. Prohibited transactions generally include sales of assets that constitute inventory or other property held for sale in the ordinary course of a business, other than foreclosure property. This 100% tax could impact our desire to sell mortgage-backed securities at otherwise opportune times if we believe such sales could be considered a prohibited transaction.

Complying with the REIT requirements may limit our ability to hedge effectively.

The existing REIT provisions of the Internal Revenue Code substantially limit our ability to hedge mortgage-backed securities and related borrowings. Under these provisions, our annual income from qualified hedges, together with any other income not generated from qualified REIT real estate assets, is limited to less than 25% of our gross income. In addition, we must limit our aggregate income from hedging and services from all sources, other than from qualified REIT real estate assets or qualified hedges, to less than 5% of our annual gross income. As a result, we might in the future have to limit our use of advantageous hedging techniques, which could leave us exposed to greater risks associated with changes in interest rates than we would otherwise want to bear. If we fail to satisfy the 25% or 5% limitations, unless our failure was due to reasonable cause and we meet certain other technical requirements, we could lose our REIT status for federal income tax purposes. Even if our failure were due to reasonable cause, we might have to pay a penalty tax equal to the amount of our income in excess of certain thresholds, multiplied by a fraction intended to reflect our profitability.

Complying with the REIT requirements may force us to borrow to make distributions to our stockholders.

As a REIT, we must distribute 90% of our annual taxable income (subject to certain adjustments) to our stockholders. From time to time, we might generate taxable income greater than our net income for financial reporting purposes from, among other things, amortization of capitalized purchase premiums, or our taxable income might be greater than our cash flow available for distribution to our stockholders. If we do not have other funds available in these situations, we might be unable to distribute 90% of our taxable income as required by the REIT rules. In that case, we would need to borrow funds, sell a portion of our mortgage-backed securities potentially at disadvantageous prices or find another alternative source of funds. These alternatives could increase our costs or reduce our equity and reduce amounts available to invest in mortgage-backed securities.

Complying with the REIT requirements may force us to liquidate otherwise attractive investments.

In order to qualify as a REIT, we must ensure that at the end of each calendar quarter at least 75% of the value of our assets consists of cash, cash items, government securities and qualified REIT real estate assets. The remainder of our investment in securities generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, generally, no more than 5% of the value of our assets can consist of the securities of any one issuer. If we fail to comply with these requirements, we could lose our REIT status unless we are able to avail ourselves of certain relief provisions. Under certain relief provisions, we would be subject to penalty taxes.

Failure to maintain an exemption from the Investment Company Act would harm our results of operations.

We intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act of 1940, as amended. If we fail to qualify for this exemption, our ability to use leverage would be substantially reduced and we would be unable to conduct our business as described in this prospectus.

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. Under the current interpretation of the SEC, in order to qualify for this exemption, we must maintain at least 55% of our assets directly in these qualifying real estate interests. Mortgage-backed securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as separate from the

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underlying mortgage loans and, thus, may not qualify for purposes of the 55% requirement. Therefore, our ownership of these mortgage-backed securities is limited by the provisions of the Investment Company Act.