LUMINENT MORTGAGE CAPITAL INC
Form 10-K
March 14, 2005

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

**Form 10-K**
**FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO**
**SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

(Mark One)

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

**For the fiscal year ended December 31, 2004**

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

**For the transition period from to .**

**Commission file number 001-31828**
**LUMINENT MORTGAGE CAPITAL, INC.**
*(Exact name of registrant as specified in its charter)*

| | |
|---|---|
| **Maryland** | **06-1694835** |
| *(State or other jurisdiction of incorporation or organization)* | *(I.R.S. Employer Identification No.)* |
| **909 Montgomery Street, Suite 500 San Francisco, California** | **94133** |
| *(Address of principal executive offices)* | *(Zip Code)* |

**Registrant s telephone number, including area code:**
**(415) 486-2110**
**Securities registered pursuant to Section 12(b) of the Act:**

| **Title of Each Class** | **Name of Each Exchange on Which Registered** |
|---|---|
| Common Stock, par value $0.001 per share | New York Stock Exchange |

**Securities registered pursuant to Section 12(g) of the Act:**
**None**

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 requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in a definitive proxy or information statement incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes þ No o

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of June 30, 2004 was $437,481,924, based on 36,456,827 shares of our common stock then held by non-affiliates and a the price at which our common stock was last sold on the New York Stock Exchange as of such date.

The number of shares of our common stock outstanding on February 28, 2005 was 37,841,280.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of our proxy statement for our 2005 Annual Meeting of Stockholders are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III of this Annual Report on Form 10-K.

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EXHIBIT 32.2

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## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are those that are not historical in nature. They can often be identified by their inclusion of words such as will, anticipate, estimate, should, expect, believe, and similar expressions. Any projection of revenues, earnings or losses, capital expenditures, distributions, capital structure or other financial terms is a forward-looking statement.

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 statements. Some of the important factors that could cause our actual results, performance or financial condition to differ materially from 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, or Seneca, 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;
- 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; and
- the other important factors described in this Annual Report on Form 10-K, including those under the captions Management s Discussion and Analysis of Financial Condition and Results of Operations, Risk Factors and Quantitative and Qualitative Disclosures about Market Risk.

We undertake no obligation to publicly update 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 by our forward-looking events might not occur. We qualify any and all of our forward-looking statements by these cautionary factors. In addition, you should carefully review the risk factors described in other documents we file from time to time with the Securities and Exchange Commission, including the Quarterly Reports on Form 10-Q to be filed by Luminent Mortgage Capital, Inc. in 2005.

This Annual Report on Form 10-K contains market data, industry statistics and other data that have been obtained from, or compiled from, information made available by third parties. We have not independently verified their data.

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# PART I

## Item 1. *Business*

## Our Company

### Background

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 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 are externally managed and advised by Seneca Capital Management LLC, or 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 Real Estate Investment Trust, or REIT, under the Internal Revenue Code of 1986, as amended. As such, we will routinely distribute substantially all of the REIT taxable net 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 taxes on our income to the extent that we distribute our net income to our stockholders.

In February 2005, we entered into a Controlled Equity Offering Sales Agreement with Cantor Fitzgerald & Co., pursuant to the shelf registration statement on Form S-3 filed on January 3, 2005. See Note 14 to our financial statements in Item 8 of this Annual Report on Form 10-K for further discussion.

Effective March 9, 2005, we hired S. Trezevant Moore, Jr. as our President and Chief Operating Officer. In conjunction with Mr. Moore s appointment, Albert J. Gutierrez has resigned as President but continues to concentrate on management of our agency and AAA mortgage-backed securities portfolio.

### Assets

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. See Note 3 to our financial statements included in Item 8 of this Annual Report on Form 10-K for further discussion.

We have acquired and will seek to acquire additional assets 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. We expect that substantially all of the mortgage-backed securities that we acquire will be agency-backed or have AAA credit ratings from at least one nationally-recognized statistical rating agency, and most of the securities will be hybrid adjustable-rate mortgage-backed securities.

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We review the credit risk associated with each potential investment and may diversify our portfolio to avoid undue geographic, insurer, 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.

We have financed our acquisition of mortgage-backed securities 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.

**Borrowings**

On December 31, 2004, we had borrowing arrangements with 17 different investment banking firms and other lenders, 12 of which were in use as of that date. These borrowing arrangements facilitated the purchase of our initial portfolio of securities through the leveraging of our private placement proceeds and provided us with sufficient borrowing capacity to fully leverage the net proceeds of our initial public offering and follow-on public offering. The repurchase agreements are secured by mortgage-backed securities. We intend to seek to renew repurchase agreements as they mature under the then-applicable borrowing terms of the counterparties to our repurchase agreements. See Note 4 to our financial statements in Item 8 of this Annual Report on Form 10-K for further discussion.

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 interest rate adjustment periods and the selection of interest rate indices on our mortgage-backed securities in order to manage our liquidity and interest rate related risks.

**Hedging**

We may choose to engage in various hedging activities designed to match more closely the terms of our assets and liabilities. Hedging involves risk and typically involves costs, including transaction costs. The costs of hedging can increase as the periods covered by the hedging increase and during periods of rising and volatile interest rates. We may increase our hedging activity and, thus, increase our hedging costs during such periods when interest rates are volatile or rising. We generally intend to hedge as much of the interest rate risk as Seneca determines is in the best interest of our stockholders, after considering the cost of such hedging transactions and our desire to maintain our status as a REIT. Our policies do not contain specific requirements as to the percentages or amount of interest rate risk that we hedge. There can be no assurance that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Moreover, no hedging activity can completely insulate us from the risks associated with changes in interest rates and prepayment rates.

At December 31, 2004, we have engaged in short sales of Eurodollar futures contracts as a means of mitigating our interest rate risk on forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements for a specified future time period, which is defined as the calendar quarter immediately following the contract expiration date. At December 31, 2004, we have also entered into interest rate swap contracts to mitigate our interest rate risk associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements for the period defined by maturity of the interest rate swap. See Note 12 to our financial statements in Item 8 of this Annual Report on Form 10-K for further discussion.

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## Business Strategy

### Our Operating Policies and Programs

Our board of directors has established the following four primary operating policies to implement our business strategies:

- asset acquisition policy;
- capital/liquidity and leverage policies;
- credit risk management policy; and
- asset/liability management policy.

***Asset Acquisition Policy***

Our asset acquisition policy provides guidelines for acquiring investments in order to maintain compliance with our overall investment strategy. In particular, we acquire a portfolio of investments that can be grouped into specific categories. Each category and our respective investment guidelines are as follows:

*Category I* At least 75% of our total assets will generally be residential mortgage-related securities and short-term investments. Assets in this category are rated within one of the two highest rating categories by at least one nationally-recognized statistical rating organization, or will be obligations guaranteed by federal agencies or federally chartered agencies, such as Fannie Mae, Freddie Mac or Ginnie Mae.

*Category II* At least 90% of our total assets will consist of Category I investments plus mortgage-related securities that are rated at least investment grade by at least one nationally-recognized statistical rating organization.

*Category III* No more than 10% of our total assets may be of a type not meeting any of the above criteria. Among the types of assets generally assigned to this category are mortgage-related securities rated below investment grade and leveraged mortgage derivative securities, shares of other REITs or other investments.

We expect to acquire only those mortgage-related assets that we believe our manager has the necessary expertise to evaluate and manage, that we can readily finance and that are consistent with our overall investment strategy and our asset acquisition policy. Generally, we expect to hold our mortgage-backed securities until maturity. Therefore, we generally do not seek to acquire assets with investment returns that are attractive only in a limited range of scenarios. Future interest rates and mortgage prepayment rates are difficult to predict and, as a result, we seek to acquire mortgage-backed securities that we believe provide acceptable returns over a broad range of interest rate and prepayment scenarios.

We expect most of our acquisitions to consist of adjustable-rate mortgage-backed securities, hybrid adjustable-rate mortgage-backed securities and fixed-rate mortgage-backed securities. We anticipate that our investments in fixed-rate mortgage-backed securities will be focused in shorter-term mortgages, including balloon mortgages. We may, however, purchase longer-term fixed-rate mortgage-backed securities if we view the potential net returns as attractive or if the acquisition of such assets serves to reduce or diversify the overall risk profile of our portfolio.

***Capital/ Liquidity and Leverage Policies***

We employ a leverage strategy to increase our investment assets by borrowing against existing mortgage-backed securities and using the proceeds to acquire additional mortgage-backed securities. We generally seek to borrow between eight to 12 times the amount of our equity, although our borrowings may vary from time to time depending on market conditions and other factors deemed relevant by our manager and our board of directors. We believe that this strategy provides us an adequate capital base to protect against interest rate environments in which our borrowing costs might exceed our interest income from mortgage-backed securities.

Depending on the different cost of borrowing funds at different maturities, we expect to vary the maturities of our borrowed funds to attempt to produce lower borrowing costs. In general, our borrowings are short-term. We actively manage, on an aggregate basis, both the interest rate indices and interest rate adjustment periods of our borrowings against the interest rate indices and interest rate adjustment periods related to our mortgage-backed securities.

We expect to continue to finance our mortgage-backed securities primarily at short-term borrowing rates through repurchase agreements and, to a lesser extent, our equity capital. We anticipate that, upon repayment of each borrowing under a repurchase agreement, we will use the collateral immediately for borrowing under a new repurchase agreement. In the future we may also employ borrowings under lines of credit, term loans and other collateralized financings that we may establish with approved institutional lenders and we may employ long-term borrowings.

On December 31, 2004, we had established borrowing arrangements with 17 different investment banking firms and other lenders. A repurchase agreement, although structured as a sale and repurchase obligation, acts as a financing under which we effectively pledge our mortgage-backed securities as collateral to secure a short-term loan. Generally, the other party to the agreement makes the loan in an amount equal to a percentage of the market value of the pledged collateral. At the maturity of the repurchase agreement, we are required to repay the loan and correspondingly receive back our collateral. While used as collateral, the mortgage-backed securities continue to pay principal and interest to us. In the event of our insolvency or bankruptcy, certain repurchase agreements may qualify for special treatment under the U.S. Federal Bankruptcy Code, the effect of which, among other things, would be to allow the creditor under the agreement to avoid the automatic stay provisions of the U.S. Federal Bankruptcy Code and to foreclose on the collateral without delay. In the event of the insolvency or bankruptcy of the lender during the term of a repurchase agreement, the lender may be permitted, under applicable insolvency laws, to repudiate the agreement, and our claim against the lender for damages may be treated simply as an unsecured creditor. In addition, if the lender is a broker or dealer subject to the Securities Investor Protection Act of 1970, or an insured depository institution subject to the Federal Deposit Insurance Act, our ability to exercise our rights to recover our securities under a repurchase agreement or to be compensated for any damages resulting from the lender s insolvency may be further limited by those statutes. These claims would be subject to significant delay and, if and when received, may be substantially less than the damages we actually incur. As a result, we expect to enter into collateralized borrowings only with institutions that we believe are financially sound and which are rated investment grade by at least one nationally-recognized statistical rating organization.

Substantially all of our borrowing agreements require us to deposit additional collateral in the event the market value of existing collateral declines, which may require us to sell assets to reduce our borrowings. We have designed our liquidity management policy to maintain an adequate capital base sufficient to provide required liquidity to respond to the effects under our borrowing arrangements of interest rate movements and changes in the market value of our mortgage-backed securities. However, a major disruption in the repurchase or other market that we rely on for short-term borrowings would harm our results of operations unless we were able to arrange alternative sources of financing on comparable terms.

***Credit Risk Management Policy***

We review credit risk associated with each of our potential investments, and seek to reduce risk from sellers and servicers by obtaining representations and warranties. In addition, we seek to diversify our portfolio of mortgage-backed securities to avoid undue geographic, insurer, industry and certain other types of concentration risk. Our manager monitors the overall portfolio risk in order to determine appropriate levels of provision for losses we may experience.

We generally determine, at the time of purchase, whether or not a mortgage-related asset complies with our credit risk management policy guidelines, based upon the most recent information utilized by us. Such compliance is not expected to be affected by events subsequent to such purchase, such as changes in

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characterization, value or rating of any specific mortgage-related assets or economic conditions or events generally affecting any mortgage-related assets of the type we hold.

***Asset/Liability Management Policy***

*Interest Rate Risk Management.* To the extent consistent with maintaining our status as a REIT, we seek to manage our interest rate risk exposure to protect our portfolio of mortgage-backed securities and related debt against the effects of major interest rate changes. We generally seek to manage our interest rate risk by:

- monitoring and adjusting, if necessary, the interest rate sensitivity of our mortgage-backed securities compared with the interest rate sensitivities of our borrowings;

- attempting to structure our borrowing agreements to have a range of different maturities, terms, amortizations and interest rate adjustment periods;

- using derivatives, financial futures, swaps, options, caps, floors and forward sales, to adjust the interest rate sensitivity of our mortgage-backed securities and our borrowings; and

- actively managing, on an aggregate basis, the interest rate indices, interest rate adjustment periods, and gross reset margins of our mortgage-backed securities and the interest rate indices and adjustment periods of our borrowings.

As a result, we expect to be able to adjust the average maturity/adjustment period of our borrowings on an ongoing basis by changing the mix of maturities and interest rate adjustment periods as borrowings mature or are renewed. Through the use of these procedures, we attempt to reduce the risk of differences between interest rate adjustment periods of our adjustable-rate mortgage-backed securities and our related borrowings.

We manage the assets in our portfolio with regard to risk characteristics such as duration, in order to carefully limit the overall interest rate risk of our portfolio. On occasion, we may alter the overall duration in order to better protect the portfolio in order to protect stockholder value. Similarly, we manage the duration of our liabilities. Generally, we seek to reduce the gap between the duration of our assets and our liabilities to a level that is consistent with protection of the portfolio during volatile interest rate environments. The means by which we seek to accomplish this objective will vary over time, and may include the use of hedging instruments and the alteration of the duration of the asset and/or the liability side of our balance sheet through asset purchases or sales and through the assumption or the retirement of repurchase agreements of varying maturities or the structuring of other financing arrangements.

Depending on market conditions and the cost of the transactions, we may conduct hedging activities in connection with our portfolio management. When we engage in hedging activities, we intend to do so in a manner consistent with our election to qualify as a REIT. The goal of any hedging strategy we adopt will be to lessen the effects of interest rate changes and to enable us to earn net interest income in periods of generally rising, as well as declining or static, interest rates. Specifically, consistent with our existing hedging program, any future hedging program would likely be formulated with the intent to offset some of the potential adverse effects of changes in interest rate levels relative to the interest rates on the mortgage-backed securities held in our investment portfolio, as well as differences between the interest rate adjustment indices and maturity or reset periods related to our mortgage-backed securities and our borrowings. See further discussion of our current hedging program at Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations, Critical Accounting Policies Accounting for Derivative Financial Instruments and Hedging Activities, Financial Condition Hedging Instruments as well as Note 12 to our financial statements included in Item 8 Derivative Instruments and Hedging Activities.

Under the REIT rules of the Internal Revenue Code, some hedging activities produce income that is not qualifying income for purposes of the REIT gross income tests or create assets that are not qualifying assets for purposes of the REIT assets test. As a result, we may have to terminate certain hedging activities before the benefits of such activities are realized. In the case of excess hedging income, we would be required to pay a penalty tax for failure to satisfy certain REIT income tests under the Internal Revenue Code if the excess is

due to reasonable cause and not willful neglect. If we had excess hedging income in relation to our mortgage-related assets, the penalty would result in our disqualification as a REIT. In addition, asset/liability management involves transaction costs that increase dramatically as the period covered by hedging protection increases and that may increase during periods of fluctuating interest rates.

*Prepayment Risk Management.* We also seek to lessen the effects of prepayment of mortgage loans underlying our securities at a faster or slower rate than anticipated. We expect to accomplish this objective by using a variety of techniques that include, without limitation, structuring a diversified portfolio with a variety of prepayment characteristics, investing in mortgage-backed securities based on mortgage loans with prepayment prohibitions and penalties, investing in certain mortgage security structures that have prepayment protections and purchasing mortgage-backed securities at a premium and at a discount. We monitor prepayment risk through the periodic review of the impact of a variety of prepayment scenarios on our revenues, net earnings, distributions, cash flow and net balance sheet market value.

We believe that we have developed cost-effective asset/liability management policies to mitigate interest rate and prepayment risks. We monitor our risk management strategies on a regular basis as market conditions change. However, no strategy can completely insulate us from interest rate and prepayment risks. Further, as noted above, certain of the U.S. federal income tax requirements that we must satisfy to qualify as a REIT limit our ability to fully hedge our interest rate and prepayment risks. Therefore, we could be prevented from effectively hedging our interest rate and prepayment risks.

## Description of Mortgage-Related Assets

### *Mortgage-Backed Securities*

*Pass-Through Certificates.* We expect to invest principally in pass-through certificates, which are securities representing interests in pools of mortgage loans secured by residential real property in which payments of both interest and principal on the securities are generally made monthly. In effect, these securities pass through the monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer or guarantor of the securities. Pass-through certificates can be divided into various categories based on the characteristics of the underlying mortgages, such as the term or whether the interest rate is fixed or variable.

A key feature of most mortgage loans is the ability of the borrower to repay principal earlier than scheduled, which we refer to as a prepayment. Prepayments can arise due to sale of the underlying property, refinancing, foreclosure or other events. Prepayments result in a return of principal to pass-through certificate holders. This return may result in a lower or higher rate of return upon reinvestment of principal, and is generally referred to as prepayment uncertainty. If a security purchased at a premium prepays at a higher than expected rate, then the value of the premium would be eroded at a faster than expected rate. Similarly, if a discount mortgage prepays at a lower than expected rate, the amortization towards par would be accumulated at a slower than expected rate. We refer to the possibility of these undesirable effects as prepayment risk.

In general, but not always, declining interest rates tend to increase prepayments, and rising interest rates tend to slow prepayments. Like other fixed-income securities, when interest rates rise, the value of mortgage-backed securities generally decline. The rate of prepayments on underlying mortgages will affect the price and volatility of mortgage-backed securities and may have the effect of shortening or extending the effective maturity of the security beyond what was anticipated at the time of purchase. If interest rates rise, our holdings of mortgage-backed securities may experience reduced returns if the borrowers of the underlying mortgages pay off their mortgages later than anticipated, which we refer to as extension risk.

Payment of limited amounts of principal and interest on some mortgage pass-through securities, although not the market value of the securities themselves, may be guaranteed by the full faith and credit of the federal government, including securities backed by Ginnie Mae, or by agencies or instrumentalities of the federal government, including Fannie Mae or Freddie Mac. Mortgage-backed securities created by non-governmental issuers, including commercial banks, savings and loan institutions, private mortgage insurance companies, mortgage bankers and other secondary market issuers, may be supported by various forms of insurance or

guarantees, including individual loan, title, pool and hazard insurance and letters of credit, which may be issued by governmental entities, private insurers or the mortgage poolers.

The mortgage loans underlying pass-through certificates can generally be classified in the following four categories:

*Adjustable-Rate Mortgages.* Adjustable-rate mortgages, or ARMs, are those for which the borrower pays an interest rate that varies over the term of the loan. The interest rate usually resets based on market interest rates, although the adjustment of such an interest rate may be subject to certain limitations. Traditionally, interest rate resets occur at fixed intervals (for example, once per year). We refer to such ARMs as traditional ARMs. Because the interest rates on ARMs fluctuate based on market conditions, ARMs tend to have interest rates that do not deviate from current market rates by a large amount. ARMs may therefore have less price sensitivity to interest rates.

*Fixed-Rate Mortgages.* Fixed-rate mortgages are those where the borrower pays an interest rate that is constant throughout the term of the loan. Traditionally, most fixed-rate mortgages have an original term of 30 years. However, shorter terms (also referred to as final maturity dates) have become common in recent years. Because the interest rate on the loan never changes, even when market interest rates change, over time there can be a divergence between the interest rate on the loan and current market interest rates, which in turn can make a fixed-rate mortgage s price sensitive to market fluctuations in interest rates. In general, the longer the remaining term on the mortgage loan, the greater the price sensitivity. One way to attempt to lower the price sensitivity of a portfolio of fixed-rate mortgages is to buy those with shorter remaining terms or maturities.

*Hybrid Adjustable-Rate Mortgages.* A recent development in the mortgage market has been the popularity of ARMs that do not reset at regular intervals. Many of these ARMs have a fixed-rate for the first few years of the loan typically three, five, seven or 10 years and thereafter reset periodically like a traditional ARM. Effectively such mortgages are hybrids, combining the features of a pure fixed-rate mortgage and a traditional ARM. Hybrid ARMs have a price sensitivity to interest rates similar to that of a fixed-rate mortgage during the period when the interest rate is fixed and similar to that of an ARM when the interest rate is in its periodic reset stage. However, because many hybrid ARMs are structured with a relatively short initial time span during which the interest rate is fixed, even during that segment of its existence, the price sensitivity may be low.

*Balloon Maturity Mortgages.* Balloon maturity mortgages are a type of fixed-rate mortgage. Thus, they have a static interest rate for the life of the loan. However the term of the loan is usually quite short and is less than the amortization schedule of the loan. Typically, this term or maturity is less than seven years. When the mortgage matures, the investor receives all of his principal back, which effectively is a price reset of the invested principal to par. As the balloon maturity mortgage approaches its maturity date, the price sensitivity of the mortgage declines. In fact, the price sensitivity for an agency balloon mortgage with a set maturity is actually lower than that for an agency hybrid ARM with the same time to interest rate reset.

*Collateralized Mortgage Obligations.* Collateralized mortgage obligations, or CMOs, are a type of mortgage-backed security. Interest and principal on a CMO are paid, in most cases, on a monthly basis. CMOs may be collateralized by whole mortgage loans, but are more typically collateralized by portfolios of mortgage pass-through securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. CMOs are structured into multiple classes, or tranches, with each class bearing a different stated maturity. Monthly payments of principal, including prepayments, are first returned to investors holding the shortest maturity class; investors holding the longer maturity classes receive principal only after the first class has been retired.

Generally, fixed-rate mortgages are used to collateralize CMOs. However, the CMO tranches need not all have fixed-rate coupons. Some CMO tranches have floating rate coupons that adjust based on market interest rates, subject to some limitations. Such tranches, often called CMO floaters, can have relatively low price sensitivity.

*Mortgage Derivative Securities.* We may acquire mortgage derivative securities in an amount not to exceed 10% of our total assets. Mortgage derivative securities allow the holder to receive interest only, principal only or interest and principal in amounts that are disproportionate to those payable on the underlying mortgage loans. Payments on mortgage derivative securities can be highly sensitive to the rate of prepayments on the underlying mortgage loans. In the event of faster or slower than anticipated prepayments on these mortgage loans, the rates of return on interests in mortgage derivative securities representing the right to receive interest only or a disproportionately large amount of interest, or interest only derivatives, would be likely to decline or increase, respectively. Conversely, the rates of return on mortgage derivative securities representing the right to receive principal only or a disproportionate amount of principal, or principal only derivatives, would be likely to increase or decrease in the event of faster or slower prepayment speeds, respectively.

We may also invest in inverse floaters, a class of CMOs with a coupon rate that resets in the opposite direction from the market rate of interest to which it is indexed, including LIBOR or the 11th District Cost of Funds Index, or COFI. Any rise in the index rate, which can be caused by an increase in interest rates, causes a drop in the coupon rate of an inverse floater while any drop in the index rate causes an increase in the coupon rate of an inverse floater. An inverse floater may behave like a leveraged security since its interest rate usually varies by a magnitude much greater than the magnitude of the index rate of interest. The leverage-like characteristics inherent in inverse floaters are associated with greater volatility in their market prices.

We may also invest in other mortgage derivative securities that may be developed in the future.

*Subordinated Interests.* We may also acquire subordinated interests, which are classes of mortgage-backed securities that are junior to other classes of the same series of mortgage-backed securities in the right to receive payments from the underlying mortgage loans. The subordination may be for all payment failures on the mortgage loans securing or underlying such series of mortgage securities. The subordination will not be limited to those resulting from particular types of risks, including those resulting from war, earthquake or flood, or the bankruptcy of a borrower. The subordination may be for the entire amount of the series of mortgage-related securities or may be limited in amount.

***Mortgage Loans***

We may acquire and accumulate mortgage loans (i.e., fixed-rate, ARMs, hybrid and balloon mortgage loans) as part of our investment strategy until a sufficient quantity has been accumulated for securitization into high-quality mortgage-backed securities in order to enhance their value and liquidity. Pursuant to our asset acquisition policy, the aggregate amount of any mortgage loans that we acquire and do not immediately securitize, together with our investments in other mortgage-related assets that are not Category I or Category II assets, will not constitute more than 10% of our total assets at any time. All mortgage loans, if any, will be acquired with the intention of securitizing them into high-credit quality mortgage securities. Despite our intentions, however, we may not be successful in securitizing these mortgage loans. To meet our investment criteria, mortgage loans we acquire will generally conform to underwriting guidelines consistent with high quality mortgages. Applicable banking laws generally require that an appraisal be obtained in connection with the original issuance of mortgage loans by the lending institution. We do not intend to obtain additional appraisals if we acquire any mortgage loans.

Mortgage loans may be originated by or purchased from various suppliers of mortgage-related assets throughout the United States, including savings and loans associations, banks, mortgage bankers and other mortgage lenders. We may acquire mortgage loans directly from originators and from entities holding mortgage loans originated by others. Our board of directors has not established any limits upon the geographic concentration of mortgage loans that we may acquire. However, our asset acquisition policy limits the amount and/or type of mortgage loans we may acquire.

***Other Investments***

We may acquire other investments that include equity and debt securities issued primarily by other mortgage-related finance companies, interests in mortgage-related collateralized bond obligations, other

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subordinated interests in pools of mortgage-related assets, commercial mortgage loans and securities and residential mortgage loans other than high-credit quality mortgage loans. These investments are generally considered Category III investments under our asset acquisition policy and are limited to 10% of our total assets.

We also intend to operate in a manner that will not subject us to regulation under the Investment Company Act of 1940. Our board of directors has the authority to modify or waive our current operating policies and our strategies without prior notice to you and without stockholder approval.

**Investment Strategy**

Our strategy is to invest primarily in U.S. agency and other highly-rated single-family adjustable-rate and fixed-rate mortgage-backed securities. We acquire these investments in the secondary market and seek to acquire assets that will produce competitive returns after considering 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. We do not construct our overall investment portfolio in order to express a directional expectation for interest rates or mortgage prepayment rates. Future interest rates and mortgage prepayment rates are difficult to predict and, as a result, we seek to acquire mortgage-backed securities that we believe provide acceptable returns over a broad range of interest rate and prepayment scenarios. When evaluating the purchase of mortgage-backed securities, we analyze whether the purchase will permit us to continue to satisfy the minimum 55% portfolio whole-pool requirement, with which we must comply to maintain our REIT status. We also assess the relative value of the mortgage-backed security and how well it would fit into our existing portfolio of mortgage-backed securities. Many aspects of a mortgage-backed security, and the dynamic interaction of its characteristics with those of our portfolio, can influence our perception of what that security is worth and the amount of premium we would be willing to pay to own the specific security. The characteristics of each potential investment we analyze generally include, but are not limited to, the following:

*origination year* the underwriting year for the mortgages comprising the mortgage-backed security. This characteristic helps to determine how seasoned the mortgage-backed security is and can influence our expectations for the investment s future cash flows. In the current low interest rate environment, mortgages that were originated several years ago (when interest rates were higher) tend to have been refinanced. Those borrowers who did not refinance their homes during the period of lower interest rates may be relatively less likely than more recent borrowers to refinance during the remaining life of their mortgages. Therefore, the expected cash flows from a potential investment with an earlier origination year could exhibit less sensitivity to changes in interest rates.

*originator* the financial services entity that underwrites the mortgages comprising the mortgage-backed security. Originators do not have homogeneous underwriting standards. The particular underwriting standards utilized by an originator tend to influence the characteristics of the borrowers in its mortgage loan pools which, in turn, can influence the pool s prepayment rates and other cash flows. When analyzing a pool of mortgages, it can be useful to review the historical cash flows exhibited by the originator s prior mortgage loan pools. For example, we may limit the premium we would be willing to pay for a security if the originator has a history of early refinancings. The quality of the originator s underwriting standards and the terms it offers borrowers can also be important to our purchase decisions. These variables potentially include the originator s required loan documentation, FICO scores, loan-to-value ratios, prepayment penalties, cap rates and assumability terms. Any of these variables might influence our expectations regarding the timing of cash flows from an originator s mortgage-backed securities and, thus, their attractiveness for our portfolio.

*coupon* the weighted-average mortgage coupon of the mortgage-backed security. Higher coupons are initially attractive because they can generate more interest income for us than lower-coupon mortgage-backed securities. However, the sustainability of cash flows from higher-coupon pools is less predictable because, all else being equal, higher-coupon mortgages have a greater probability of being refinanced than lower-coupon mortgages. We generally analyze a mortgage-backed security s coupon

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in comparison to current market rates to form an expectation regarding how sustainable the interest income from the investment will be.

*margin* the spread between an adjustable-rate mortgage s market index and the interest rate that the borrower must pay to service the mortgage. Similar to higher coupons, higher margins are attractive because they can generate more interest income for us than lower-margin mortgage-backed securities. However, higher-margin mortgage pools may be more prone to experience faster refinancing rates because high-margin borrowers are relatively more likely to find opportunities to refinance into mortgages with lower spreads to the index. As a result, the sustainability of the yield from an investment in a high-margin mortgage pool is less certain and the premium we would be willing to pay on such an investment, all else being equal, is less.

*periodic cap* the amount by which the interest rate on an adjustable-rate mortgage can adjust during a specified period, usually six or 12 months. In rapidly rising interest rate environments, higher periodic caps are more attractive because they reduce the risk of the adjustable-rate mortgage coupon not being able to reset fully upwards to the current market rate. Conversely, in rapidly falling interest rate environments, lower periodic caps increase the probability that the mortgage s coupon will reset to a level that remains above the current market rate.

*lifetime cap* the maximum interest rate that a specific ARM can have during its lifetime. The lifetime cap of a mortgage is often correlated with market interest rates at the time of origination. An ARM originated in a low interest rate environment will frequently have a lower lifetime cap than a comparably structured mortgage originated in a high interest rate environment. If interest rates rise sufficiently, an ARM with a lifetime cap can effectively behave like a fixed-rate mortgage because the coupon of the ARM cannot adjust above the lifetime cap, and will thus remain effectively fixed at that level until rates fall. Higher lifetime caps tend to make particularly structured hybrid or adjustable-rate mortgage pools more attractive investment candidates.

*time-to-reset* the number of months before the current coupon of the hybrid or adjustable-rate mortgage will reset. Time-to-reset is an important consideration as we structure the timing of interest rate adjustments on the mortgage-backed securities in our portfolio relative to changes in our borrowing costs.

*loan-to-value* the ratio between the original loan amount and the value of the collateral securing the mortgage loan. We consider this factor less important in a decision to purchase agency-backed mortgage securities but it can be an important factor when purchasing non-agency securities. This factor also influences the subordination levels required by the national rating agencies to receive AAA-rated status.

*geographic dispersion* the degree to which the properties underlying the pooled mortgage loans are geographically dispersed. We prefer greater geographic dispersion because we seek to limit our exposure to specific states or regions, which might be experiencing relatively greater economic difficulties, to create a more stable portfolio.

*price and prepayment expectations* the expected yield of the mortgage-backed security under various assumptions about future economic conditions. A mortgage-backed security s ultimate yield is determined by its price and its actual prepayment levels. We generally form expectations, based on the above factors, regarding how the mortgage pool s prepayment levels will change over time, including in response to possible changes in prevailing interest rates and other economic conditions, so as to determine whether its offered price creates a yield that is attractive and fits well with the expected structure of our portfolio and our borrowing costs under those scenarios.

We generally consider these factors when evaluating an investment s relative value and the impact it would likely have on our overall portfolio. We do not assign a particular weight to any factor because the relative importance of the various factors varies, depending upon the characteristics we seek for our portfolio and our borrowing cost structure.

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We do not currently originate mortgage loans or provide other types of financing to the owners of real estate and we do not service any mortgage loans. However, in the future, we may elect to originate mortgage loans or other types of financing, and we may elect to service mortgage loans and other types of financing.

**Financing Strategy**

We finance the acquisition of our mortgage-backed securities with short-term borrowings and term loans with a term of less than one year and, to a lesser extent, equity capital. After analyzing the then-applicable interest rate yield curves, we may finance with long-term borrowings from time to time. The amount of borrowing we employ depends on, among other factors, the amount of our equity capital. We use leverage to attempt to increase potential returns to our stockholders. Pursuant to our capital/liquidity and leverage policies, we seek to strike a balance between the under-utilization of leverage, which reduces potential returns to our stockholders, and the over-utilization of leverage, which increases risk by reducing our ability to meet our obligations to creditors during adverse market conditions.

We borrow at short-term rates using repurchase agreements. Repurchase agreements are generally short-term in nature. We seek to 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-backed securities in order to limit our liquidity and interest rate related risks. We generally seek to diversify our exposure by entering into repurchase agreements with multiple lenders. In addition, we only enter into repurchase agreements with institutions that we believe are financially sound and that meet credit standards approved by our board of directors.

**Growth Strategy**

In addition to the strategies described above, we use other strategies to seek to generate earnings and distributions to our stockholders, including:

- 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.

**Industry Trends**

The U.S. residential mortgage market has experienced considerable growth over the past 12 years, with total outstanding U.S. residential mortgage debt growing from approximately $3.0 trillion in 1992 to approximately $7.7 trillion at September 30, 2004, according to the Federal Reserve Board. According to the same source, the total amount of U.S. residential mortgage debt securitized into mortgage-backed securities has grown from approximately $1.4 trillion in 1992 to approximately $4.3 trillion at September 30, 2004, approximately $3.4 trillion of which was agency-backed and therefore generally consistent with our investment guidelines. At September 30, 2004, approximately $87.9 billion of the available mortgage-backed securities were held by REITs.

**Competition**

When we invest in mortgage-backed securities and other investment assets, we compete with a variety of institutional investors, including other REITs, insurance companies, mutual funds, hedge funds, pension funds, investment banking firms, banks and other financial institutions that invest in the same types of assets. Many of these investors have greater financial resources and access to lower costs of capital than we do. The existence of these competitive entities, as well as the possibility of additional entities forming in the future, may increase the competition for the acquisition of mortgage-backed securities, resulting in higher prices and lower yields on assets.

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## Certain United States Federal Income Tax Considerations

The following discussion summarizes the material U.S. federal income tax considerations regarding our qualification and taxation as a REIT and the material U.S. federal income tax consequences resulting from the acquisition, ownership and disposition of our common stock. The following discussion is not exhaustive of all possible tax considerations. This summary neither gives a detailed discussion of any state, local or foreign tax considerations nor discusses all of the aspects of U.S. federal income taxation that may be relevant to you in light of your particular circumstances or to particular types of stockholders that are subject to special tax rules, such as insurance companies, tax-exempt entities, financial institutions or broker-dealers, foreign corporations or partnerships, persons who are not citizens or residents of the United States, stockholders that hold our stock as a hedge, part of a straddle, conversion transaction or other arrangement involving more than one position, or stockholders whose functional currency is not the U.S. dollar. This discussion assumes that you will hold our common stock as a capital asset, generally property held for investment, under the Internal Revenue Code.

**You are urged to consult with your own tax advisor regarding the specific consequences to you of the purchase, ownership and sale of stock in an entity electing to be taxed as a REIT, including the federal, state, local, foreign and other tax considerations of such purchase, ownership, sale and election and the potential changes in applicable tax laws.**

### Recent Tax Legislation

On October 22, 2004, the President signed into law the American Jobs Creation Act of 2004 (the Jobs Act ), which amended certain rules relating to REITs. The relevant provisions of the Jobs Act are discussed in this section.

### General

We elected to be taxed as a REIT under the Internal Revenue Code commencing with our taxable year ending December 31, 2003. Our qualification and taxation as a REIT depend on our ability to continue to meet, through actual annual operating results, distribution levels, diversity of stock ownership, and the various other qualification tests imposed under the Internal Revenue Code discussed below. No assurance can be given that our actual results for any particular taxable year will satisfy these requirements. See Failure to Qualify as a REIT. In addition, our continuing qualification as a REIT depends on future transactions and events that cannot be known at this time.

So long as we qualify for taxation as a REIT, we generally will be permitted a deduction for dividends we pay to our stockholders. As a result, we generally will not be required to pay federal corporate income taxes on our net income that is currently distributed to our stockholders. This treatment substantially eliminates the double taxation that ordinarily results from investment in a corporation. Double taxation means taxation once at the corporate level when income is earned and once again at the stockholder level when this income is distributed. We will be required to pay U.S. federal income tax, however, as follows:

- we will be required to pay tax at regular corporate rates on any undistributed REIT taxable net income, including undistributed net capital gain;

- we may be required to pay the alternative minimum tax on our items of tax preference; and

- if we have (1) net income from the sale or other disposition of foreclosure property which is held primarily for sale to customers in the ordinary course of business or (2) other non-qualifying income from foreclosure property, we will be required to pay tax at the highest corporate rate on this income. Foreclosure property is generally defined as property acquired through foreclosure or after a default on a loan secured by the property or on a lease of the property.

We will be required to pay a 100% tax on any net income from prohibited transactions. Prohibited transactions are, in general, sales or other taxable dispositions of property, other than foreclosure property, held primarily for sale to customers in the ordinary course of business. Under existing law, whether property is held as inventory or primarily for sale to customers in the ordinary course of a trade or business depends on all the facts and circumstances surrounding the particular transaction.

If we fail to satisfy the 75% gross income test or the 95% gross income test discussed below, but nonetheless maintain our qualification as a REIT because certain other requirements (including that our failure was due to reasonable cause) are met, we will be subject to a tax equal to:

- the greater of (1) the amount by which 75% of our gross income exceeds the amount qualifying under the 75% gross income test described below, and (2) the amount by which 95% of our gross income exceeds the amount qualifying under the 95% gross income test described below, multiplied by,

- a fraction intended to reflect our profitability.

Pursuant to the Jobs Act, commencing with our taxable year beginning on January 1, 2005, if we fail to satisfy any of the REIT asset tests, as described below, by more than a de minimis amount, due to reasonable cause and we nonetheless maintain our REIT qualification because of specified cure provisions, we will be required to pay a tax equal to the greater of $50,000 or the highest corporate tax rate multiplied by our net income generated by the nonqualifying assets.

Pursuant to the Jobs Act, commencing with our taxable year beginning on January 1, 2005, if we fail to satisfy any provision of the Internal Revenue Code that would result in our failure to qualify as a REIT other than a violation of the REIT gross income or asset tests described below and the violation is due to reasonable cause, we will retain our REIT qualification but we will be required to pay a penalty of $50,000 for each such failure.

We will be required to pay a 4% excise tax on the excess of the required distribution over the amounts actually distributed if we fail to distribute during each calendar year at least the sum of:

- 85% of our real estate investment trust ordinary income for the year;

- 95% of our real estate investment trust capital gain net income for the year; and

- any undistributed taxable income from prior periods.

This distribution requirement is in addition to, and different from the distribution requirements discussed below in the section entitled Distributions Generally.

If we acquire any asset from a corporation that is or has been taxed as a C corporation under the Internal Revenue Code in a transaction in which the basis of the asset in our hands is determined by reference to the basis of the asset in the hands of the C corporation, and we subsequently recognize gain on the disposition of the asset during the 10-year period beginning on the date on which we acquired the asset, then we will be required to pay tax at the highest regular corporate tax rate on this gain to the extent of the excess of:

- the fair market value of the asset, over

- our adjusted basis in the asset, in each case determined as of the date on which we acquired the asset.

A C corporation is generally defined as a corporation required to pay full corporate-level tax. The results described in this paragraph with respect to the recognition of gain will apply unless we make an election under Treasury regulation Section 1.337(d)-7(c) to cause the C corporation to recognize all of the gain inherent in the property at the time of our acquisition of the asset.

Finally, we could be subject to an excise tax if our dealings with any taxable REIT subsidiaries are not at arm s length.

**Requirements for Qualification as a REIT**

The Internal Revenue Code defines a REIT as a corporation, trust or association:

- that is managed by one or more trustees or directors;

- that issues transferable shares or transferable certificates to evidence beneficial ownership;

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- that would be taxable as a domestic corporation but for Sections 856 through 859 of the Internal Revenue Code;
- that is not a financial institution or an insurance company within the meaning of the Internal Revenue Code;
- that is beneficially owned by 100 or more persons;
- not more than 50% in value of the outstanding stock of which is owned, actually or constructively, by five or fewer individuals, including specified entities, during the last half of each taxable year; and
- that meets other tests, described below, regarding the nature of its income and assets and the amount of its distributions.

The Internal Revenue Code provides that all of the first four conditions stated above must be met during the entire taxable year and that the fifth condition must be met during at least 335 days of a taxable year of 12 months, or during a proportionate part of a taxable year of less than 12 months.

**Stock Ownership Tests**

Our stock must be beneficially held by at least 100 persons, which we refer to as the 100 stockholder rule, and no more than 50% of the value of our stock may be owned, directly or indirectly, by five or fewer individuals at any time during the last half of the taxable year, which we refer to as the 5/50 rule. In determining whether five or fewer individuals hold our shares, certain attribution rules of the Internal Revenue Code apply. For purposes of the 5/50 rule, pension trusts and other specific tax-exempt entities generally are treated as individuals, except that certain tax-qualified pension funds are not considered individuals and beneficiaries of such trusts are treated as holding shares of a REIT in proportion to their actuarial interests in the trust for purposes of the 5/50 rule. Our charter imposes repurchase provisions and transfer restrictions to avoid having more than 50% of the value of our stock being held by five or fewer individuals. These stock ownership requirements must be satisfied in each taxable year. We are required to solicit information from certain of our record stockholders to verify actual stock ownership levels, and our charter provides for restrictions regarding the transfer of our stock in order to aid in meeting the stock ownership requirements. We will be treated as satisfying the 5/50 rule if we comply with the demand letter and record keeping requirements discussed below, and if we do not know, and by exercising reasonable diligence would not have known, whether we failed to satisfy the 5/50 rule. We satisfied the stock ownership tests immediately following our initial public offering and we will use reasonable efforts to monitor our stock ownership in order to ensure continued compliance with these tests. If we were to fail either of the stock ownership tests, we would generally be disqualified from REIT status.

To monitor our compliance with the stock ownership tests, we are required to maintain records regarding the actual ownership of our shares of stock. To do so, we are required to demand written statements each year from the record holders of certain percentages of our shares of stock in which the record holders are to disclose the actual owners of the shares (i.e., the persons required to include our dividends in gross income). A REIT with 2,000 or more record stockholders must demand statements from record holders of 5% or more of its shares, one with fewer than 2,000, but more than 200, record stockholders must demand statements from record holders of 1% or more of its shares, while a REIT with 200 or fewer record stockholders must demand statements from record holders of 0.5% or more of its shares. A list of those persons failing or refusing to comply with this demand must be maintained as part of our records. A stockholder who fails or refuses to comply with the demand must submit a statement with his or her tax return disclosing the actual ownership of the shares of stock and certain other information.

**Income Tests**

We must satisfy two gross income requirements annually to maintain our qualification as a REIT:

- under the 75% gross income test, we must derive at least 75% of our gross income, excluding gross income from prohibited transactions, from specified real estate sources, including rental income, interest on obligations secured by mortgages on real property or on interests in real property, gain from the disposition of qualified real estate assets, i.e., interests in real property, mortgages secured by real property or interests in real property, and some other assets, and income from certain types of temporary investments; and

under the 95% gross income test, we must derive at least 95% of our gross income, excluding gross income from prohibited transactions, from (1) the sources of income that satisfy the 75% gross income test, (2) dividends, interest and gain from the sale or disposition of stock or securities, including some interest rate swap and cap agreements, options, futures and forward contracts entered into to hedge variable rate debt incurred to acquire qualified real estate assets, or (3) any combination of the foregoing. Amounts from qualified hedges will generally not constitute gross income and therefore will be disregarded for purposes of the 95% gross income test if certain identification and other requirements are satisfied, and will be treated as nonqualifying income for the 95% and 75% gross income tests if such requirements are not satisfied.

For purposes of the 75% and 95% gross income tests, a REIT is deemed to have earned a proportionate share of the income earned by any partnership, or any limited liability company treated as a partnership for U.S. federal income tax purposes, in which it owns an interest, which share is determined by reference to its capital interest in such entity, and is deemed to have earned the income earned by any qualified REIT subsidiary (in general, a 100%-owned corporate subsidiary of a REIT).

Any amount includable in our gross income with respect to a regular or residual interest in a REMIC generally also is treated as interest on an obligation secured by a mortgage on real property. If, however, less than 95% of the assets of a REMIC consists of real estate assets (determined as if we held such assets), we will be treated as receiving directly our proportionate share of the income of the REMIC. In addition, if we receive interest income with respect to a mortgage loan that is secured by both real property and other property and the highest principal amount of the loan outstanding during a taxable year exceeds the fair market value of the real property on the date we became committed to make or purchase the mortgage loan, a portion of the interest income, equal to (1) such highest principal amount minus such value, divided by (2) such highest principal amount, generally will not be qualifying income for purposes of the 75% gross income test. However, interest income received with respect to non-REMIC pay-through bonds and pass-through debt instruments, such as collateralized mortgage obligations, or CMOs, will not be qualifying income for this purpose.

Interest earned by a REIT ordinarily does not qualify as income meeting the 75% or 95% gross income tests if the determination of all or some of the amount of interest depends in any way on the income or profits of any person. Interest will not be disqualified from meeting such tests, however, solely by reason of being based on a fixed percentage or percentages of receipts or sales.

If we are entitled to avail ourselves of certain relief provisions pertaining to the income tests, we will maintain our qualification as a REIT but will be subject to certain penalty taxes as described above. We may not, however, be entitled to the benefit of these relief provisions in all circumstances. If these relief provisions do not apply to a particular set of circumstances, we will not qualify as a REIT.

**Asset Tests**

At the close of each quarter of our taxable year, we must satisfy four tests relating to the nature and diversification of our assets:

at least 75% of the value of our total assets must be represented by qualified real estate assets, cash, cash items and government securities;

not more than 25% of our total assets may be represented by securities, other than those securities included in the 75% asset test;

of the investments included in the 25% asset class, the value of any one issuer s securities may not exceed 5% of the value of our total assets (the 5% Asset Test ), and we generally may not own more

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than 10% by vote or value of any one issuer s outstanding securities (the 10% Asset Test ), in each case except with respect to stock of any taxable REIT subsidiaries; and

the value of the securities we own in any taxable REIT subsidiaries may not exceed 20% of the value of our total assets.

Qualified real estate assets include interests in mortgages on real property to the extent the principal balance of a mortgage does not exceed the fair market value of the associated real property, regular or residual interests in a REMIC (except that, if less than 95% of the assets of a REMIC consists of real estate assets (determined as if we held such assets), we will be treated as holding directly our proportionate share of the assets of such REMIC), and shares of other REITs. Non-REMIC CMOs, however, do not qualify as qualified real estate assets for this purpose.

A taxable REIT subsidiary is any corporation in which we own stock and as to which we and such corporation jointly elect to treat such corporation as a taxable REIT subsidiary. For purposes of the asset tests, we will be deemed to own a proportionate share of the assets of any partnership, or any limited liability company treated as a partnership for U.S. federal income tax purposes, in which we own an interest, which share is determined by reference to our capital interest in the entity, and will be deemed to own the assets owned by any qualified REIT subsidiary and any other entity that is disregarded for U.S. federal income tax purposes.

After initially meeting the asset tests at the close of any quarter, we will not lose our status as a REIT for failure to satisfy the asset tests at the end of a later quarter solely by reason of changes in asset values. If we fail to satisfy the asset tests because we acquire securities or other property during a quarter, we can cure this failure by disposing of sufficient non-qualifying assets within 30 days after the close of that quarter. For this purpose, an increase in our capital interest in any partnership or limited liability company in which we own an interest generally will be treated as an acquisition of a portion of the securities or other property owned by that partnership or limited liability company.

Pursuant to the Jobs Act, commencing with our taxable year beginning on January 1, 2005, if we fail to meet either the 5% Asset Test or the 10% Asset Test, after the 30-day cure period, we may dispose of sufficient assets (generally within six months after the last day of the quarter in which our identification of the failure to satisfy these asset tests occurred) to cure such a violation that does not exceed the lesser of 1% of our assets at the end of the relevant quarter or $10,000,000.

If we are entitled to avail ourselves of certain other relief provisions pertaining to the asset tests, we will maintain our qualification as a REIT, but will be subject to certain penalty taxes as described above. We may not, however, be entitled to the benefit of these relief provisions in all circumstances. If these relief provisions do not apply to a particular set of circumstances, we will not qualify as a REIT.

We may at some point securitize mortgage loans and/or mortgage-backed securities. If we were to securitize mortgage-related assets ourselves on a regular basis (other than through the issuance of non-REMIC CMOs), there is a substantial risk that the securities could be dealer property and that all of the profits from such sales would be subject to tax at the rate of 100% as income from prohibited transactions. Accordingly, where we intend to sell the securities created by that process, we expect that we will engage in the securitization through one or more taxable REIT subsidiaries, which will not be subject to this 100% tax. We also may securitize such mortgage-related assets through the issuance of non-REMIC CMOs, whereby we retain an equity interest in the mortgage-backed assets used as collateral in the securitization transaction. The issuance of any such instruments could result in a portion of our assets being classified as a taxable mortgage pool, which would be treated as a separate corporation for U.S. federal income tax purposes, which in turn could jeopardize our status as a REIT. We intend to structure our securitizations in a manner that would not result in the creation of a taxable mortgage pool.

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### Annual Distribution Requirements

To maintain our qualification as a REIT, we are required to distribute dividends, other than capital gain dividends, to our stockholders in an amount at least equal to:

90% of our REIT taxable net income, plus

90% of our after tax net income, if any, from foreclosure property, minus

the excess of the sum of specified items of our non-cash income items over 5% of REIT taxable net income, as described below.

For purposes of these distribution requirements, our REIT taxable net income is computed without regard to the dividends paid deduction and net capital gain. In addition, for purposes of this test, the specified items of non-cash income include income attributable to leveled stepped rents, certain original issue discount, certain like-kind exchanges that are later determined to be taxable and income from cancellation of indebtedness. In addition, if we disposed of any asset we acquired from a corporation that is or has been a C corporation in a transaction in which our basis in the asset is determined by reference to the basis of the asset in the hands of that C corporation and we did not elect to recognize gain currently in connection with the acquisition of such asset, we would be required to distribute at least 90% of the after-tax gain, if any, we recognize on a disposition of the asset within the 10 year period following our acquisition of such asset, to the extent that such gain does not exceed the excess of:

the fair market value of the asset on the date we acquired the asset, over

our adjusted basis in the asset on the date we acquired the asset.

Only distributions that qualify for the dividends paid deduction available to REITs under the Internal Revenue Code are counted in determining whether the distribution requirements are satisfied. We must make these distributions in the taxable year to which they relate, or in the following taxable year if they are declared before we timely file our tax return for that year, paid on or before the first regular dividend payment following the declaration and we elect on our tax return to have a specified dollar amount of such distributions treated as if paid in the prior year. For these and other purposes, dividends declared by us in October, November or December of one taxable year and payable to a stockholder of record on a specific date in any such month shall be treated as both paid by us and received by the stockholder during such taxable year, provided that the dividend is actually paid by us by January 31 of the following taxable year.

In addition, dividends distributed by us must not be preferential. If a dividend is preferential, it will not qualify for the dividends paid deduction. To avoid being preferential, every stockholder of the class of stock to which a distribution is made must be treated the same as every other stockholder of that class, and no class of stock may be treated other than according to its dividend rights as a class.

To the extent that we do not distribute all of our net capital gain, or we distribute at least 90%, but less than 100%, of our REIT taxable net income, as adjusted, we will be required to pay tax on this undistributed income at regular ordinary and capital gain corporate tax rates. Furthermore, if we fail to distribute during each calendar year (or, in the case of distributions with declaration and record dates falling in the last three months of the calendar year, by the end of the January immediately following such year) at least the sum of (1) 85% of our REIT ordinary income for such year, (2) 95% of our REIT capital gain income for such year, and (3) any undistributed taxable income from prior periods, we will be subject to a 4% nondeductible excise tax on the excess of such required distribution over the amounts actually distributed. We intend to make timely distributions sufficient to satisfy the annual distribution requirements.

Under certain circumstances, we may be able to rectify a failure to meet the distribution requirements for a year by paying deficiency dividends to our stockholders in a later year, which may be included in our deduction for dividends paid for the earlier year. Although we may be able to avoid being taxed on amounts distributed as deficiency dividends, we will be required to pay to the IRS interest based upon the amount of any deduction taken for deficiency dividends.

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**Failure to Qualify as a REIT**

If we fail to qualify for taxation as a REIT in any taxable year, and the relief provisions of the Internal Revenue Code do not apply, we will be required to pay taxes, including any applicable alternative minimum tax, on our taxable income in that taxable year and all subsequent taxable years at regular corporate rates. Distributions to our stockholders in any year in which we fail to qualify as a REIT will not be deductible by us and we will not be required to distribute any amounts to our stockholders. As a result, we anticipate that our failure to qualify as a REIT would reduce the cash available for distribution to our stockholders. In addition, if we fail to qualify as a REIT, all distributions to our stockholders will be taxable at ordinary income rates to the extent of our current and accumulated earnings and profits. In this event, corporate distributees may be eligible for the dividends-received deduction. Unless entitled to relief under specific statutory provisions, we will also be disqualified from taxation as a REIT for the four taxable years following the year in which we lose our qualification.

Specified cure provisions will be available to us in the event we violate a provision of the Internal Revenue Code that would result in our failure to qualify as a REIT. If we are entitled to avail ourselves of certain relief provisions, we will maintain our qualification as a REIT but may be subject to certain penalty taxes as described above. We may not, however, be entitled to the benefit of these relief provisions in all circumstances. If these relief provisions do not apply to a particular set of circumstances, we will not qualify as a REIT.

**Taxation of Taxable United States Stockholders**

For purposes of the discussion in this Form 10-K, the term United States stockholder means a beneficial holder of our stock that is, for U.S. federal income tax purposes:

a citizen or resident of the United States (as determined for U.S. federal income tax purposes);

a corporation, partnership, or other entity created or organized in or under the laws of the United States or of any state thereof or in the District of Columbia, unless Treasury regulations provide otherwise;

an estate the income of which is subject to U.S. federal income taxation regardless of its source; or

a trust whose administration is subject to the primary supervision of a U.S. court and which has one or more U.S. persons who have the authority to control all substantial decisions of the trust.

***Distributions Generally***

Distributions out of our current or accumulated earnings and profits, other than capital gain dividends, will be taxable to United States stockholders as ordinary income. Such REIT dividends generally are ineligible for the new reduced tax rate (with a maximum of 15%) for corporate dividends received by individuals, trusts and estates in years 2003 through 2008. However, such rate will apply to the extent that we make distributions attributable to amounts, if any, we receive as dividends from non-REIT corporations or to the extent that we make distributions attributable to the sum of (i) the excess of our REIT taxable income (excluding net capital gains) for the preceding year over the tax paid on such income, and (ii) the excess of our income subject to the built-in gain tax over the tax payable by us on such income. Provided that we qualify as a REIT, dividends paid by us will not be eligible for the dividends received deduction generally available to United States stockholders that are corporations. To the extent that we make distributions in excess of current and accumulated earnings and profits, the distributions will be treated as a tax-free return of capital to each United States stockholder, and will reduce the adjusted tax basis that each United States stockholder has in our stock by the amount of the distribution, but not below zero. Distributions in excess of a United States stockholder s adjusted tax basis in our stock will be taxable as capital gain, and will be taxable as long-term capital gain if the stock has been held for more than one year. The calculation of the amount of distributions that are applied against or exceed adjusted tax basis are made on a share-by-share basis. To the extent that we make distributions, if any, that are attributable to excess inclusion income, such amounts may not be offset by net operating losses of a United States stockholder. If we declare a dividend in October, November, or December of any calendar year that is payable to stockholders of record on a specified date in such a month and actually pay the dividend during January of the following calendar year, the dividend is deemed to be paid by us and

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received by the stockholder on December 31st of the year preceding the year of payment. Stockholders may not include in their own income tax returns any of our net operating losses or capital losses.

***Capital Gain Distributions***

Distributions designated by us as capital gain dividends will be taxable to United States stockholders as capital gain income. We can designate distributions as capital gain dividends to the extent of our net capital gain for the taxable year of the distribution. For tax years prior to 2009, this capital gain income will generally be taxable to non-corporate United States stockholders at a 15% or 25% rate based on the characteristics of the asset we sold that produced the gain. United States stockholders that are corporations may be required to treat up to 20% of certain capital gain dividends as ordinary income.

***Retention of Net Capital Gains***

We may elect to retain, rather than distribute as a capital gain dividend, our net capital gains. If we were to make this election, we would pay tax on such retained capital gains. In such a case, our stockholders would generally:

include their proportionate share of our undistributed net capital gains in their taxable income;

receive a credit for their proportionate share of the tax paid by us in respect of such net capital gain; and

increase the adjusted basis of their stock by the difference between the amount of their share of our undistributed net capital gain and their share of the tax paid by us.

***Passive Activity Losses, Investment Interest Limitations and Other Considerations of Holding Our Stock***

Distributions we make, undistributed net capital gain includible in income and gains arising from the sale or exchange of our stock by a United States stockholder will not be treated as passive activity income. As a result, United States stockholders will not be able to apply any passive losses against income or gains relating to our stock. Distributions by us, to the extent they do not constitute a return of capital, and undistributed net capital gain includible in our stockholders income, generally will be treated as investment income for purposes of computing the investment interest limitation under the Internal Revenue Code, provided the proper election is made.

If we, or a portion of our assets, were to be treated as a taxable mortgage pool, or if we were to acquire REMIC residual interests, our stockholders (other than certain thrift institutions) may not be permitted to offset certain portions of the dividend income they derive from our shares with their current deductions or net operating loss carryovers or carrybacks. The portion of a stockholder s dividends that will be subject to this limitation will equal the allocable share of our excess inclusion income.

***Dispositions of Stock***

A United States stockholder that sells or disposes of our stock will recognize gain or loss for federal income tax purposes in an amount equal to the difference between the amount of cash or the fair market value of any property the stockholder receives on the sale or other disposition and the stockholder s adjusted tax basis in our stock. This gain or loss generally will be capital gain or loss and will be long-term capital gain or loss if the stockholder has held the stock for more than one year. However, any loss recognized by a United States stockholder upon the sale or other disposition of our stock that the stockholder has held for six months or less will be treated as long-term capital loss to the extent the stockholder received distributions from us that were required to be treated as long-term capital gains. For tax years prior to 2009, capital gain of an individual United States stockholder is generally taxed at a maximum rate of 15% where the property is held for more than one year. The deductibility of capital loss is limited.

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### *Information Reporting and Backup Withholding*

We report to our United States stockholders and the IRS the amount of dividends paid during each calendar year, along with the amount of any tax withheld. Under the backup withholding rules, a stockholder may be subject to backup withholding with respect to dividends paid and redemption proceeds unless the holder is a corporation or comes within other exempt categories and, when required, demonstrates this fact, or provides a taxpayer identification number or social security number, certifying as to no loss of exemption from backup withholding, and otherwise complies with applicable requirements of the backup withholding rules. A United States stockholder that does not provide. us with its correct taxpayer identification number or social security number may also be subject to penalties imposed by the IRS. A United States stockholder can meet this requirement by providing us with a correct, properly completed and executed copy of IRS Form W-9 or a substantially similar form. Backup withholding is not an additional tax. Any amount paid as backup withholding will be creditable against the stockholder s income tax liability, if any, and otherwise be refundable, provided the proper forms are filed on a timely basis. In addition, we may be required to withhold a portion of capital gain distributions made to any stockholders who fail to certify their non-foreign status. The backup withholding tax rate currently is 28%.

## Taxation of Tax-Exempt Stockholders

The IRS has ruled that amounts distributed as a dividend by a REIT will be treated as a dividend by the recipient and excluded from the calculation of unrelated business taxable income when received by a tax-exempt entity. Based on that ruling, provided that a tax-exempt stockholder has not held our stock as debt financed property within the meaning of the Internal Revenue Code, i.e., property the acquisition or holding of which is or is treated as financed through a borrowing by the tax-exempt United States stockholder, the stock is not otherwise used in an unrelated trade or business, and we do not hold an asset that gives rise to excess inclusion income, as defined in Section 860E of the Internal Revenue Code, dividend income on our stock and income from the sale of our stock should not be unrelated business taxable income to a tax-exempt stockholder. However, if we were to hold residual interests in a REMIC, or if we or a pool of our assets were to be treated as a taxable mortgage pool, a portion of the dividends paid to a tax-exempt stockholder may be subject to tax as unrelated business taxable income. Although we do not believe that we, or any portion of our assets, will be treated as a taxable mortgage pool, we cannot assure you that that the IRS might not successfully maintain that such a taxable mortgage pool exists.

For tax-exempt stockholders that are social clubs, voluntary employees beneficiary associations, supplemental unemployment benefit trusts, and qualified group legal services plans exempt from U.S. federal income taxation under Sections 501(c)(7), (c)(9), (c)(17) and (c)(20) of the Internal Revenue Code, respectively, income from an investment in our stock will constitute unrelated business taxable income unless the organization is able to properly claim a deduction for amounts set aside or placed in reserve for certain purposes so as to offset the income generated by its investment in our stock. Any prospective investors should consult their tax advisors concerning these set aside and reserve requirements.

Notwithstanding the above, however, a substantial portion of the dividends received with respect to our stock may constitute unrelated business taxable income, or UBTI, if we are treated as a pension-held REIT and you are a pension trust that:

- is described in Section 401(a) of the Internal Revenue Code; and
- holds more than 10%, by value, of our equity interests.

Tax-exempt pension funds that are described in Section 401 (a) of the Internal Revenue Code and exempt from tax under Section 501(a) of the Internal Revenue Code are referred to below as qualified trusts.

A REIT is a pension-held REIT if:

- it would not have qualified as a REIT but for the fact that Section 856(h)(3) of the Internal Revenue Code provides that stock owned by a qualified trust shall be treated, for purposes of the 5/50 rule, described above, as owned by the beneficiaries of the trust, rather than by the trust itself; and

- either at least one qualified trust holds more than 25%, by value, of the interests in the REIT, or one or more qualified trusts, each of which owns more than 10%, by value, of the interests in the REIT, holds in the aggregate more than 50%, by value, of the interests in the REIT.

The percentage of any REIT dividends treated as UBTI under these rules is equal to the ratio of:

- the UBTI earned by the REIT, less directly related expenses, treating the REIT as if it were a qualified trust and therefore subject to tax on UBTI, to

- the total gross income, less directly related expenses, of the REIT.

A de minimis exception applies where this percentage is less than 5% for any year. As a result of the limitations on the transfer and ownership of stock contained in our charter, we do not expect to be classified as a pension-held REIT.

**Taxation of Non-United States Stockholders**

The rules governing U.S. federal income taxation of non-United States stockholders are complex and no attempt will be made herein to provide more than a summary of these rules. Beneficial owners of shares of our stock that are not United States stockholders (as such term is defined in the discussion above under the heading entitled Taxation of Taxable United States Stockholders ) are referred to herein as non-United States stockholders.

**PROSPECTIVE NON-U.S. STOCKHOLDERS SHOULD CONSULT THEIR TAX ADVISORS TO DETERMINE THE IMPACT OF FOREIGN, FEDERAL, STATE, AND LOCAL INCOME TAX LAWS WITH REGARD TO AN INVESTMENT IN OUR STOCK AND OF OUR ELECTION TO BE TAXED AS A REAL ESTATE INVESTMENT TRUST, INCLUDING ANY REPORTING REQUIREMENTS.**

Distributions of Operating Income. Distributions to non-United States stockholders that are not attributable to gain from our sale or exchange of U.S. real property interests and that are not designated by us as capital gain dividends or retained capital gains, which we refer to as ordinary income distributions will be treated as dividends of ordinary income to the extent that they are made out of our current or accumulated earnings and profits. These distributions will generally be subject to a withholding tax equal to 30% of the distribution unless an applicable tax treaty reduces or eliminates that tax. However, if income from an investment in our stock is treated as effectively connected with the non-United States stockholder s conduct of a U.S. trade or business (or, if an income tax treaty applies, is attributable to a U.S. permanent establishment of the non-United States stockholder), the non-United States stockholder generally will be subject to federal income tax at graduated rates in the same manner as United States stockholders are taxed with respect to those distributions, and also may be subject to the 30% branch profits tax in the case of a non-United States stockholder that is a corporation, unless a treaty reduces or eliminates these taxes. We expect to withhold tax at the rate of 30% on the gross amount of any ordinary income distributions made to a non-United States stockholder unless:

- a lower treaty rate applies and any required form, for example IRS Form W-8BEN, evidencing eligibility for that reduced rate is filed by the non-United States stockholder with us; or

- the non-United States stockholder files an IRS Form W-8ECI with us claiming that the distribution is effectively connected income.

Any portion of the dividends paid to non-United States stockholders that is treated as excess inclusion income, as defined in Section 860E of the Internal Revenue Code, will not be eligible for exemption from the 30% withholding tax or a reduced treaty rate.

Distributions in excess of our current and accumulated earnings and profits that are not treated as attributable to the gain from our disposition of a U.S. real property interest will not be taxable to non-United States stockholders to the extent that these distributions do not exceed the adjusted basis of the stockholder s stock, but rather will reduce the adjusted basis of that stock. To the extent that distributions in excess of our current and accumulated earnings and profits exceed the adjusted basis of a non-United States stockholder s stock, these distributions will give rise to tax liability if the non-United States stockholder would otherwise be subject to tax on any gain from the sale or disposition of its stock, as described below. Because it generally cannot be determined at the time a distribution is made whether or not such distribution may be in excess of our current and accumulated earnings and profits, the entire amount of any ordinary income distribution normally will be subject to withholding at the same rate as a dividend. However, amounts so withheld are creditable against U.S. tax liability, if any, or refundable by the IRS to the extent the distribution is subsequently determined to be in excess of our current and accumulated earnings and profits and the proper forms are filed with the IRS by the stockholder on a timely basis. We are also required to withhold 10% of any distribution in excess of our current and accumulated earnings and profits if our stock is a U.S. real property interest because we are not a domestically controlled REIT, as discussed below. Consequently, although we intend to withhold at a rate of 30% on the entire amount of an ordinary income distribution, to the extent that we do not do so, any portion of an ordinary income distribution not subject to withholding at a rate of 30% may be subject to withholding at a rate of 10%.

Capital Gains Distributions. Distributions attributable to our capital gains that are not attributable to gain from the sale or exchange of a U.S. real property interest generally will not be subject to income taxation, unless (1) investment in our stock is effectively connected with the non-United States stockholder s U.S. trade or business (or, if an income tax treaty applies, is attributable to a U.S. permanent establishment of the non-United States stockholder), in which case the non-United States stockholder will be subject to the same treatment as United States stockholders with respect to such gain (and a corporate non-United States stockholder may also be subject to the 30% branch profits tax), or (2) the non-United States stockholder is a non-resident alien individual who is present in the U.S. for 183 days or more during the taxable year and certain other conditions are satisfied, in which case the non-resident alien individual will be subject to a 30% tax on the individual s net capital gains.

For any year in which we qualify as a REIT, distributions that are attributable to gain from the sale or exchange of a U.S. real property interest, which includes some interests in real property, but generally does not include an interest solely as a creditor in mortgage loans or mortgage-backed securities, will be taxed to a non- United States stockholder under the provisions of the Foreign Investment in Real Property Tax Act, or FIRPTA. Under FIRPTA, distributions attributable to gain from sales of U.S. real property interests are taxed to a non-United States stockholder as if that gain were effectively connected with the stockholder s conduct of a U.S. trade or business. Non-United States stockholders thus would be taxed at the normal capital gain rates applicable to United States stockholders, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals. Distributions subject to FIRPTA also may be subject to the 30% branch profits tax in the hands of a non-U.S. corporate stockholder. We are required to withhold 35% of any distribution paid to a non-United States stockholder that we designate (or, if greater, the amount that we could designate) as a capital gains dividend. The amount withheld is creditable against the non-United States stockholder s FIRPTA tax liability, provided the proper forms are filed by the stockholders on a timely basis.

Pursuant to the Jobs Act, any capital gain dividend with respect to any class of stock that is regularly traded on an established securities market located in the United States is not subject to FIRPTA, and therefore, not subject to the 35% U.S. withholding tax, if the non-United States stockholder did not own more than 5% of such class of stock at any time during the taxable year. Instead, any such capital gain dividend will be treated as an ordinary dividend distribution generally subject to withholding at a rate of 30% unless otherwise reduced or eliminated by an applicable income tax treaty.

Gains on the Sale of Our Stock. Gains recognized by a non-United States stockholder upon a sale of our stock generally will not be taxed under FIRPTA if we are a domestically controlled REIT, which is a REIT in which at all times during a specified testing period less than 50% in value of the stock was held

directly or indirectly by non-United States stockholders. Because our stock is publicly traded/widely held, we cannot assure our investors that we are or will remain a domestically controlled REIT. Even if we are not a domestically controlled REIT, however, a non-United States stockholder that owns, actually or constructively, 5% or less of our stock throughout a specified testing period will not recognize taxable gain on the sale of our stock under FIRPTA as long as our shares are traded on the New York Stock Exchange.

If gain from the sale of our stock were subject to taxation under FIRPTA, the non-United States stockholder would be subject to the same treatment as United States stockholders with respect to that gain, subject to applicable alternative minimum tax, a special alternative minimum tax in the case of nonresident alien individuals, and the possible application of the 30% branch profits tax in the case of non-U.S. corporations. In addition, the purchaser of the stock could be required to withhold 10% of the purchase price and remit such amount to the IRS on behalf of the non-United States stockholder.

Gains not subject to FIRPTA will be taxable to a non-United States stockholder if the non-United States stockholder s investment in our stock is effectively connected with a trade or business in the U.S. (or, if an income tax treaty applies, is attributable to a U.S. permanent establishment of the non-United States stockholder), in which case the non-United States stockholder will be subject to the same treatment as United States stockholders with respect to that gain; or the non-United States stockholder is a nonresident alien individual who was present in the U.S. for 183 days or more during the taxable year and other conditions are met, in which case the nonresident alien individual will be subject to a 30% tax on the individual s capital gains.

**Information Reporting and Backup Withholding for Non-United States Stockholders**

If the proceeds of a disposition of our stock are paid by or through a U.S. office of a broker-dealer, the payment is generally subject to information reporting and to backup withholding (currently at a rate of 28%) unless the disposing non-United States stockholder certifies as to his name, address and non-U.S. status or otherwise establishes an exemption. Generally, U.S. information reporting and backup withholding will not apply to a payment of disposition proceeds if the payment is made outside the U.S. through a foreign office of a foreign broker-dealer. If the proceeds from a disposition of our stock are paid to or through a foreign office of a U.S. broker-dealer or a non-U.S. office of a foreign broker-dealer that is (1) a controlled foreign corporation for U.S. federal income tax purposes, (2) a foreign person 50% or more of whose gross income from all sources for a three-year period was effectively connected with a U.S. trade or business, (3) a foreign partnership with one or more partners who are U.S. persons and who in the aggregate hold more than 50% of the income or capital interest in the partnership, or (4) a foreign partnership engaged in the conduct of a trade or business in the U.S., then (a) backup withholding will not apply unless the broker-dealer has actual knowledge that the owner is not a foreign stockholder, and (b) information reporting will not apply if the non-United States stockholder satisfies certification requirements regarding its status as a foreign stockholder. Other information reporting rules apply to non-United States stockholders, and prospective non-United States stockholders should consult their own tax advisors regarding these requirements.

**Possible Legislative or Other Action Affecting Tax Consequences**

You should recognize that the present U.S. federal income tax treatment of an investment in us may be modified by legislative, judicial or administrative action at any time and that any such action may affect investments and commitments previously made. The rules dealing with U.S. federal income taxation are constantly under review by persons involved in the legislative process and by the Internal Revenue Service and the Treasury Department, resulting in revisions of regulations and revised interpretations of established concepts as well as statutory changes. Revisions in federal tax laws and interpretations thereof could affect the tax consequences of an investment in us.

**State, Local and Foreign Taxation**

We may be required to pay state, local and foreign taxes in various state, local and foreign jurisdictions, including those in which we transact business or make investments, and our stockholders may be required to pay state, local and foreign taxes in various state, local and foreign jurisdictions, including those in which they reside. Our state, local and foreign tax treatment may not conform to the federal income tax consequences summarized above. In addition, a stockholder s state, local and foreign tax treatment may not conform to the federal income tax consequences summarized above. Consequently, prospective investors should consult their tax advisors regarding the effect of state, local and foreign tax laws on an investment in our stock.

**Employees**

Our day-to-day operations are externally managed and advised by our manager, Seneca Capital Management LLC, which we sometimes refer to as Seneca. At December 31, 2004 we had three full-time employees. We employ a full-time chief financial officer, Christopher J. Zyda, whose primary responsibilities include monitoring Seneca s performance under our management agreement, as well as two other full-time employees.

We do not employ any of our officers other than Mr. Zyda. Our other executive officers are employees and/or officers of Seneca and are compensated by Seneca.

**Website Access to our Periodic SEC Reports**

Our corporate website address is *www.luminentcapital.com.* We make our periodic SEC reports on Forms 10-K and 10-Q and current reports on Form 8-K, as well as the beneficial ownership reports filed by our directors, officers and 10% stockholders on Forms 3, 4 and 5 available free of charge through our website as soon as reasonably practicable after they are filed electronically with the SEC. We may from time to time provide important disclosures to investors by posting them in the investor relations section of our website, as allowed by SEC rules. The information on our website is not a part of this Annual Report on Form 10-K.

Materials we file with the SEC may be read and copied at the SEC s Public Reference Room at 450 Fifth Street, N.W., Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet website at *www.sec.gov* that contains our reports, proxy and information statements, and other information regarding us that we will file electronically with the SEC.

We are in compliance with the requirements of the New York Stock Exchange to make available on our website and in printed form upon request our Code of Business Conduct and Ethics, and the respective charters of our Audit, Compensation and Governance Committees.

**Item 2.** ***Properties***

Our principal offices are located at 909 Montgomery Street, Suite 500, San Francisco, California 94133. We utilize approximately 1,500 square feet of space provided by our manager.

**Item 3.** ***Legal Proceedings***

At December 31, 2004, neither we nor any of our properties were subject to any pending legal proceedings.

**Item 4.** ***Submission of Matters to A Vote of Security Holders***

None.

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# PART II

## Item 5. *Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

### Market Information

Since December 19, 2003, our common stock has been listed on the NYSE under the symbol LUM. Prior to our initial public offering, our common stock was not listed or quoted on any national securities exchange or market system. However, certain of our stockholders privately sold shares of our common stock using the PORTAL system.

The following table sets forth the intra-day high and low sale prices for our common stock as reported on the PORTAL Market of which we are aware (for dates prior to December 19, 2003) and as reported on the NYSE (for dates on or after December 19, 2003) for each quarterly period since June 11, 2003, the date of our private placement offering:

| | Common Stock | |
|---|---|---|
| | **High** | **Low** |
| **2004** | | |
| First Quarter | $ 15.35 | $ 13.77 |
| Second Quarter | 14.35 | 11.45 |
| Third Quarter | 12.88 | 10.50 |
| Fourth Quarter | 12.78 | 11.30 |

| | Common Stock | |
|---|---|---|
| | **High** | **Low** |
| **2003** | | |
| Second Quarter (from June 11, 2003) | $ 15.35 | $ 15.00 |
| Third Quarter | 15.60 | 15.00 |
| Fourth Quarter | 15.00 | 13.00 |

### Holders

As of February 28, 2005, we had 37,841,280 issued and outstanding shares of common stock that were held by 78 holders of record. The 78 holders of record include Cede & Co., which holds shares as nominee for The Depository Trust Company, which itself holds shares on behalf of the beneficial owners of our common stock.

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**Distributions and Distribution Policy**

The following table sets forth, for the periods indicated, the cash distributions declared per share of our common stock since June 11, 2003, the date of our private placement:

| | Cash Distributions Declared per Share | Declaration Date |
|---|---|---|
| **2004** | | |
| First Quarter | $ 0.42 | March 9, 2004 |
| Second Quarter | 0.43 | June 28, 2004 |
| Third Quarter | 0.43 | September 28, 2004 |
| Fourth Quarter | 0.43 | December 21, 2004 |
| **2003** | | |
| Second Quarter (from June 11, 2003) | $ | N/A |
| Third Quarter | 0.50 | October 1, 2003 |
| Fourth Quarter | 0.45 | November 24, 2003 |

Our distributions declared to date are not necessarily indicative of distributions that we will declare in the future. We expect that future distributions will be based on our REIT taxable net income in future periods, which we cannot predict with any certainty. All distribution declarations are made at the discretion of our board of directors.

The distributions are taxable dividends and are not considered a return of capital. Distributions are funded with cash flows from our ongoing operations, including principal and interest payments received on our mortgage-backed securities.

We intend to distribute all or substantially all of our REIT taxable net income (which does not ordinarily equate to net income as calculated in accordance with accounting principles generally accepted in the United States, which are known as GAAP) to our stockholders in each year. We intend to make regular quarterly distributions to our stockholders to be paid out of funds readily available for such distributions. Our distribution policy is subject to revision at the discretion of our board of directors without stockholder approval or notice to you. We have not established a minimum distribution level and our ability to make distributions may be harmed for the reasons described under the caption Risk Factors. All distributions will depend on our earnings and financial condition, maintenance of REIT status, applicable provisions of the Maryland general corporation law, or MGCL, and such other factors as our board of directors deems relevant.

In order to avoid corporate income and excise tax and to maintain our qualification as a REIT under the Internal Revenue Code, we must make distributions to our stockholders each year in an amount at least equal to:

90% of our REIT taxable net income, plus

90% of our after tax net income, if any, from foreclosure property, minus

the excess of the sum of specified items of our non-cash income items over 5% of REIT taxable net income.

In general, our distributions will be applied toward these requirements only if paid in the taxable year to which they relate, or in the following taxable year if the distributions are declared before we timely file our tax return for that year, the distributions are paid on or before the first regular distribution payment following the declaration and we elect on our tax return to have a specified dollar amount of such distributions treated as if paid in the prior year. Distributions declared by us in October, November or December of one taxable year and payable to a stockholder of record on a specific date in such a month are treated as both paid by us and received by the stockholder during such taxable year, provided that the distribution is actually paid by us by January 31 of the following taxable year.

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We anticipate that distributions generally will be taxable as ordinary income to our stockholders, although a portion of such distributions may be designated by us as capital gain or may constitute a return of capital. We will furnish annually to each of our stockholders a statement setting forth distributions paid during the preceding year and their characterization as ordinary income, return of capital or capital gains.

In the future, our board of directors may elect to adopt a dividend reinvestment and stock purchase plan.

**Equity Compensation Plan**

Effective June 4, 2003, we adopted a 2003 Stock Incentive Plan and a 2003 Outside Advisors Stock Incentive Plan pursuant to which up to 1,000,000 shares of our common stock is authorized to be awarded at the discretion of the Compensation Committee of the Board of Directors. The plans provide for the grant of a variety of long-term incentive awards to employees and officers, individual consultants or advisors who render or have rendered bona fide services, and officers, employees or directors of Seneca as an additional means to attract, motivate, retain and reward eligible persons. These plans provide for the grant of awards that meet the requirements of Section 422 of the Internal Revenue Code, non-qualified stock options, stock appreciation rights, restricted stock, stock units and other stock-based awards and dividend equivalent rights.

The following table illustrates common stock authorized for issuance under the 2003 Stock Incentive Plan and 2003 Outside Advisors Stock Incentive Plan as of December 31, 2004:

| Plan Category | (a) Number of Securities to Be Issued upon Exercise of Outstanding Options, Warrants and Rights | (b) Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights | (c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) |
|---|---|---|---|
| Incentive plans approved by stockholders | 55,000 | $ 14.82 | 919,878 |
| Incentive plans not approved by stockholders | | | |
| Total | 55,000 | $ 14.82 | 919,878(1) |

(1) At December 31, 2004, the maximum number of shares of common stock that may be delivered pursuant to awards granted under both plans is 919,878 shares of our common stock.

See Note 6 to our financial statements in Item 8 of this Annual Report on Form 10-K for further information regarding the 2003 Stock Incentive Plan and 2003 Outside Advisors Stock Incentive Plan.

**Recent Sales of Unregistered Securities**

The following table summarizes shares of our restricted common stock issued to Seneca pursuant to the provisions of our management agreement with Seneca in reliance on the exemption from registration provided by Section 4(2) of the Securities Act and Rule 506 thereunder:

| Date Issued | Period Earned | Number of Shares | Aggregate Value (In thousands) |
|---|---|---|---|
| February 4, 2004 | Fourth quarter 2003 | 25,651 | $ 357 |
| April 26, 2004 | First quarter 2004 | 55,849 | 767 |
| August 10, 2004 | Second quarter 2004 | 97,297 | 1,086 |
| November 10, 2004 | Third quarter 2004 | 95,092 | 1,117 |

The common stock issued to Seneca was in exchange for services.

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**Item 6. *Selected Financial Data***

The following selected financial data are derived from our audited financial statements as of December 31, 2004 and 2003 and for the year ended December 31, 2004 and the period from April 26, 2003 through December 31, 2003. The selected financial data should be read in conjunction with the more detailed information contained in Management s Discussion and Analysis of Financial Condition and Results of Operations and the audited financial statements and notes thereto in Item 8 of this Annual Report on Form 10-K.

| (dollars in thousands, except share and per share amounts) | For the Year Ended Months Ended December 31, 2004 | For the Period from April 26, 2003 through December 31, 2003 |
|---|---|---|
| **Statement of Operations Data:** | | |
| Interest income | $ 123,754 | $ 22,654 |
| Interest expense | 55,116 | 9,009 |
| Net interest income | 68,638 | 13,645 |
| Other income | 1,070 | |
| Losses on sale of mortgage-backed securities | | (7,831) |
| Expenses | 12,596 | 3,053 |
| Net income | 57,112 | 2,761 |
| **Per Common Share Data:** | | |
| Net income basic | $ 1.68 | $ 0.27 |
| Net income diluted | 1.68 | 0.27 |
| Cash distributions declared(1) | 1.71 | 0.95 |
| Book value (end of period)(2) | 10.93 | 11.38 |
| Common shares outstanding (end of period) | 37,113,011 | 24,814,000 |
| Weighted-average shares outstanding basic | 33,895,967 | 10,139,280 |
| Weighted-average shares outstanding diluted | 33,947,414 | 10,139,811 |
| **Balance Sheet Data (end of period):** | | |
| Mortgage-backed securities available-for-sale, at fair value | $ 186,351 | $ 352,123 |
| Mortgage-backed securities available-for-sale, pledged as collateral, at fair value | 4,641,604 | 1,809,822 |
| Total mortgage-backed securities available-for-sale, at fair value | 4,827,955 | 2,161,945 |
| Total assets | 4,879,828 | 2,179,340 |
| Repurchase agreements | 4,436,456 | 1,728,973 |
| Total liabilities | 4,474,325 | 1,896,844 |
| Accumulated other comprehensive loss | (61,368) | (26,510) |
| Total stockholders equity | 405,503 | 282,496 |
| **Financial Ratios:** | | |
| Leverage ratio (period end)(3) | 10.9 | 6.1 |

(1) Cash distributions declared during the period from April 26, 2003 through December 31, 2003 were payable to stockholders of the 11,704,000 shares outstanding on each of the record dates prior to the completion of our initial

public offering. Cash distributions of $0.42 per share declared on March 9, 2004 were payable to stockholders of the 24,841,146 shares outstanding on the record date, which was prior to the completion of our follow-on public offering.

(2) Book value is calculated as total stockholders equity divided by the number of shares issued and outstanding as of December 31, 2004 and 2003.

(3) Leverage is calculated as total repurchase agreements divided by total stockholders equity. At December 31, 2003, substantially all of the net offering proceeds from our initial public offering had been used to purchase mortgage-backed securities. However, at December 31, 2003, we had not fully levered our portfolio to within our target range of eight to 12 times the amount of our equity. As a result, the total amount of mortgage-backed securities and repurchase agreement liabilities as of December 31, 2003 were lower than they were once our portfolio was fully levered through additional repurchase agreement liabilities and related mortgage-backed security purchases.

**Item 7.** ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

*The following discussion of our financial condition and results of operations should be read in conjunction with the financial statements and notes to those statements included in Item 8 in this Annual Report on Form 10-K. This discussion may contain certain forward-looking statements that involve risks and uncertainties. Forward-looking statements are those that are not historical in nature. The words will, anticipate, estimate, should, expect, beli intend and similar expressions or the negatives of these words or phrases are intended to identify forward-looking statements. As a result of many factors, such as those set forth under Risk Factors and elsewhere in this document, our actual results may differ materially from those anticipated in such forward-looking statements.*

## Overview

Luminent Mortgage Capital, Inc. is a REIT headquartered in San Francisco, California. 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. Substantive operations began mid-June 2003, after completing a private placement of our common stock. 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 have acquired and will seek to acquire additional assets 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.

Our business is affected by a variety of economic and industry factors. The most significant risk factors management considers while managing the business that could have a material adverse effect on the financial condition and results of operations are:

- interest rate mismatches between our adjustable-rate and hybrid adjustable-rate mortgage-backed securities and our borrowings used to fund our purchases of mortgage-backed securities;
- increasing or decreasing levels of prepayments on the mortgages underlying our mortgage-backed securities;
- the potential for increased borrowing costs related to repurchase agreements;
- interest rate caps related to our adjustable-rate and hybrid adjustable-rate mortgage-backed securities;
- the overall leverage of our portfolio;
- our ability or inability to use derivatives to mitigate our interest rate and prepayment risks;
- the impact that increases in interest rates would have on our book value;
- maintaining adequate borrowing capacity so that we can 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;
- 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;

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

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

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

Management has established interest rate risk and other policies for managing the portfolio of mortgage-backed securities and the related borrowings outstanding. These policies include, but are not limited to, evaluating the level of risk we assume when purchasing adjustable-rate or hybrid adjustable-rate mortgage-backed securities that are subject to periodic and lifetime interest rate caps, matching the interest rates on our assets and liabilities, acquiring new mortgage-backed securities to replace prepaid securities, purchasing mortgage-backed securities that we believe to have favorable-risk adjusted expected returns relative to the market interest rates at the time of purchase, borrowing between eight and 12 times the amount of our stockholders equity, entering into derivative transactions to protect us from rising interest rates on our repurchase agreements and monitoring our qualification as a REIT.

Refer to the section titled Risk Factors for additional discussion regarding these and other risk factors that affect our business. Refer to the section Interest Rate Risk of Item 7A, Quantitative and Qualitative Disclosure About Market Risk, for additional interest rate risk discussion.

## Critical Accounting Policies

Our financial statements are prepared in accordance with GAAP. These accounting principles require us to make some complex and subjective decisions and assessments. Our most critical accounting policies involve decisions and assessments that could significantly affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our financial statements are based were reasonable at the time made based upon information available to us at that time. See Note 2 to our financial statements included in Item 8 of this Annual Report on Form 10-K for a complete discussion of our significant accounting policies. Management has identified our most critical accounting policies to be the following:

***Classifications of Investment Securities***

Our investments in mortgage-backed securities are classified as available-for-sale securities that are carried on our balance sheet at their fair value. The classification of the securities as available-for-sale results in changes in fair value being recorded as adjustments to accumulated other comprehensive income or loss, which is a component of stockholders equity, rather than immediately through earnings. If available-for-sale securities were classified as trading securities, our earnings could experience substantially greater volatility from period-to-period.

***Valuations of Mortgage-backed Securities***

Our mortgage-backed securities have fair values as determined by management with reference to price estimates provided by independent pricing services and dealers in the securities. Because the price estimates may vary to some degree between sources, management must make certain judgments and assumptions about the appropriate price to use to calculate the fair values for financial reporting purposes. Different judgments and assumptions could result in different presentations of value.

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

Management considers the following factors when evaluating the securities for an other-than-temporary impairment:

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

The determination of other-than-temporary impairment is evaluated at least quarterly. If in the future management determines an impairment to be other-than-temporary we may need to realize a loss that would have an impact on future income.

***Interest Income Recognition***

Interest income on our mortgage-backed securities is accrued based on the actual coupon rate and the outstanding principal amount of the underlying mortgages. Premiums and discounts are amortized or accreted into interest income over the lives of the securities using the effective yield method adjusted for the effects of estimated prepayments based on Statement of Financial Accounting Standards, or SFAS, No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. If our estimate of prepayments is incorrect, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

***Accounting for Derivative Financial Instruments and Hedging Activities***

Our policies permit us to enter into derivative contracts, including Eurodollar futures contracts and interest rate swaps, as a means of mitigating our interest rate risk on forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements, or hedged items, for a specified future time period.

At December 31, 2004, we have engaged in short sales of Eurodollar futures contracts to mitigate our interest rate risk for the specified future time period, which is defined as the calendar quarter immediately following the contract expiration date. The value of these futures contracts is marked-to-market daily in our margin account with the custodian. Based upon the daily market value of these futures contracts, we either receive funds into, or wire funds into, our margin account with the custodian to ensure that an appropriate margin account balance is maintained at all times through the expiration of the contracts.

At December 31, 2004, we have entered into interest rate swap contracts to mitigate our interest rate risk for the period defined by the maturity of the swap. Cash flows that occur each time the swap is repriced are associated with forecasted interest expense for a specified future period, which is defined as the calendar period preceding each repricing date with the same number of months as the repricing frequency.

The futures and interest rate swap contracts, or hedge instruments, have been designated as cash flow hedges and are evaluated at inception and on an ongoing basis in order to determine whether they qualify for hedge accounting under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted. The hedge instrument must be highly effective in achieving offsetting changes in the hedged item attributable to the risk being hedged in order to qualify for hedge accounting. In order to determine whether the hedge instrument is highly effective, we use regression methodology to assess the effectiveness of our hedging strategies. Specifically, at the inception of each new hedge and on an ongoing basis, we assess effectiveness using ordinary least squares regression to evaluate the correlation between the rates consistent with the hedge instrument and the underlying hedged items. A hedge instrument is highly effective if the changes in the fair value of the derivative provide offset of at least 80% and not more than 120% of the changes in fair value or cash flows of the hedged item attributable to the risk being hedged. The futures and interest rate swap contracts are carried on the balance sheet at fair value. Any ineffectiveness that arises during the hedging relationship is recognized in interest expense during the period in which it arises. Prior to the end of the specified hedge time period, the effective portion of all contract gains and losses (whether

realized or unrealized) is recorded in other comprehensive income or loss. Realized gains and losses on futures contracts are reclassified into earnings as an adjustment to interest expense during the specified hedge time period. Realized gains and losses on interest rate swap contracts are reclassified into earnings as an adjustment to interest expense during the period subsequent to the swap repricing date through the remaining maturity of the swap. For REIT taxable net income purposes, realized gains and losses on futures and interest rate swap contracts are reclassified into earnings immediately when positions are closed or have expired.

We are not required to account for the futures and interest rate swap contracts using hedge accounting as described above. If we decided not to designate the futures and interest rate swap contracts as hedges and to monitor their effectiveness as hedges, or if we entered into other types of financial instruments that did not meet the criteria to be designated as hedges, changes in the fair values of these instruments would be recorded in the statement of operations, potentially resulting in increased volatility in our earnings.

***Management Incentive Compensation Expense***

The management agreement provides for the payment of incentive compensation to Seneca if our financial performance exceeds certain benchmarks. Incentive compensation is calculated on a cumulative, quarterly basis for GAAP purposes and on a stand-alone quarterly basis with an annual cumulative reconciliation calculation for incentive compensation payment purposes. During each quarter of the fiscal year, we calculate the incentive compensation expense quarterly, on a cumulative basis, making any necessary adjustments for any expensed amounts that were recognized in previous quarters. As a result, if we experience poor quarterly performance in a particular quarter and this performance causes the cumulative incentive compensation expense for the current quarter to be lower than the cumulative incentive compensation for the prior quarter, we will record a negative incentive compensation expense in the current quarter. The incentive compensation is payable one-half in cash and one-half in the form of our restricted common stock.

For the first, second and third quarters of each fiscal year, incentive compensation payments actually paid to Seneca are calculated based upon the net income and relevant performance thresholds solely for the applicable quarter, and a cumulative calculation is performed at the end of the fiscal year. As a result, during the first three quarters of each fiscal year there may be differences between incentive compensation expense, for GAAP purposes, and the incentive compensation amounts actually paid to Seneca. Any differences between these amounts will be reflected on the balance sheet as a receivable due from or payable due to Seneca. In addition, when each annual cumulative incentive compensation calculation and reconciliation is performed, Seneca may be required to return cash incentive compensation payments earlier received or shares of common stock earlier granted, as applicable, to it as part of its incentive compensation payments for the first three quarters of the fiscal year.

The cash portion of the incentive compensation is accrued and expensed during the period for which it is calculated and paid. We account for the restricted common stock portion of the incentive compensation in accordance with SFAS No. 123, *Accounting for Stock-based Compensation*, and related interpretations, and EITF 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

This restricted common stock portion of the incentive compensation is granted to Seneca on a quarterly basis pursuant to the terms of the management agreement. The number of shares issued 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 quarterly by our board of directors to account for the transfer restrictions during the vesting period. During periods of lower stock prices, we will issue more restricted common stock to Seneca under the management agreement to pay for the same amount of incentive compensation earned in periods that had higher stock prices. Over the vesting period, any additional shares issued would have a dilutive effect on book value and net income per share.

On the date of each restricted common stock grant to Seneca under the management agreement, the fair market value of the restricted common stock is recorded in the stockholders equity section of our balance sheet as common stock and additional paid-in capital. The corresponding portion of any restricted common

stock grant that is not expensed is reflected in the stockholders equity section of our balance sheet as deferred compensation. Each quarter s incentive compensation restricted common stock grant to Seneca is divided into three tranches. The first tranche vests over a one-year period and is expensed over a five-quarter period, beginning in the quarter in which it was earned. The second tranche vests over a two-year period and is expensed over a nine-quarter period beginning in the quarter in which it was earned. The third tranche vests over a three-year period and is expensed over a thirteen-quarter period beginning in the quarter in which it was earned. As a result of this vesting schedule for the restricted common stock granted to Seneca, we will incur incentive compensation expense in each of the periods following the grant of the restricted common stock over a three-year period. We will continue to incur incentive compensation expense related to each restricted common stock grant, even in subsequent periods in which Seneca did not earn incentive compensation under the management agreement.

As the price of our common stock changes in future periods, the fair value of the unvested portions of shares paid to Seneca pursuant to the management agreement will be marked-to-market, with corresponding entries on the balance sheet. The net effect of any mark-to-market adjustments to the value of the unvested portions of the restricted common stock will be expensed in future periods, on a ratable basis, according to the remaining vesting schedules of each respective tranche of restricted common stock. Accordingly, incentive compensation expense related to the portion of the incentive compensation paid to Seneca in each restricted common stock grant may be higher or lower from one reporting period to the next, and may vary throughout the vesting period. For example, future incentive compensation expense related to previously issued but unvested restricted common stock will be higher during periods of increasing stock prices, and lower during periods of decreasing stock prices. In addition, over the vesting period for each restricted common stock grant, our stockholders equity will increase or decrease based upon the current market price of our stock. As a result, this expense adjustment will have the effect of increasing or decreasing our net worth, the factor used in calculating Seneca s base management fee, and may increase or decrease the amount of base management fees in future periods.

Pursuant to the management agreement, it is possible for Seneca to earn incentive compensation each quarter and, as a result, receive a restricted common stock grant each quarter. As Seneca is granted multiple tranches of restricted common stock for incentive compensation, we will experience increasing management fee expense due to the cumulative impact of multiple tranches and vesting schedules of restricted common stock grants, and the mark-to-market impact of the unvested portions of these grants. This increase in management fee expense will be true even in periods where there is little change in our income or stock price.

We also pay incentive compensation, in the form of cash and restricted common stock, to our chief financial officer, in accordance with the terms of his employment agreement. The incentive compensation is accounted for in the same manner as the incentive compensation earned by Seneca.

**Financial Condition**

All of our assets at December 31, 2004 were acquired with the proceeds of our June 2003 private placement of 11,500,000 shares of our common stock, our December 2003 initial public offering of 13,110,000 shares of our common stock, our March 2004 follow-on public offering of 12,000,000 shares of our common stock and use of leverage. We received net proceeds after offering costs of $159.7 million from the private placement offering, which was completed in mid-June 2003, $157.0 million from the initial public offering, which was completed on December 18, 2003 and $157.5 million from the follow-on public offering, which was completed on March 29, 2004.

***Mortgage-Backed Securities***

At December 31, 2004, we held $4.8 billion of mortgage-backed securities at fair value, net of unrealized gains of $772 thousand and unrealized losses of $70.1 million. At December 31, 2003, we held $2.2 billion of mortgage-backed securities at fair value, net of unrealized gains of $1.1 million and unrealized losses of $27.4 million. The increase in mortgage-backed securities held is primarily the result of the public offering that was completed on March 29, 2004, as well as security purchases in the first quarter of 2004 made as a

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result of fully leveraging the proceeds from our initial public offering. As of December 31, 2004 and 2003, substantially all of the mortgage-backed securities in our portfolio were purchased at a premium to their par value and our portfolio had a weighted-average amortized cost of 101.7% and 102.2% of the face amount, respectively.

Fair value was below amortized cost for certain of the securities held at December 31, 2004 and 2003. At December 31, 2004 and 2003, our entire portfolio was invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities. None of the securities held had been downgraded by a credit rating agency since their purchase. In addition, we intend and have the ability to hold the securities for a period of time sufficient to allow for the anticipated recovery in fair value of the securities held. As such, we do not believe any of the securities held were other-than-temporarily impaired at December 31, 2004 and 2003.

The stated contractual final maturity of the mortgage loans underlying our portfolio of mortgage-backed securities ranges up to 30 years, however, the expected maturity is subject to change based on the prepayments of the underlying mortgage loans. The following table sets forth the maturity dates, by year, and percentage composition related to the assets that comprise our investment portfolio at December 31, 2004:

| Asset | Average Final Maturity | % of Total |
|---|---|---|
| Adjustable-Rate Mortgage-Backed Securities | 2033 | 2.6% |
| Hybrid Adjustable-Rate Mortgage-Backed Securities | 2034 | 96.3% |
| Balloon Mortgage-Backed Securities | 2008 | 1.1% |
| Fixed-Rate Mortgage-Backed Securities | N/A | N/A |

The following table sets forth the maturity dates, by year, and percentage composition related to the assets that comprise our investment portfolio at December 31, 2003:

| Asset | Average Final Maturity | % of Total |
|---|---|---|
| Adjustable-Rate Mortgage-Backed Securities | 2033 | 8.6% |
| Hybrid Adjustable-Rate Mortgage-Backed Securities | 2033 | 88.9% |
| Balloon Mortgage-Backed Securities | 2008 | 2.5% |
| Fixed-Rate Mortgage-Backed Securities | N/A | N/A |

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

The principal payment rate on our mortgage-backed securities, an annual rate of principal paydowns for our mortgage-backed securities relative to the outstanding principal balance of our mortgage-backed securities, was 25% for the three months ended December 31, 2004. The principal payment rate for the three months ended December 31, 2003 was 23%. The principal payment rate attempts to predict the percentage of principal that will paydown over the next 12 months based on historical principal paydowns. The principal payment rate within our portfolio for the second half of 2004 was relatively constant. This rate cannot be considered an indication of future principal prepayment rates because actual changes in interest rates in 2005 will have a direct impact on the principal prepayments within our portfolio.

At December 31, 2004 and 2003, the weighted-average effective duration of the securities in our overall investment portfolio, assuming constant prepayment rates, or CPR, to the balloon or reset date, or the CPB duration, was 1.69 years and 1.75 years, respectively. CPR is a measure of the rate of prepayment for our mortgage-backed securities, expressed as an annual rate relative to the outstanding principal balance of our mortgage-backed securities. CPB duration is similar to CPR except that it also assumes that the hybrid adjustable-rate mortgage-backed securities prepay in full at their next reset date. At December 31, 2004 and 2003, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities had fixed interest rates for a weighted-average of approximately 39 months and 43 months, respectively, after which time the interest rates reset and become adjustable. The average length of time until maturity of those mortgages was 30 years.

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Those mortgages are also subject to interest rate caps that limit the amount that the applicable interest rate can increase during any year, known as an annual cap, and through the maturity of the applicable security, known as a lifetime cap. At December 31, 2004 and 2003, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities with specific annual caps had average annual caps of 2.24% and 2.47%, respectively, and average lifetime caps of 9.99% and 10.03%, respectively.

The following table summarizes our mortgage-backed securities at December 31, 2004 according to their estimated weighted-average life classifications:

| Weighted-Average Life | Fair Value | Amortized Cost | Weighted-Average Coupon |
|---|---|---|---|
| | (in thousands) | | |
| Less than one year | $ 211,475 | $ 215,099 | 3.76% |
| Greater than one year and less than five years | 4,616,480 | 4,682,154 | 4.24 |
| Greater than five years | | | |
| Total | $ 4,827,955 | $ 4,897,253 | 4.22% |

The following table summarizes our mortgage-backed securities at December 31, 2003 according to their estimated weighted-average life classifications:

| Weighted-Average Life | Fair Value | Amortized Cost | Weighted-Average Coupon |
|---|---|---|---|
| | (in thousands) | | |
| Less than one year | $ 299,685 | $ 304,556 | 4.07% |
| Greater than one year and less than five years | 1,829,471 | 1,850,899 | 4.09 |
| Greater than five years | 32,789 | 32,843 | 3.96 |
| Total | $ 2,161,945 | $ 2,188,298 | 4.09% |

The weighted-average lives of the mortgage-backed securities at December 31, 2004 and 2003 in the tables above are based upon data provided through a subscription-based financial information service provided by a major investment bank, assuming constant prepayment rates to the balloon or reset date for each security. At December 31, 2004 and 2003, the weighted-average lives were calculated using estimated prepayment speeds or actual prepayment speed history. The weighted-average lives for some of the mortgage-backed securities included in the table above were estimated using expected prepayment speeds for pools with similar characteristics, since certain pools were new issues and did not have historical performance data available. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loan, loan age, margin and volatility.

The actual weighted-average lives of the mortgage-backed securities in our investment portfolio could be longer or shorter than the estimates in the tables above depending on the actual prepayment rates experienced over the life of the applicable securities and is sensitive to changes in both prepayment rates and interest rates.

***Equity Securities***

Our investment policies allow us to acquire a limited amount of equity securities, including common and preferred shares issued by other real estate investment trusts. At December 31, 2004 and 2003, we did not hold any equity securities.

***Unsettled Securities Purchases***

At December 31, 2004, we had no unsettled security trades. At December 31, 2003, we had unsettled securities purchases of $156.1 million, which subsequently settled in January 2004. Of the $156.1 million of unsettled securities purchases, $59.8 million were related to to be announced, or TBA, mortgage-backed securities.

***Other Assets***

We had other assets of $33.4 million and $10.2 million at December 31, 2004 and 2003, respectively. Other assets at December 31, 2004 consist primarily of interest receivable of $18.9 million, principal receivable of $13.4 million, prepaid directors and officers liability insurance of $137 thousand, deferred financing costs of $174 thousand and deferred compensation of $732 thousand. Other assets at December 31, 2003 consist primarily of interest receivable of $7.3 million, principal receivable of $2.3 million, prepaid directors and officers liability insurance of $220 thousand and deferred compensation of $270 thousand. The increases in interest receivable and principal receivable at December 31, 2004 compared to December 31, 2003 are primarily due to the increase in our portfolio of mortgage-backed securities during the year.

***Hedging Instruments***

Hedging involves risk and typically involves costs, including transaction costs. The costs of hedging can increase as the period covered by the hedging increases and during periods of rising and volatile interest rates. We may increase our hedging activity and, thus, increase our hedging costs during such periods when interest rates are volatile or rising. We generally intend to hedge as much of the interest rate risk as Seneca determines is in the best interest of our stockholders, after considering the cost of such hedging transactions and our desire to maintain our status as a REIT. Our policies do not contain specific requirements as to the percentages or amount of interest rate risk that Seneca is required to hedge. There can be no assurance that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Moreover, no hedging activity can completely insulate us from the risks associated with changes in interest rates and prepayment rates.

At December 31, 2004, we have engaged in short sales of Eurodollar futures contracts as a means of mitigating our interest rate risk on forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements, or hedged item, for a specified future time period, which is defined as the calendar quarter immediately following the contract expiration date. At December 31, 2004, we had short positions on 4,740 Eurodollar futures contracts, which expire in March 2005, June 2005, December 2005 and March 2006 with a notional amount totaling $4.7 billion. The value of these futures contracts is marked-to-market daily in our margin account with the custodian. Based upon the daily market value of these futures contracts, we either receive funds into, or wire funds into, our margin account with the custodian to ensure that an appropriate margin account balance is maintained at all times through the expiration of the contracts. At December 31, 2003, we had short positions on 2,090 Eurodollar futures contracts, which expired in March 2004, June 2004, and September 2004, with a notional amount totaling $2.1 billion. At December 31, 2004 and December 31, 2003, the fair value of the Eurodollar futures contracts was $1.1 million and $157 thousand recorded in liabilities, respectively.

At December 31, 2004, we have entered into interest rate swap contracts to mitigate our interest rate risk for the period defined by maturity of the interest rate swap. Cash flows that occur each time the swap is repriced are associated with forecasted interest expense for a specified future period, which is defined as the calendar period preceding each repricing date with the same number of months as the repricing frequency. At December 31, 2004, the current notional amount of interest rate swap contracts totaled $1.6 billion and the fair value of the interest rate swap contracts was $7.9 million recorded in assets. We had not entered into interest rate swap contracts at December 31, 2003. Counterparties to our interest rate swap contracts are well-known financial institutions and default risk is considered low.

***Liabilities***

We have entered into repurchase agreements to finance some of our acquisitions of mortgage-backed securities. None of the counterparties to these agreements are affiliates of Seneca or us. These agreements are secured by our mortgage-backed securities and bear interest at rates that have historically moved in close relationship to LIBOR. As of December 31, 2004 and 2003, we had established 17 borrowing arrangements with various investment banking firms and other lenders, 12 of which were in use on December 31, 2004 and 2003.

At December 31, 2004, we had outstanding $4.4 billion of repurchase agreements with a weighted-average current borrowing rate of 2.38%, $230.4 million of which matures within 30 days, $1.9 billion of which matures between 31 and 90 days and $2.3 billion of which matures in greater than 90 days. At December 31, 2003, we had outstanding $1.7 billion of repurchase agreements with a weighted-average current borrowing rate of 1.19%, $337.3 million of which matures within 30 days, $281.9 million of which matures between 31 and 90 days and $1.1 billion of which matures in greater than 90 days. The increase in outstanding repurchase agreements is primarily due to the public offering that was completed on March 29, 2004, as well as from fully leveraging the proceeds from our initial public offering. We used the net proceeds of the initial public offering and follow-on equity offering to purchase mortgage-backed securities through leverage. It is our present intention to seek to renew the repurchase agreements outstanding at December 31, 2004 as they mature under the then-applicable borrowing terms of the counterparties to our repurchase agreements. At December 31, 2004 and 2003, the repurchase agreements were secured by mortgage-backed securities with an estimated fair value of $4.6 billion and $1.8 billion, respectively, and had a weighted-average maturity of 133 days and 145 days, respectively. The net amount at risk, defined as the sum of the fair value of securities sold plus accrued interest income minus the sum of repurchase agreement liabilities plus accrued interest expense, with all counterparties was $205.9 million and $83.2 million at December 31, 2004 and 2003, respectively.

After consideration of the terms of our Eurodollar futures and interest rate swap contracts, the weighted-average days to rate reset of our total liabilities was 275 days and 255 days at December 31, 2004 and 2003, respectively. The increase in the weighted-average days to rate reset of our total liabilities is primarily attributed to the use of interest rate swap contracts to hedge the impact of changes in interest rates on our liability costs.

We had $36.8 million and $167.9 million of other liabilities at December 31, 2004 and 2003, respectively. Other liabilities at December 31, 2004 consisted primarily of $16.0 million of cash distribution payable, $17.3 million of accrued interest expense on repurchase agreements and interest rate swap contracts and $3.0 million of management fees payable, incentive compensation payable and other related party liabilities. Other liabilities at December 31, 2003 consisted primarily of $156.1 million of unsettled securities purchases, $5.3 million of cash distribution payable, $3.8 million of accrued interest expense on repurchase agreements, $1.4 million of accounts payable and accrued expenses and $1.1 million of management fee payable, incentive compensation payable and other related party liabilities.

We have a margin lending facility with our primary custodian from which we may borrow money in connection with the purchase or sale of securities. The terms of the borrowings, including the rate of interest payable, are agreed to with the custodian for each amount borrowed. Borrowings are repayable immediately upon demand by the custodian. There were no outstanding borrowings under the margin lending facility at December 31, 2004 and 2003, respectively.

***Stockholders Equity***

Stockholders equity at December 31, 2004 and 2003 was $405.5 million and $282.5 million, respectively, which included $69.3 million and $26.3 million, respectively, of net unrealized losses on mortgage-backed securities available-for-sale and $7.9 million and ($157) thousand, respectively, of net deferred realized and unrealized gains/(losses) on cash flow hedges presented as accumulated other comprehensive loss.

Weighted-average stockholders equity and return on average equity for year ended December 31, 2004 were $389.0 million and 14.68%, respectively. Return on average equity is defined as annualized net income divided by weighted-average stockholders equity.

Weighted-average stockholders equity for the period from June 11, 2003, commencement of operations, through December 31, 2003 was $134.2 million. Weighted-average stockholders equity and return on average equity for the period from April 26, 2003 through December 31, 2003 is considered not meaningful as the Company was organized on April 25, 2003 and substantive operations did not begin until mid-June 2003.

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Return on average equity was 7.21% for the period from June 11, 2003, commencement of operations, through December 31, 2003.

Our book value at December 31, 2004 was as follows:

| (dollars in thousands, except per share amounts) | Total Stockholders Equity | Book Value per Share(1) |
|---|---|---|
| Total stockholders equity (GAAP) | $ 405,503 | $ 10.93 |
| *Addback/ (Subtract)* | | |
| Accumulated other comprehensive loss on mortgage-backed securities | 69,298 | 1.86 |
| Accumulated other comprehensive income on interest rate swap contracts | (7,748) | (0.21) |
| Total stockholders equity, excluding accumulated other comprehensive income and loss on mortgage-backed securities and interest rate swap contracts (NON-GAAP) | $ 467,053 | $ 12.58 |

(1) Based on 37,113,011 shares outstanding at December 31, 2004.

Our book value at December 31, 2003 was as follows:

| (dollars in thousands, except per share amounts) | Total Stockholders Equity | Book Value per Share(1) |
|---|---|---|
| Total stockholders equity (GAAP) | $ 282,496 | $ 11.38 |
| *Addback* | | |
| Accumulated other comprehensive loss on mortgage-backed securities | 26,353 | 1.07 |
| Total stockholders equity, excluding accumulated other comprehensive loss on mortgage-backed securities (NON-GAAP) | $ 308,849 | $ 12.45 |

(1) Based on 24,814,000 shares outstanding on December 31, 2003.

Management believes that total stockholders equity excluding accumulated other comprehensive income and loss on mortgage-backed securities and interest rate swap contracts, is a useful measure to investors because book value unadjusted for temporary changes in fair value more closely represents the cost basis of our invested assets, net of our leverage, which is the basis for our net interest income and our distributions to stockholders under the tax provisions of the Internal Revenue Code governing REIT distributions.

**Results of Operations**

***Year ended December 31, 2004 compared to the period from April 26, 2003 through December 31, 2003***

The results of operations for the current year are not comparable to those in 2003 primarily due to the substantial asset base growth resulting from our initial public offering and follow-on public offering and full year of operations in 2004.

For the year ended December 31, 2004, net income was $57.1 million, or $1.68 per weighted-average share outstanding (basic and diluted). For the same period, interest income, net of premium amortization, was approximately $123.8 million, and was primarily earned from investments in mortgage-backed securities. Interest expense for the year ended December 31, 2004 was $55.1 million and was primarily due to costs on short-term borrowings.

For the period from April 26, 2003 through December 31, 2003, net income was $2.8 million or $0.27 per weighted-average share (basic and diluted). For the same period, interest income, net of premium amortization, was approximately $22.6 million, and was primarily earned from investments in mortgage-

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backed securities. Interest expense on short-term borrowings was $9.0 million. Because of the timing of our initial investment of portfolio assets (investment activities began on June 11, 2003) as well as the timing of our initial public offering (proceeds were received on December 24, 2003), interest income and interest expense for the period from April 26, 2003 through December 31, 2003 was substantially lower than the full year of operations in 2004, both in an absolute sense and also relative to the average net invested assets for the period. In addition, prepayment activity declined in 2004 due to the changing interest rate environment and resulted in decreased premium amortization and increased yield on average earning assets.

For the year ended December 31, 2004, the weighted-average yield on average earning assets, net of amortization of premium, was 3.28%, and the cost of funds on our repurchase agreement liabilities was 1.57%, resulting in a net interest spread of 1.71%. For the year ended at December 31, 2003, substantive operations began in mid-June, 2003, after completing a private placement of our common stock. For the period June 16, 2003 (date of the first security purchase settlement) through December 31, 2003, the weighted-average yield on average earning assets, net of amortization of premium, was 2.77%. For the period June 23, 2003 (date of the first security purchase financed through leverage) through December 31, 2003, the cost of funds on our repurchase agreement liabilities was 1.14%. The resulting net interest spread was 1.63%. Cost of funds is defined as total interest expense divided by weighted-average repurchase agreement liabilities. Refer to the section titled Critical Accounting Policies for a description of our accounting policy for derivative instruments and hedging activities and the impact on interest expense. Interest expense for the year ended December 31, 2004 and the period from June 23, 2003 through December 31, 2003 was calculated as follows:

| | For the Year Ended December 31, 2004 (in thousands) | Percentage of Average Repurchase Agreement Liabilities | For the Period from June 23, 2003 through December 31, 2003 (in thousands) | Percentage of Average Repurchase Agreement Liabilities |
|---|---|---|---|---|
| Interest expense on repurchase agreement liabilities | $ 56,309 | 1.60% | $ 8,999 | 1.14% |
| Net hedge ineffectiveness (gains)/losses on futures and interest rate swap contracts | (2,268) | (0.06) | | |
| Amortization of net realized gains on futures | (2,803) | (0.08) | | |
| Net interest expense on interest rate swap contracts | 3,720 | 0.11 | | |
| Other | 158 | nm | 10 | nm |
| Total interest expense | $ 55,116 | 1.57% | $ 9,009 | 1.14% |

nm = not meaningful

The net hedge ineffectiveness gains recognized in interest expense during the year ended December 31, 2004 are primarily due to an adjustment to the construction of the hypothetical derivative during the three months ended June 30, 2004 in accordance with our SFAS No. 133 accounting policy, which is used to measure hedge ineffectiveness on our Eurodollar futures contracts. We changed the term of our forecasted repurchase agreement liabilities to conform more closely with common industry issuance terms. We do not anticipate further changes to the term of our forecasted repurchase agreement liabilities, and therefore we believe that we will incur no future ineffectiveness from this change. As required by SFAS No. 133, we recognized one-time gains of $2.0 million in the form of hedge ineffectiveness on our Eurodollar futures contracts during the three months ended June 30, 2004. The impact of this recognition was that a portion of the liabilities we had hedged in anticipation of rising interest rates were recognized as gains or offsets to our interest expense in the second quarter of 2004. The remaining net ineffectiveness gains at December 31, 2004 relate to our cash flow hedges. At December 31, 2004, the maximum length of time over which we were hedging our exposure was 15 months compared to 9 months at December 31, 2003. No net hedge ineffectiveness gains or losses were recognized in 2003.

Average repurchase agreement liabilities during the year ended December 31, 2004 and the period from June 23, 2003 through December 31, 2003 were $3.5 billion and $1.6 billion, respectively.

Other income of $1.1 million for the year ended December 31, 2004 represents a one-time gain on the termination of certain repurchase agreements that was initiated by our counterparty, Federal Home Loan Mortgage Corporation. We had no other income for the period from April 26, 2003 through December 31, 2003.

Net losses on sales of mortgage-backed securities of $7.8 million are included in net income for the period from April 26, 2003 through December 31, 2003. Between June 30, 2003 and mid-August 2003, the U.S. bond markets experienced dramatic price and yield volatility. Increasing interest rates caused the overall market value of our portfolio to decrease and our leverage (defined as our total debt divided by stockholders equity) to increase beyond management s desired range. To reduce leverage, we sold securities in mid-August 2003 totaling $130.7 million and realized a loss of $2.3 million. In an attempt to protect our portfolio from further increases in interest rates, we sold short $200 million of TBA mortgage securities. Interest rates subsequently declined, and we closed out this short position in the month of September 2003 for a total realized loss of $5.7 million. During the third quarter of 2003, we also simultaneously sold and purchased securities totaling $215.9 million and $215.7 million, respectively, that resulted in a realized gain on sale of $0.2 million. We did not sell any mortgage-backed securities during the period from April 26, 2003 through June 30, 2003 or during the quarter ended December 31, 2003, therefore, there were no gains or losses on sales of securities for these periods. In addition, we did not sell any mortgage-backed securities during the year ended December 31, 2004. Although we generally intend to hold our investment securities to maturity, Seneca may determine at some time before they mature that it is in our interest to sell them and purchase securities with other characteristics. In that event, our earnings will be affected by realized gains or losses.

Operating expenses for the year ended December 31, 2004 and the period from April 26, 2003 through December 31, 2003 were $12.6 million and $3.1 million, respectively, for an increase of $9.5 million. The increase in operating expenses in 2004 is primarily due to a full year of operations versus a partial year in 2003. Operating expenses in 2003 were high in proportion to gross interest income and expense and to net interest income as compared to the same proportions for the full year of operations in 2004 primarily due to start-up costs.

Base management fees to Seneca under the management agreement, which were $4.1 million and $0.9 million for the year ended December 31, 2004 and the period from April 26, 2003 through December 31, 2003, respectively, are based on a percentage of our average net worth. Average net worth for these purposes is calculated on a monthly basis and equals the difference between the aggregate book value of our consolidated assets prior to accumulated depreciation and other non-cash items, including the fair market value adjustment on mortgage-backed securities, minus the aggregate book value of our consolidated liabilities.

Incentive compensation expense to related parties for the year ended December 31, 2004 and the period from April 26, 2003 through December 31, 2003 was $4.9 million and $1.0 million, respectively. Incentive compensation is earned by related parties when REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) relative to the average net invested assets for the period, as defined in the management agreement, exceeds the threshold return taxable income that would have produced an annualized return on equity equal to the sum of the 10-year U.S. Treasury rate plus 2.0% for the same period.

For the year ended December 31, 2004, total incentive compensation earned by Seneca was $6.7 million, one-half payable in cash and one-half payable in the form of a restricted common stock award. The cash portion of the incentive compensation of $3.3 million for the year ended December 31, 2004 was expensed in that period as well as 15.2% of the restricted common stock portion of the incentive compensation, or $509 thousand. In accordance with the terms of his employment agreement, our chief financial officer earned incentive compensation for the year ended December 31, 2004 of $334 thousand. This incentive compensation is also payable one-half in cash and one-half in the form of a restricted common stock award under our 2003 Stock Incentive Plan. The shares are payable and vest over the same vesting schedule as the stock issued to

Seneca. The cash portion of the incentive compensation of $167 thousand for the year ended December 31, 2004 was expensed in that period as well as 15.2% of the restricted common stock portion of the incentive compensation, or $25 thousand. The remaining incentive compensation expense of $871 thousand for the year ended December 31, 2004 relates primarily to restricted common stock awards vested during the period.

For the period from April 26, 2003 through December 31, 2003, total incentive compensation earned by Seneca was $1.2 million, of which $613 thousand was waived by Seneca for the quarter ended September 30, 2003. The remaining incentive compensation of $606 thousand was one-half payable in cash and one-half payable in the form of restricted common stock. The cash portion of the incentive compensation of $303 thousand for the quarter ended December 31, 2003 was expensed in that period as well as 15.2% of the restricted common stock portion of the incentive compensation, or $46 thousand. In accordance with the terms of his employment agreement, our chief financial officer earned incentive compensation for the quarter ended December 31, 2003 of $30 thousand. This incentive compensation is also payable one-half in cash and one-half in the form of a restricted common stock award under our 2003 Stock Incentive Plan. The shares are payable and vest over the same vesting schedule as the stock issued to Seneca. The cash portion of the incentive compensation of $15 thousand for the quarter ended December 31, 2003 was expensed in that period as well as 15.2% of the restricted common stock portion of the incentive compensation, or $3 thousand.

For the period from April 26, 2003 through June 30, 2003, REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) was $298 thousand and was less than the threshold return net income of $426 thousand and, therefore, no incentive compensation was earned by Seneca or paid by the Company for that period. The Company also did not pay incentive compensation to Seneca for the three months ended September 30, 2003. Although the Company reported a net loss for the three months ended September 30, 2003 of $2.8 million, REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) was $6.0 million and was greater than the threshold return taxable income of $2.9 million and, therefore, an incentive compensation of $613 thousand was earned by Seneca. Although Seneca was entitled to receive incentive compensation under the management agreement for the three months ended September 30, 2003, because of the net loss reported by the Company for the period, Seneca voluntarily waived, on a one-time basis, its right to incentive compensation for the period. Since Seneca waived its right to its incentive compensation for the three months ended September 30, 2003, the waived incentive compensation has been accounted for as a capital contribution as of September 30, 2003. The incentive compensation of $613 thousand was expensed in the three months ended September 30, 2003.

Salaries and benefits expense for the year ended December 31, 2004 and for the period from April 26, 2003 through December 31, 2003 was $593 thousand and $99 thousand, respectively. The increase is primarily due to salaries and benefits paid for a full year in 2004 as well as performance bonuses paid in 2004.

Professional services expense for the year ended December 31, 2004 and the period from April 26, 2003 through December 31, 2003 of $1.3 million and $0.5 million, respectively, includes legal, accounting and other professional services provided to us.

Insurance expense for the year ended December 31, 2004 and the period from April 26, 2003 through December 31, 2003 of $631 thousand and $291 thousand, respectively, consisting primarily of premium for directors and officers insurance. Custody expense of $383 thousand and $115 thousand for the year ended December 31, 2004 and the period from April 26, 2003 through December 31, 2003, respectively, is related to the services provided by our primary custodian. These expenses may vary based on levels of activity within the portfolio. Other general and administrative expenses of $411 thousand and $73 thousand for the year ended December 31, 2004 and the period from April 26, 2003 through December 31, 2003, respectively. The increase in other general and administrative expenses is primarily due to printing costs incurred in the first and second quarters of 2004 related to the filing of our resale shelf registration statement, our annual report and proxy and NYSE listing fees.

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REIT taxable net income is calculated according to the requirements of the Internal Revenue Code, rather than GAAP. The following table reconciles GAAP net income to REIT taxable net income income for the year ended December 31, 2004 and for the period from April 26, 2003 through December 31, 2003:

| | For the Year Ended December 31, 2004 | For the Period from April 26, 2003 through December 31, 2003 |
|---|---|---|
| | (in thousands) | |
| GAAP net income | $ 57,112 | $ 2,761 |
| Adjustments to GAAP net income: | | |
| Addback of organizational costs expensed during the period | | 163 |
| Amortization of organizational costs | (33) | (19) |
| Addback unvested stock compensation expense for unvested options | 5 | 3 |
| Addback unvested stock compensation expense for unvested restricted common stock | 1,494 | 48 |
| Subtract net hedge ineffectiveness losses on futures and interest rate swap contracts | (308) | |
| Addback net realized gains on futures contracts | 1,410 | |
| Subtract dividend equivalent rights on restricted common stock | (258) | |
| Addback of net capital losses in the period | | 7,831 |
| Addback waived incentive compensation for the quarter ended September 30, 2003 | | 613 |
| Net adjustments to GAAP net income | 2,310 | 8,640 |
| REIT taxable net income | $ 59,422 | $ 11,400 |

Undistributed REIT taxable net income for the year ended December 31, 2004 and for the period from April 26, 2003 through December 31, 2003 was as follows:

| | For the Year Ended December 31, 2004 | For the Period from April 26, 2003 through December 31, |
|---|---|---|