GORMAN RUPP CO
Form DEF 14A
March 29, 2006

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

SCHEDULE 14A

(Rule 14a-101)

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the Securities

Exchange Act of 1934 (Amendment No.)

Filed by the Registrant þ
Filed by a Party other than the Registrant o
Check the appropriate box:

o Preliminary Proxy Statement
o **Confidential, for Use of the Commission Only (as permitted by**
Rule 14a-6(e)(2)) **þ** Definitive Proxy Statement o Definitive Additional Materials
o Soliciting Material Pursuant to §240.14a-12

THE GORMAN-RUPP COMPANY

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

þ No fee required.

o Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

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(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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THE GORMAN-RUPP COMPANY

Mansfield, Ohio

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

The Annual Meeting of the shareholders of The Gorman-Rupp Company will be held at the Company s Training Center, 270 West 6th Street, Mansfield, Ohio, on Thursday, April 27, 2006 at 10:00 a.m., Eastern Daylight Time, for the purpose of considering and acting upon:

1. A proposal to fix the number of Directors of the Company at eight and to elect eight Directors to hold office until the next annual meeting of shareholders and until their successors are elected;

2. A proposal to ratify the appointment of Ernst & Young LLP as independent public accountants for the Company during the year ending December 31, 2006; and

3. Such other business as may properly come before the Meeting or any adjournment or adjournments thereof.

Holders of Common Shares of record at the close of business on March 15, 2006 are the only shareholders entitled to notice of and to vote at the Meeting.

Please promptly execute the enclosed proxy and return it in the enclosed envelope (which requires no postage if mailed in the United States), regardless of whether you plan to attend the Meeting.

By Order of the Board of Directors

DAVID P. EMMENS
Corporate Secretary

March 29, 2006

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PROXY STATEMENT

March 29, 2006

SOLICITATION AND REVOCATION OF PROXIES

This Proxy Statement is furnished to shareholders of The Gorman-Rupp Company in connection with the solicitation by the Board of Directors of the Company of proxies for use at the Annual Meeting of the shareholders to be held at the Company s Training Center, 270 West 6th Street, Mansfield, Ohio, at 10:00 a.m., Eastern Daylight Time, on Thursday, April 27, 2006. Holders of Common Shares of record at the close of business on March 15, 2006 are the only shareholders entitled to notice of and to vote at the Meeting.

A shareholder, without affecting any vote previously taken, may revoke his proxy by the execution and delivery to the Company of a later proxy with respect to the same shares, or by giving notice to the Company in writing or in open meeting. The presence at the Meeting of the person appointing a proxy does not in and of itself revoke the appointment.

OUTSTANDING SHARES AND VOTING RIGHTS

As of March 15, 2006, the record date for the determination of persons entitled to vote at the Meeting, there were 10,685,697 Common Shares outstanding. Each Common Share is entitled to one vote.

The mailing address of the principal executive offices of the Company is 305 Bowman Street, Mansfield, Ohio 44903. This Proxy Statement and accompanying proxy are being mailed to shareholders on or about March 29, 2006.

If notice in writing is given by any shareholder to the President, a Vice President or the Secretary of the Company, not less than 48 hours before the time fixed for the holding of the Meeting, that such shareholder desires that the voting for the election of Directors be cumulative, and if announcement of the giving of such notice is made upon the convening of the Meeting by the Chairman or Secretary or by or on behalf of the shareholder giving such notice, each shareholder shall have the right to cumulate such voting power as he possesses at such election. Under cumulative voting, a shareholder controls voting power equal to the number of votes which he otherwise would have been entitled to cast multiplied by the number of Directors to be elected. All of such votes may be cast for a single nominee or may be distributed among any two or more nominees as he may desire. If cumulative voting is invoked, and unless contrary instructions are given by a shareholder who signs a proxy, all votes represented by such proxy will be divided evenly among the candidates nominated by the Board of Directors, except that if so voting should for any reason not be effective to elect all of the nominees

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named in this Proxy Statement, then such votes will be cast so as to maximize the number of the Board of Directors nominees elected to the Board.

ELECTION OF DIRECTORS

(Proposal No. 1)

All Directors will be elected to hold office until the next annual meeting of shareholders and until their successors are elected and qualified. Proxies received are intended to be voted in favor of fixing the number of Directors at eight and for the election of the nominees named below. Each of the nominees is presently a Director of the Company. Mr. Jeffrey S. Gorman is the son of Mr. James C. Gorman, and Mr. Christopher H. Lake is the son of Dr. Peter B. Lake.

In the event that any of the nominees should become unavailable, which the Board of Directors does not anticipate, proxies are intended to be voted in favor of fixing the number of Directors at a lesser number or for a substitute nominee or nominees designated by the Board of Directors, in the discretion of the persons appointed as proxy holders. The proxies may be voted cumulatively for less than the entire number of nominees if any situation arises which, in the opinion of the proxy holders, makes such action necessary or desirable.

Based upon information received from the respective nominees as of February 1, 2006, the following information is furnished with respect to each person nominated for election as a Director.

Name, Age and Principal Occupation(1)	Director Continuously Since	Shares Owned Beneficially at Feb. 1, 2006(2)	Percent of Outstanding Shares
James C. Gorman Chairman of the Company. Chief Executive Officer (1968-1996). Age: 81	1946	902,246(3)	8.44%
Jeffrey S. Gorman President and Chief Executive Officer of the Company; General Manager of the Company s Mansfield Division (until January 1, 2006). Age: 53	1989	544,536(4)	5.10%

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Name, Age and Principal Occupation(1)	Director Continuously Since	Shares Owned Beneficially at Feb. 1, 2006(2)	Percent of Outstanding Shares
Thomas E. Hoaglin Chairman, President, Chief Executive Officer and Director; Huntington Bancshares, Inc. (NASDAQ); Columbus, Ohio(5). Age: 56	1993(6)	8,312(7)	*
Christopher H. Lake President (Vice President, July-December, 2005); SRI Quality System Registrar; Wexford, Pennsylvania. President; Dean & Lake Consulting, Inc.; Powder Springs, Georgia (2001-2005). Age: 41	2000	19,014(8)	*
Dr. Peter B. Lake President (until January 1, 2006) and Chief Executive Officer; SRI Quality System Registrar; Wexford, Pennsylvania. Age: 63	1975	16,018(9)	*
Rick R. Taylor President; Jay Industries (automotive parts manufacturer); President; Longview Steel Corp. (steel wholesaler); Mansfield, Ohio. Director; Park National Corporation (AMEX). Age: 58	2003	2,375	*

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Name, Age and Principal Occupation(1)	Director Continuously Since	Shares Owned Beneficially at Feb. 1, 2006(2)	Percent of Outstanding Shares
W. Wayne Walston Owner; Walston Elder Law Office (attorneys); Warsaw, Indiana. Managing Partner; Valentine, Miner & Lemon, LLP (attorneys); Warsaw, Indiana (2002-2003). Retired (2001-2002). Vice President-External Affairs (1989-2001); Sprint (telecommunications); Mansfield, Ohio. Age: 63	1999	5,225(10)	*
John A. Walter Retired May 1, 1998. Formerly President (beginning 1989) and Chief Executive Officer (beginning 1996) of the Company. Chief Operating Officer (1993-1996). Age: 72	1989	9,087(11)	*

* Represents less than 1% of the outstanding shares.

(1) Except as otherwise indicated, there has been no change in occupation during the past five years.

(2) Reported in accordance with the beneficial ownership rules of the Securities and Exchange Commission under which a person is deemed to be the beneficial owner of a security if he has or shares voting power or investment power in respect of such security. Accordingly, the amounts shown in the table do not purport to represent beneficial ownership for any purpose other than compliance with the Commission s reporting requirements. Voting power or investment power with respect to shares reflected in the table are not shared with others except as otherwise indicated.

(3) Includes 361,993 shares owned by Mr. Gorman s wife and 92,262 shares held in a trust of which Mr. Gorman is a co-trustee. Mr. Gorman has a beneficial interest in 68,090 of the shares held in the trust, considers that he shares the voting and investment power with respect to all of the foregoing shares, but otherwise disclaims any beneficial interest therein. The amount shown in the table excludes 1,126,957 shares beneficially owned by members of Mr. Gorman s

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immediate family and 288,614 shares held in trusts of which he and members of his family have beneficial interests. (68,090 of these trust shares are the same shares described above.) Mr. Gorman disclaims beneficial ownership of all of the shares referred to in this note (3).

(4) Includes 42,112 shares owned by Mr. Gorman s wife and 132,015 shares owned by his minor children. Mr. Gorman considers that he shares the voting and investment power with respect to all of the foregoing shares, but otherwise disclaims any beneficial interest therein. The amount shown in the table excludes 47,851 shares held in a trust in which Mr. Gorman has a beneficial interest. Mr. Gorman disclaims beneficial ownership of all of the shares referred to in this note (4).

(5) On June 2, 2005, Huntington Bancshares, Inc. (Huntington) announced that the Securities and Exchange Commission (Commission) approved the settlement of the Commission s previously announced formal investigation into certain financial accounting matters relating to Huntington s fiscal years 2002 and earlier and certain related disclosure matters. As a part of the settlement, the Commission instituted a cease and desist administrative proceeding and entered a cease and desist order, as well as filed a civil action in federal district court pursuant to which, without admitting or denying the allegations in the complaint, Huntington, its former chief financial officer, its former controller, and Mr. Hoaglin consented to pay civil money penalties. Huntington consented to pay a penalty of $7.5 million. Without admitting or denying the charges in the administrative proceeding, Huntington and the individuals each agreed to cease and desist from committing and/ or causing the violations charged as well as any future violations of the Commission s regulations. Additionally, Mr. Hoaglin, agreed to pay disgorgement, pre-judgment interest, and penalties in the amount of $667,609. The former chief financial officer and the former controller each also agreed to pay amounts consisting of disgorgement, pre-judgment interest, and penalties and also consented to certain other non-monetary penalties.

(6) Mr. Hoaglin also served as a Director of the Company from 1986 to 1989.

(7) Includes 2,812 shares as to which Mr. Hoaglin shares voting and investment power.

(8) Includes 15,714 shares owned by Mr. Lake s minor children as to which Mr. Lake considers that he shares the voting and investment power with respect thereto, but otherwise disclaims any beneficial interest therein.

(9) Includes 3,375 shares owned by Mrs. Lake as to which Dr. Lake shares voting and investment power.

(10) The amount shown in the table excludes 312 shares held in a trust of which Mrs. Walston is trustee. Mr. Walston disclaims beneficial ownership of all of the shares referred to in this note (10).

(11) The amount shown in the table excludes 1,405 shares held in a trust of which Mrs. Walter is trustee. Mr. Walter disclaims beneficial ownership of all of the shares referred to in this note (11).

BOARD OF DIRECTORS AND DIRECTORS COMMITTEES

During 2005, a total of five regularly scheduled meetings of the Board of Directors (at least one each quarter) and a total of 14 meetings of all standing Directors Committees were held. All Directors attended at least 75% of the aggregate of the total number of meetings held by the Board of Directors and of the total number of meetings held by the respective committees on which they served. In 2005, the independent Directors met once in executive session without the presence of the non-independent Directors and any members of the Company s management.

The Board of Directors has four separately designated standing committees: (1) an Audit Review Committee, whose present members are Thomas E. Hoaglin (Chairman and independent audit committee financial expert), Peter B. Lake and W. Wayne Walston; (2) a Salary Committee, whose present members are W. Wayne Walston (Chairman), Thomas E. Hoaglin and Christopher H. Lake; (3) a Pension Committee, whose present members are Peter B. Lake (Chairman), Rick R. Taylor and John A. Walter; and (4) a Nominating Committee, whose present members are John A. Walter (Chairman), Christopher H. Lake and Rick R. Taylor. All members of each committee are independent Directors.

The Audit Review Committee held six meetings in 2005. Its principal functions include reviewing the arrangement and scope of the audit, considering comments made by the independent accountants with respect to internal controls and financial reporting, considering corrective action taken by management, reviewing internal accounting procedures and controls with the Company s internal auditor and financial staff, and reviewing non-audit services provided by the independent accountants. The Committee is governed by a written charter adopted by the Board of Directors.

The Salary Committee held two meetings during 2005. Its principal functions are to determine the salaries of the elected officers and certain senior executives of the Company and to determine profit sharing amounts for eligible employees, subject to approval by the Board of Directors.

The Pension Committee held five meetings in 2005. Its principal functions are to monitor and assist in the investment of the assets associated with the Company s pension plan.

The Nominating Committee held one meeting during 2005. Its principal functions involve the identification, evaluation and recommendation of individuals for nomination as new members of the Board of Directors. Members of the Nominating Committee are independent in accordance with Section 121 of the listing standards of the American Stock Exchange.

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The Nominating Committee does not have a written charter but follows policies and procedures by which to consider recommendations from shareholders for Director nominees. (These written policies and procedures were recommended by the Committee and adopted by the Board of Directors for the Committee in 1991.) Any shareholder wishing to propose a candidate should deliver a typewritten or legible hand-written communication to the Company s Corporate Secretary. The submission should provide detailed business and personal biographical data about the candidate, and include a brief analysis explaining why the individual is well-qualified to become a Director nominee. All recommendations will be acknowledged by the Corporate Secretary and promptly referred to the Nominating Committee for evaluation.

The Nominating Committee does not believe that any particular set of skills or qualities are most appropriate for a Director candidate. All Director candidates, including any recommended by shareholders, are evaluated based upon their (i) business and financial expertise and experience; (ii) intellect to comprehend the issues confronting the Company; (iii) reputation for diligence, and limited time conflicts; and (iv) integrity, strength of character, practical wisdom and mature judgment. Any Director candidate will be subject to a background check performed by the Committee. In addition, the candidate will be personally interviewed by one or more Committee members before he or she is nominated to be a new member of the Board of Directors.

The Board of Directors has determined that all Non-Employee Directors (Messrs. Hoaglin, C. H. Lake, P. B. Lake, Taylor, Walston and Walter) are independent Directors in accordance with Section 121 of the listing standards of the American Stock Exchange. Directors who are employees of the Company (Messrs. J. C. Gorman and J. S. Gorman) do not receive any compensation for service as Directors. Each Non-Employee Director receives a fee for each of the Board of Directors meetings attended. The fee was $2,300 for meetings held during 2005. No fees are paid, however, for attendance at committee meetings, except that Directors serving as members of the Audit Review Committee receive an additional fee of $300 for each Audit Review Committee meeting attended that is held in conjunction with a Board of Directors meeting. Each Committee Chairman also receives a retainer of $1,000 per year. Effective May 22, 1997, the Board of Directors adopted a Non-Employee Directors Compensation Plan. Under the Plan, as additional compensation for regular services to be performed as a Director, an automatic award of 500 Common Shares (from the Company s treasury) will be made on each July 1 (through 2006 unless extended) to each Non-Employee Director then serving on the Board. The award of 500 Common Shares made on July 1, 2005 had a market value of $10,628.

Members of the Board of Directors are encouraged to attend the Company s annual meetings of shareholders, time permitting. All Directors were in attendance at the annual meeting in 2005.

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AUDIT REVIEW COMMITTEE REPORT

The Audit Review Committee has submitted the following report to the Board of Directors:

(i) The Audit Review Committee has reviewed and discussed the Company s audited consolidated financial statements for the fiscal year ended December 31, 2005 with the Company s management and the Company s independent public accountants;

(ii) The Audit Review Committee has discussed with the Company s independent public accountants the matters required to be discussed by Statement on Auditing Standards No. 61 (Codification of Statements on Auditing Standards, AU§380);

(iii) The Audit Review Committee has received the written disclosures and the letter from the Company s independent public accountants required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees), and has discussed the issue of independence, including the provision of non-audit services to the Company, with the independent public accountants;

(iv) With respect to the provision of non-audit services to the Company, the Audit Review Committee has obtained a written statement from the Company s independent public accountants that they have not rendered any non-audit services prohibited by the Securities and Exchange Commission rules relating to auditor independence, and that the delivery of any permitted non-audit services has not and will not impair their independence;

(v) Based upon the review and discussions referred to above, the Audit Review Committee has recommended to the Board of Directors that the Company s audited consolidated financial statements be included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2005, to be filed with the Securities and Exchange Commission; and

(vi) In general, the Audit Review Committee has fulfilled its commitments in accordance with its Charter.

Members of the Audit Review Committee are independent in accordance with Section 121 of the listing standards of the American Stock Exchange. The Chairman is also an independent audit committee financial expert in accordance with Securities and Exchange Commission rules.

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Based upon a recommendation of the Audit Review Committee, the Board of Directors adopted a written Charter for the Audit Review Committee on October 23, 2003 (replacing the previous Charter adopted on June 8, 2000). The Committee reviews and reassesses the adequacy of the Charter on an annual basis. A proposal to amend the Charter was adopted by the Committee on October 27, 2005, and approved by the Board of Directors on January 26, 2006. The Charter (as amended) is set forth as an appendix to this Proxy Statement, and will again be set forth as an appendix to the Proxy Statement in 2009.

The foregoing report has been furnished by members of the Audit Review Committee.

/s/ W. Wayne Walston	/s/ Thomas E. Hoaglin	/s/ Peter B. Lake
W. Wayne Walston	Thomas E. Hoaglin Chairman	Peter B. Lake

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SHAREHOLDINGS BY EXECUTIVE OFFICERS*

Name and Principal Position	Shares Owned Beneficially	Shared Voting and Investment Power
Robert E. Kirkendall Senior Vice President and Chief Financial Officer	18,454	-0-
William D. Danuloff Vice President and Chief Information Officer	13,873	8,668
Judith L. Sovine Treasurer	4,562	3,978

*The table sets forth information received from the executive officers as of February 1, 2006, and all amounts represent less than 1% of the outstanding shares. The shareholdings of James C. Gorman and Jeffrey S. Gorman are included below and under the caption Election of Directors.

PRINCIPAL SHAREHOLDERS

The following table sets forth information pertaining to the beneficial ownership of the Company s Common Shares as of February 1, 2006 by James C. Gorman and Jeffrey S. Gorman, and as of December 31, 2005 by each other person known to the Company to own beneficially at least five percent of the outstanding Common Shares.

Name and Address	Type of Ownership	Number of Shares Owned	Percent of Outstanding Shares
James C. Gorman 305 Bowman Street Mansfield, Ohio 44903	Sole voting and investment power Shared voting and investment power	447,991 454,255	4.19% 4.25%
	Total	902,246	8.44%
Jeffrey S. Gorman 305 Bowman Street Mansfield, Ohio 44903	Sole voting and investment power Shared voting and investment power	354,324 190,212	3.32% 1.78%
	Total	544,536	5.10%

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Name and Address	Type of Ownership	Number of Shares Owned	Percent of Outstanding Shares
Unicredito Italiano S.p.A. Piazzo Cordusio 2 20123 Milan, Italy	Sole voting power	662,796	6.20%
	Sole investment power	662,796	6.20%
	Shared voting power	-0-	
	Shared investment power	-0-	
	Total	662,796(1)	6.20%
Tweedy, Browne Company LLC 350 Park Avenue New York, New York 10022	As broker/ dealer and investment adviser with sole voting power	560,071	5.25%
	As broker/ dealer and investment adviser with sole investment power	561,070	5.25%
	As broker/ dealer and investment adviser with shared voting power	-0-	
	As broker/ dealer and investment adviser with shared investment power	-0-	
	Total	561,070(1)	5.25%
All Directors and Executive Officers as a group (12 persons)		1,547,729(2)	14.48%

(1) This figure represents the aggregate amount of Common Shares beneficially owned. Of the aggregate amount, however, some shares are subject to sole voting power but shared or no investment power, and some shares are subject to sole investment power but shared or no voting power. Consequently, the sum of this column does not equal the aggregate amount shown.

(2) Includes 679,014 shares as to which voting and investment power are shared.

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EXECUTIVE COMPENSATION

There is shown below information concerning the annual and long-term compensation for services in all capacities to the Company for the fiscal years ended December 31, 2005, 2004 and 2003 of those persons who were, at December 31, 2005, (i) the chief executive officer and (ii) the other four most highly compensated executive officers of the Company (the Named Officers).

Summary Compensation Table

		Annual Compensation(1)(2)			Long-Term Compensation		All Other Compensation(4)	
Name and Principal Position	Year	Salary	Bonus	Other(3)	Stock Options/ SARs	Long-term Incentive Payouts		Total
Jeffrey S. Gorman	2005	$ 187,500	$ 100,000	$ 2,322	0	0	$ 2,800	$ 292,622
President and Chief	2004	182,500	82,000	2,322	0	0	3,200	270,022
Executive Officer	2003	180,000	84,000	2,322	0	0	3,169	269,491
Robert E. Kirkendall	2005	133,333	50,000	3,091	0	0	2,748	189,172
Senior Vice President and	2004	128,333	36,000	3,012	0	0	2,600	169,945
Chief Financial Officer	2003	120,000	37,000	2,866	0	0	2,400	162,266
Judith L. Sovine	2005	106,333	32,000	3,870	0	0	2,151	144,354
Treasurer	2004	101,500	26,000	3,838	0	0	2,061	133,399
	2003	98,500	25,500	2,861	0	0	1,928	128,789
William D. Danuloff	2005	106,333	32,000	991	0	0	2,137	141,461
Vice President and Chief	2004	102,000	26,000	948	0	0	2,054	131,002
Information Officer	2003	100,000	25,500	930	0	0	1,937	128,367
James C. Gorman	2005	100,000	21,000	3,864	0	0	977	125,841
Chairman	2004	100,000	21,000	3,864	0	0	975	125,839
	2003	100,000	21,000	3,864	0	0	916	125,780

(1) The Company sponsors The Gorman-Rupp Company 401(k) Plan. Substantially all the employees of the Company, including the executive officers and the employees of Patterson Pump Company (a wholly owned subsidiary), are eligible to participate in the 401(k) Plan. Each participant in the 401(k) Plan may make before-tax contributions to the Plan of up to 15% of compensation, but not in excess of the maximum annual amount permitted by the Internal Revenue Code. The maximum annual amount was $12,000 for 2003, $13,000 for 2004 and $14,000 for 2005. In 2006, the maximum annual amount will be $15,000 (and $20,000 for participants who are age 50 and older). Before-tax contributions made to the 401(k) Plan qualify for deferred tax treatment under Section 401(k) of the Code. The Company makes matching contributions in its Common Shares on a monthly basis for each participant who is an employee

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on the last day of the month equal to 40% of the first 4% of the participant s before-tax contributions made during the month. The participant s before-tax contributions and the Company s matching contributions are nonforfeitable, but are subject to special nondiscrimination tests imposed by the Code. If the tests are not satisfied, contributions by or for highly compensated employees are reduced. Each participant (or the beneficiary of a deceased participant) receives the full amount allocated to a participant s account upon any termination of the participant s employment. During 2005, a total of $2,401,217, consisting of both participant before-tax contributions and Company matching contributions, was allocated to participants accounts under the 401(k) Plan, including an aggregate amount of $80,784 to the accounts of the executive officers which is included in the compensation shown in the table. The amounts allocated during 2005 to the accounts of the executive officers named in the table are as follows: Mr. J.S. Gorman ($16,800); Mr. Kirkendall ($16,488); Mr. Danuloff ($10,148); Ms. Sovine ($14,254); and Mr. J.C. Gorman ($3,421).

(2) The pension plan in which the Company s executive officers participate is a defined benefit plan covering substantially all employees of the Company and Patterson Pump Company; and the amounts of contributions or accruals applicable to the individual participants therein cannot be readily calculated. The aggregate contributions made to such plan for the benefit of the Company s executive officers amount to approximately 2.1% of the total contributions made on behalf of all participants covered by the plan.

In general, a participant s monthly benefit under the pension plan is determined by multiplying 1.1% of his final average monthly compensation by the number of his credited years and months of service. A participant s final average monthly compensation is one-twelfth of the average annual compensation of the participant for the last 10 years of the participant s employment with the Company (or Patterson Pump Company) or, if less than 10, for his actual years of such employment. The compensation covered by the pension plan for 2005 is identical to the compensation set forth in the table, except that the plan does not cover profit-sharing bonuses or amounts labeled other in the table received by any executive officer, as well as any compensation in excess of $210,000, effective November 1, 2005. However, compensation covered by the pension plan does include any before-tax contributions made by the participant to the 401(k) Plan. The benefit amounts applicable to each individual participant are not subject to any deduction for Social Security benefits or other offset amounts.

As of November 1, 2005, the Named Officers had the following number of credited full years of service under the Company s pension plan: Mr. J.S. Gorman 27; Mr. Kirkendall 27; Mr. Danuloff 34; Ms. Sovine 26; and Mr. J.C. Gorman 56. As of November 1, 2005, the estimated annual benefits payable at age 65 upon retirement to Messrs. Gorman, Kirkendall, Danuloff, Ms. Sovine and Mr. Gorman are $51,282, $32,449, $36,183, $25,803 and $71,388, respectively. Mr. J.C. Gorman is age 81 and remains active as an officer of the Company. In accordance with the terms of the pension plan, because Mr. J.C. Gorman is over age 70 1/2, he received payments from the pension plan which totaled $73,219 in 2005.

(3) Amounts include taxable life insurance, and Company contributions to Christmas Savings Plan and Employee Stock Purchase Plan.

(4) Amounts contributed by the Company on behalf of the Named Officers to the 401(k) Plan.

PENSION AND RETIREMENT BENEFITS

The following table shows the estimated annual benefits under the Company s pension plan which would have been payable to employees in various compensation classifications upon retirement in 2005 at age 65 after selected periods of service.

Final Average Annual Pay at Age 65*	10 Years	20 Years	30 Years	40 Years
$ 25,000	$ 2,750	$ 5,500	$ 8,250	$11,000
50,000	5,500	11,000	16,500	22,000
75,000	8,250	16,500	24,750	33,000
100,000	11,000	22,000	33,000	44,000
125,000	13,750	27,500	41,250	55,000
150,000	16,500	33,000	49,500	66,000
175,000	19,250	38,500	57,750	77,000
200,000	22,000	44,000	66,000	88,000

* Compensation in excess of $210,000 is not taken into account under the pension plan.

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SALARY COMMITTEE REPORT ON EXECUTIVE COMPENSATION

Under the supervision of the Salary Committee of the Board of Directors, the Company has developed compensation policies which seek to enhance the profitability of the Company, and thus shareholder value, by aligning closely the financial interests of the Company s corporate officers and other key employees with those of its shareholders. As a starting point, annual base salaries are generally set somewhat below competitive levels so that the Company relies to a large degree on annual incentive compensation to retain corporate officers and other key employees of outstanding abilities and to motivate them to perform to the full extent of their abilities. The incentive compensation is then closely tied to corporate and individual performances in a manner that encourages a long and continuing focus on building profitability and shareholder value.

Based on an evaluation of these factors, the Committee believes that the corporate officers and other key employees of the Company are dedicated to achieving improvements in long-term financial performance and that the compensation policies the Committee administers have contributed to achieving this management focus.

Compensation for each of the Named Officers, as well as other executive officers and certain senior executives, consists of a base salary and annual incentive compensation or profit sharing. The base salaries are fixed at levels somewhat below the competitive amounts paid to senior managers with comparable qualifications, experience and responsibilities at other companies engaged in the same or similar businesses as the Company. The annual incentive compensation is more closely tied to the Company s success in achieving significant financial and non-financial performance goals. The Committee considers the total compensation of each of the Named Officers and the other executive officers and certain senior executives in establishing the elements of compensation.

In the early part of each fiscal year, the Committee reviews with the Chief Executive Officer and approves, with modifications considered appropriate, an annual salary for the Company s executive officers and certain senior executives (other than the Chief Executive Officer). Salaries are developed based upon industry and national surveys and performance judgments as to the past and expected future contributions of the individual executive officers and certain senior executives. The Committee independently reviews and fixes the base salary of the Chief Executive Officer based on similar competitive compensation data and the Committee s assessment of his past performance and its expectation as to his future contributions in leading the Company.

At the beginning of each year, performance objectives for purposes of determining annual profit sharing are also established based upon operating earnings. At the end of each year, performance against these objectives is determined by an arithmetic calculation. In determining the profit sharing in 2005 for eligible employees, including the Named Officers, the Committee reviews management s recommendations with the Chief Executive Officer based on individual performance. The results of

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these evaluations are considered by the Salary Committee and the Board of Directors when determining the amounts to be awarded as profit sharing (which appear as Bonus in the Summary Compensation Table on page 14).

The Committee believes that its compensation policies have successfully focused the Company s senior management on building continued profitability and shareholder value.

The foregoing report has been furnished by members of the Salary Committee.

/s/ THOMAS E. HOAGLIN	/s/ W. WAYNE WALSTON	/s/ CHRISTOPHER H. LAKE
Thomas E. Hoaglin	W. Wayne Walston Chairman	Christopher H. Lake

SHAREHOLDER RETURN PERFORMANCE PRESENTATION

Set forth below is a line graph comparing the yearly percentage change in the cumulative total shareholder return on the Company s Common Shares against the cumulative total return of the American Stock Exchange Market Value Index and a Peer Group Index for the period of five fiscal years commencing January 1, 2001 and ending December 31, 2005. The issuers in the Peer Group Index were selected on a line-of-business basis by reference to SIC Code 3561 Pumps and Pumping Equipment. The Peer Group Index is composed of the following issuers: Ampco-Pittsburgh Corp., Dyneco Corporation, Flowserve Corp., Graco Inc., Idex Corp., Met-Pro Corp., Robbins & Myers Inc. and Roper Industries Inc., in addition to the Company.

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COMPARISON OF 5-YEAR CUMULATIVE TOTAL RETURN

AMONG THE GORMAN-RUPP COMPANY,
AMEX MARKET INDEX AND PEER GROUP INDEX

	The Gorman-Rupp Co.	Peer Group Index	AMEX Market Index
2000	100.00	100.00	100.00
2001	153.84	128.82	95.39
2002	137.92	109.05	91.58
2003	159.77	146.37	124.66
2004	178.53	198.29	142.75
2005	175.99	228.64	157.43

ASSUMES $100 INVESTED ON JAN. 1, 2001

ASSUMES DIVIDEND REINVESTED
FISCAL YEAR ENDING DEC. 31, 2005

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APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

(Proposal No. 2)

A proposal will be presented at the Meeting to ratify the appointment by the Audit Review Committee of the Board of Directors of Ernst & Young LLP as independent public accountants for the Company during the year ending December 31, 2006. Representatives of Ernst & Young LLP are expected to be present at the Meeting, will have an opportunity to make a statement if they so desire, and are expected to be available to respond to appropriate questions.

The Company paid Ernst & Young LLP the following fees in connection with the Company s fiscal years ending December 31, 2005 and 2004:

Audit Fees $795,000 (2005); $865,000 (2004). Audit fees consist of the aggregate fees billed for professional services rendered for the audit of the Company s annual financial statements and the reviews of the Company s interim financial statements included in its quarterly reports on Form 10-Q, or services that are normally provided by the accounting firm in connection with statutory and regulatory filings or engagements for those fiscal years. The fees paid in 2004 and 2005 also cover services performed in connection with the Sarbanes-Oxley Section 404 attestation and other Sarbanes-Oxley requirements.

Audit-Related Fees $30,000 (2005); $30,000 (2004). Audit-related fees consist of the aggregate fees billed for assurance and related services that are reasonably related to the performance of the audit or review of the Company s financial statements and are not reported under the caption Audit Fees. The audit-related fees were paid for the following services: benefit plan audits.

Tax Fees $48,000 (2005); $205,000 (2004). Tax fees consist of the aggregate fees billed for professional services rendered for tax compliance, tax advice and tax planning. The tax fees were paid for the following services: federal and international tax planning and advice; federal, state, local and international tax compliance; state and local tax consulting; form 5500 compliance issues; Canadian compliance issues; and other tax advice and assistance regarding statutory and regulatory matters.

All Other Fees $0 (2005); $0 (2004). The all other fees category consists of the aggregate fees billed for products and services provided, other than the services reported in the foregoing three paragraphs.

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Under its Charter, the Audit Review Committee of the Company s Board of Directors is directly responsible for the oversight of the work of Ernst & Young LLP and has the sole authority to (i) appoint, retain and terminate Ernst & Young LLP, (ii) pre-approve all audit engagement fees, terms and services, and (iii) pre-approve scope and fees for any non-audit engagements with Ernst & Young LLP. The Committee exercises this authority in a manner consistent with applicable law and the rules of the Securities and Exchange Commission and the American Stock Exchange, and Ernst & Young LLP reports directly to Committee. In addition, the Committee has determined to delegate its authority to grant any pre-approvals to its Chairman, subject to the report of any such pre-approvals to the Committee at its next scheduled meeting. With respect to certain of the services categorized above, the following percentage of services were rendered by Ernst & Young LLP in accordance with the annual *de minimus* exception to the pre-approval requirement: Audit-Related Fees 0%; Tax Fees 0%; All Other Fees 0%.

Ratification by the shareholders of the appointment of Ernst & Young LLP is not required by law. However, the Board of Directors believes that shareholders should be given this opportunity to express their views on the subject. While not binding on the Audit Review Committee of the Board of Directors, the failure of the shareholders to ratify the appointment of Ernst & Young LLP as the Company s independent public accountants would be considered by the Audit Review Committee in determining whether to continue the engagement of Ernst & Young LLP. Even if the appointment is ratified, the Audit Review Committee of the Board of Directors may, in its discretion, select a different firm of independent public accountants for the Company at any time during the year if it determines that such a change would be in the best interests of the Company and its shareholders.

The Directors recommend a vote FOR Proposal No. 2 to ratify the appointment of Ernst & Young LLP as the Company s independent public accountants.

GENERAL INFORMATION

The Company s 2005 annual report to shareholders, including financial statements, is being mailed concurrently with this Proxy Statement to all shareholders of the Company.

The cost of soliciting proxies will be paid by the Company. In addition to the use of the mails, proxies may be solicited personally or by telephone, telecopy or other means of communication by a few officers or regular employees of the Company. No separate compensation will be paid for the solicitation of proxies, although the Company may reimburse brokers and other persons holding Common Shares in their names or in the names of nominees for their expenses in sending proxy material to the beneficial owners of such Common Shares.

Any proposal by a shareholder intended to be presented at the 2007 annual meeting of shareholders must be received by the Company for inclusion in the proxy statement and form of proxy of the Company relating to such meeting on or before November 29, 2006. If a shareholder proposal is received after February 27, 2007, it will be considered untimely and the proxy holders may use their discretionary voting authority if and when the proposal is raised at such annual meeting, without any discussion of the matter in the proxy statement. The Board of Directors proxy for the 2007 annual meeting of shareholders will grant discretionary voting authority to the proxy holders with respect to any such proposal received after February 27, 2007.

Any shareholder wishing to communicate with the Board of Directors may send a written statement or inquiry to the Company s Corporate Secretary. All writings will be acknowledged by the Corporate Secretary and presented for consideration and response at the next scheduled Board meeting.

OTHER BUSINESS

Financial and other reports will be submitted to the Meeting, but it is not intended that any action will be taken in respect thereof. The Company did not receive notice by February 28, 2006 of, and the Board of Directors is not aware of, any matters other than those referred to in this Proxy Statement which might be brought before the Meeting for action. Therefore, if any such other matters should arise, it is intended that the persons appointed as proxy holders will vote or act thereon in accordance with their own judgment.

You are urged to date, sign and return your proxy promptly. For your convenience, enclosed is a self-addressed return envelope requiring no postage if mailed in the United States.

By Order of the Board of Directors

DAVID P. EMMENS
Corporate Secretary

March 29, 2006

APPENDIX

THE GORMAN-RUPP COMPANY

AUDIT REVIEW COMMITTEE CHARTER

Purposes

The purposes of the Committee are to (a) assist the Board of Directors in fulfilling the Board of Directors oversight responsibilities with respect to (i) the integrity of the Company s financial statements, (ii) the Company s compliance with legal and regulatory requirements, (iii) the independent auditors qualifications and independence, and (iv) the performance of the independent auditors and the Company s internal audit function; and (b) prepare the Committee s report to be included in the Company s annual proxy statement (the Audit Review Committee Report).

Authority of the Committee

The Committee has the sole authority to (a) appoint, retain and terminate the Company s independent auditors, (b) pre-approve all audit engagement fees, terms and services, and (c) pre-approve any non-audit engagements with the Company s independent auditors. The independent auditors shall report directly to the Committee. The Committee shall exercise this authority in a manner consistent with applicable law and the rules of the Securities and Exchange Commission (SEC) and the American Stock Exchange, LLC (AMEX). The Committee may delegate the authority to grant any pre-approvals required by applicable law or rules to one or more members of the Committee as it designates, subject to the delegated member or members reporting any such pre-approvals to the Committee at its next scheduled meeting.

The Committee shall have the resources and authority necessary to discharge its responsibilities as required by law, including the authority to engage independent counsel and other advisors as the Committee deems necessary to carry out its duties, and the Company will provide appropriate funding as determined by the Committee.

The Committee is further empowered to:

Resolve any disagreements between management and independent auditors regarding financial reporting.

Conduct or authorize investigations into matters within its scope of responsibility.

Solicit information from or meet with Company officers, employees or agents, as necessary.

Set hiring policies for employees or former employees of the independent auditors.

Composition of the Committee

The Committee shall consist of at least three members. The Board of Directors will appoint the members and the Chairman of the Committee. Committee members shall serve at the pleasure of the Board of Directors and for such term or terms as the Board of Directors may determine.

Each Committee member shall (a) meet the independence criteria of the rules of the SEC and the AMEX, and (b) be financially literate or become financially literate within a reasonable period of time after his or her appointment to the Committee. Additionally, at least one member of the Committee shall have accounting or related financial management expertise sufficient to meet the criteria of a financial expert within the meaning of the SEC rules.

Each Committee member shall serve on no more than three audit committees of public companies (including the Company).

Meetings of the Committee

The Committee shall meet in person or telephonically at least quarterly, or more frequently as it may determine necessary. The Chairman of the Committee shall, in consultation with the other members of the Committee, the Company s independent auditors and the appropriate officers of the Company, be responsible for calling meetings of the Committee, establishing agenda therefor and supervising the conduct thereof. The Committee may also take any action permitted hereunder by unanimous written consent.

The Committee may invite any officer or employee of the Company or the Company s outside legal counsel or independent auditors or others to attend a meeting of the Committee. The Committee shall meet quarterly with the Company s management, and as needed with the internal audit staff and/or the independent auditors to discuss any matter that the Committee, management, the independent auditors or such other persons believe should be discussed.

Duties and Responsibilities of the Committee

The Committee is responsible for overseeing the Company s financial reporting process on behalf of the Board of Directors.

The Committee shall carry out the following responsibilities:

Financial Statements

Review and discuss with appropriate officers of the Company and the independent auditors the annual audited and quarterly financial statements of the Company, including (a) the Company s disclosure of significant accounting policies under Management s Discussion and Analysis of Financial Condition and Results of Operations, and (b) the disclosures regarding internal controls and other matters required by applicable law and SEC rules.

Review and discuss earnings and other financial press releases (including any use of pro forma or adjusted non-GAAP information), as well as financial information and earnings guidance provided to analysts and rating agencies (which review may occur after issuance and may be done generally as a review of the types of information to be disclosed and the form of presentation to be made).

Review disclosures made by the Company s CEO and CFO in connection with the Forms 10-K and 10-Q certification process concerning significant deficiencies in the design or operation of internal controls or any fraud that involves management or other employees who have a significant role in the Company s internal controls.

Review significant accounting, legal and reporting issues, and understand their impact on the financial statement presentations.

Internal Audit

The Audit Committee should approve the appointment and replacement of the internal auditor or outsourced internal audit service provider. At least annually, the Audit Committee should evaluate the effectiveness of the internal audit function and consider the need to make changes to ensure that internal audit objectives are being met.

Review and discuss with the internal audit staff the Internal Audit Charter and plans for and the scope of ongoing audit activities.

Review and discuss with the internal audit staff risk assessment issues, the annual report of audit activities, and examinations and results thereof performed by the internal audit staff.

Understand the scope of internal and independent auditors review of internal controls, and obtain reports on significant findings and recommendations, together with management s responses.

Review the effectiveness of the Company s internal control system, including information technology security.

Meet separately with management to discuss any matters that the Committee or internal audit staff believes should be discussed privately.

Independent Audit

Review the performance of the independent auditors. In performing this review, the Committee shall:

At least annually, obtain and review a report by the independent auditors describing (a) the audit firm s internal quality-control procedures, and (b) any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, with respect to one or more independent audits carried out by the firm, and any steps taken to deal with any such issues raised.

In connection with the retention of the Company s independent auditors, at least annually, review and discuss the information provided by management and the auditors relating to the independence of the audit firm, including, among other things, information related to the non-audit services provided and expected to be provided by the auditors.

Review and discuss with the independent auditors the plans for, and the scope of, the annual audit and other examinations, including the adequacy of staffing and compensation.

Review and discuss with the independent auditors the matters required to be discussed by Statement on Auditing Standards No. 61 relating to the conduct of the audit, as well as any audit problems or difficulties and management s response.

Review and discuss with the independent auditors (a) the report of their annual audit, or proposed report of their annual audit, (b) the accompanying management letter, if any, (c) their reviews of the Company s interim financial statements conducted in accordance with Statement on Auditing Standards No. 100, and (d) the reports of the results of such other examinations outside of the course of the independent auditors normal audit procedures that the independent auditors may from time to time undertake.

Confirm the rotation of the independent audit partner every five years and other audit partners every seven years.

Review and discuss with the internal audit staff recommendations made by the independent auditors.

Compliance

Periodically obtain reports from management that the Company and its subsidiary/foreign affiliated entities are in conformity with applicable legal requirements and the Company s Code of Ethics.

Establish procedures for (a) the receipt, retention and treatment of complaints received by the Company regarding accounting, internal controls or auditing matters; and (b) the confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters as required by applicable law and the SEC and AMEX rules and (c) the confidential receipt, retention and consideration of any report of evidence of a material violation (within the meaning of Rule 205 of the Rules of Practice of the SEC).

Discuss with the Company s Corporate Counsel legal matters that may have a material impact on the financial statements or the Company s compliance policies.

Reporting Responsibility

Report its activities regularly to the Board of Directors in such manner and at such times as the Committee and the Board of Directors deem appropriate, but in no event less than once a year.

Other Responsibilities

Obtain assurance from the independent auditors that in the course of conducting the audit, there have been no acts detected or that have otherwise come to the attention of the audit firm

that require disclosure to the Committee under Section 10A(b) of the Securities Exchange Act of 1934.

Discuss guidelines and policies with respect to risk assessment and risk management to assess and manage the Company s exposure to risk. The Committee shall discuss the Company s major financial risk exposures and the steps management has taken to monitor and control these exposures.

Review and discuss any filing with the Securities and Exchange Commission in which the independent auditor has been involved with respect to preparation or review.

Review and discuss such other matters that relate to the accounting, auditing and financial reporting practices and procedures of the Company as the Committee may, in its own discretion, deem desirable in connection with the review functions described above.

The Committee shall have the authority to establish other rules and operating procedures in order to fulfill its obligation under this Charter and applicable rules or regulations.

Audit Review Committee Report

The Committee will prepare, with the assistance of management, the independent auditors and outside legal counsel, the Audit Review Committee Report.

Annual Review of Charter

The Committee will conduct and review with the Board of Directors annually an evaluation of this Charter and recommend any changes to the Board of Directors. The Committee may conduct this charter evaluation in such manner as the Committee, in its business judgment, deems appropriate. In addition, the Committee will assure that the Charter will be attached as an appendix to the Company s proxy statement at least once every three years.

Annual Performance Evaluation

The Committee Will conduct and review with the Board of Directors annually an evaluation of the Committee s performance with respect to the requirements of this Charter. This evaluation will also set forth the goals and objectives of the Committee for the upcoming year. The Committee may conduct this performance evaluation in such manner as the Committee, in its business judgment, deems appropriate.

Adopted by the Audit Review Committee October 23, 2003.

Reviewed and approved by the Audit Review Committee without change July 22, 2004.

Reviewed by Audit Review Committee October 27, 2005. Internal Audit Section amended. Amendment approved by Board of Directors January 26, 2006.

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The Gorman-Rupp Company
c/o National City Bank
Corporate Trust Operations
Locator 5352
P.O. Box 92301
Cleveland, OH 44101-4301

PLEASE MARK, DATE AND SIGN THIS PROXY CARD AND
RETURN IT IN THE ENCLOSED POSTAGE-PAID ENVELOPE TO:
Corporate Election Services
PO Box 3230
Pittsburgh, PA 15230
ê **Please fold and detach card at perforation before mailing** ê

P R O X Y
COMMON
SHARES

Nominees For Directors:
James C. Gorman
Jeffrey S. Gorman
Thomas E. Hoaglin
Christopher H. Lake
Dr. Peter B. Lake
Rick R. Taylor
W. Wayne Walston
John A. Walter

The Gorman-Rupp Company
305 Bowman Street Mansfield, Ohio 44903

This proxy is solicited on behalf of the Board of Directors

The undersigned hereby appoints James C. Gorman, Jeffrey S. Gorman and David P. Emmens as Proxies, each with the power to appoint his substitute, and hereby authorizes them to represent and to vote all of The Gorman-Rupp Company Common Shares held of record on March 15, 2006 by the undersigned at the Annual Meeting of the shareholders to be held on April 27, 2006, or at any adjournment thereof, as follows:

The Board of Directors recommend a vote FOR Proposal No. 1.		**WITHHOLD AUTHORITY to vote for all nominees listed**
1. ELECTION OF DIRECTORS Fixing the number of Directors at 8 and electing all nominees listed *(except as marked to the contrary below)* ***(INSTRUCTION: To withhold authority to vote for any individual nominee, write his name below)***	**FOR** o	o

The Board of Directors recommend a vote FOR Proposal No. 2	**FOR**	**AGAINST**	**ABSTAIN**
2. RATIFICATION OF THE APPOINTMENT OF ERNST & YOUNG LLP as independent public accountants	o	o	o

3. In their discretion, the Proxies are authorized to vote upon such other business as may properly come before the Meeting.

When properly executed, this proxy will be voted in the manner directed by the undersigned shareholder; if no direction is made, this proxy will be voted FOR proposals 1 and 2.

Please sign exactly as your name appears below. If signing as attorney, executor, administrator, trustee or guardian, please give full title as such; and if signing for a corporation, please give your title. When shares are in the names of more than one person, each should sign.

Dated: , 2006

Signature of Shareholder(s)

o Please check this box if you plan to attend the Meeting.

olor:#cceeff;padding-right:2px;padding-top:2px;padding-bottom:2px;">

%
73-84 months

75,000

1.77
%

—

—
%
85-96 months

125,000

1.98
%

—

—
%
97-108 months

—

—
%

—

—
%
109-120 months

485,000

2.96
%

25,000

2.71
%

The table above contains forward-starting interest rate swaps with a combined notional value of $800,000 and a weighted average pay-fixed rate of 2.38% which will not be effective until 2016.

The following table summarizes the volume of activity related to derivative instruments for the period indicated:

For the six months ended June 30, 2015:	Beginning of Period Notional Amount	Additions	Settlement, Termination, Expiration or Exercise		End of Period Notional Amount
Receive-fixed interest rate swaps	$275,000	$50,000	$—		$325,000
Pay-fixed interest rate swaps	650,000	1,735,000	(520,000	)	1,865,000
Eurodollar futures	16,600,000	—	(2,600,000	)	14,000,000
	$17,525,000	$1,785,000	$(3,120,000	)	$16,190,000

The table below provides detail of the Company's "gain (loss) on derivative instruments, net" by type of interest rate derivative for the periods indicated:

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
(amounts in thousands except share and per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
Type of Derivative Instrument	2015	2014	2015	2014
Receive-fixed interest rate swaps	$(1,746)	$—	$2,782	$—
Pay-fixed interest rate swaps	16,263	(11,694)	2,900	(20,702)
Eurodollar futures	2,573	(11,380)	(13,915)	(15,794)
Gain (loss) on derivative instruments, net	$17,090	$(23,074)	$(8,233)	$(36,496)

There is a net unrealized loss of $663 remaining in AOCI on the Company's consolidated balance sheet as of June 30, 2015 which represents the activity related to these interest rate swap agreements while they were previously designated as cash flow hedges, and this amount will be recognized in the Company's net income as a portion of "interest expense" over the remaining contractual life of the agreements. The Company estimates the portion of existing net unrealized loss on discontinued cash flow hedges expected to be reclassified to net income within the next 12 months is $1,491.

Many of the Company's interest rate swaps were entered into under bilateral agreements which contain various covenants related to the Company’s credit risk. Specifically, if the Company defaults on any of its indebtedness, including those circumstances whereby repayment of the indebtedness has not yet been accelerated by the lender, or is declared in default of any of its covenants with any counterparty, then the Company could also be declared in default under the bilateral agreement. Additionally, these agreements allow those counterparties to require settlement of its outstanding derivative transactions if the Company fails to earn net income excluding derivative gains and losses greater than one dollar as measured on a rolling two quarter basis. These interest rate agreements also contain provisions whereby, if the Company fails to maintain a minimum net amount of shareholders’ equity, then the Company may be declared in default on its derivative obligations. The Company was in compliance with all covenants under bilateral agreements on June 30, 2015.
Please see Note 6 for the Company's disclosures related to offsetting assets and liabilities.

NOTE 6 – OFFSETTING ASSETS AND LIABILITIES

The Company's derivatives and repurchase agreements are subject to underlying agreements with master netting or similar arrangements, which provide for the right of offset in the event of default or in the event of bankruptcy of either party to the transactions. The Company reports its assets and liabilities subject to these arrangements on a gross basis. The following tables present information regarding those assets and liabilities subject to such arrangements as if the Company had presented them on a net basis as of June 30, 2015 and December 31, 2014:

Offsetting of Assets

	Gross Amount of Recognized Assets	Gross Amount Offset in the Balance Sheet	Net Amount of Assets Presented in the Balance Sheet	Gross Amount Not Offset in the Balance Sheet [1]		
				Financial Instruments Received as Collateral	Cash Received as Collateral	Net Amount
June 30, 2015:						
Derivative assets	$20,804	$—	$20,804	$(2,848)	$(17,956)	$—
December 31, 2014:						

Derivative assets	$5,727	$—	$5,727	$(1,073)	$(4,521)	$133

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NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
(amounts in thousands except share and per share data)

Offsetting of Liabilities

	Gross Amount of Recognized Liabilities	Gross Amount Offset in the Balance Sheet	Net Amount of Liabilities Presented in the Balance Sheet	Gross Amount Not Offset in the Balance Sheet [1]		Net Amount
				Financial Instruments Posted as Collateral	Cash Posted as Collateral	
June 30, 2015:						
Derivative liabilities	$48,240	$—	$48,240	$(4,249)	$(43,991)	$—
Repurchase agreements	3,402,964	—	3,402,964	(3,402,964)	—	—
	$3,451,204	$—	$3,451,204	$(3,407,213)	$(43,991)	$—
December 31, 2014:						
Derivative liabilities	$35,898	$—	$35,898	$(2,494)	$(32,994)	$410
Repurchase agreements	3,013,110	—	3,013,110	(3,013,110)	—	—
	$3,049,008	$—	$3,049,008	$(3,015,604)	$(32,994)	$410

(1) Amount disclosed for collateral received by or posted to the same counterparty include cash and the fair value of MBS up to and not exceeding the net amount of the asset or liability presented in the balance sheet. The fair value of the actual collateral received by or posted to the same counterparty may exceed the amounts presented.

NOTE 7 – FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and also requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability. ASC Topic 820 established a valuation hierarchy of three levels as follows:

- Level 1 – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities as of the measurement date.
- Level 2 – Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs either directly observable or indirectly observable through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.
- Level 3 – Unobservable inputs are supported by little or no market activity. The unobservable inputs represent management's best estimate of how market participants would price the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

The following table presents the fair value of the Company's assets and liabilities presented on its consolidated balance sheets, segregated by the hierarchy level of the fair value estimate, that are measured at fair value on a recurring basis as of the dates indicated:

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
DYNEX CAPITAL, INC.
(amounts in thousands except share and per share data)

	June 30, 2015			
	Fair Value	Level 1 - Unadjusted Quoted Prices in Active Markets	Level 2 - Observable Inputs	Level 3 - Unobservable Inputs
Assets:				
Mortgage-backed securities	$3,852,883	$—	$3,813,929	$38,954
Derivative assets	20,804	—	20,804	—
Total assets carried at fair value	$3,873,687	$—	$3,834,733	$38,954
Liabilities:				
Derivative liabilities	$48,240	$43,991	$4,249	$—
Total liabilities carried at fair value	$48,240	$43,991	$4,249	$—

	December 31, 2014			
	Fair Value	Level 1 - Unadjusted Quoted Prices in Active Markets	Level 2 - Observable Inputs	Level 3 - Unobservable Inputs
Assets:				
Mortgage-backed securities	$3,516,239	$—	$3,472,282	$43,957
Derivative assets	5,727	—	5,727	—
Total assets carried at fair value	$3,521,966	$—	$3,478,009	$43,957
Liabilities:				
Derivative liabilities	$35,898	$32,896	$3,002	$—
Total liabilities carried at fair value	$35,898	$32,896	$3,002	$—

The Company did not have assets or liabilities measured at fair value on a non-recurring basis as of June 30, 2015 or December 31, 2014.

The Company's derivative assets and liabilities include interest rate swaps and Eurodollar futures. Interest rate swaps are valued using the income approach with the primary input being the forward interest rate swap curve, which is considered an observable input and thus their fair values are considered Level 2 measurements. Eurodollar futures are valued based on closing exchange prices on these contracts. Accordingly, these financial futures are classified as Level 1.

Agency MBS, as well a majority of non-Agency MBS, are substantially similar to securities that either are currently actively traded or have been recently traded in their respective market. Their fair values are derived from an average of multiple dealer quotes and thus are considered Level 2 fair value measurements. The Company’s remaining non-Agency MBS are comprised of securities for which there are not substantially similar securities that trade frequently, and their fair values are therefore considered Level 3 measurements. The Company determines the fair value of its Level 3 securities by discounting the estimated future cash flows derived from cash flow models using assumptions that are confirmed to the extent possible by third party dealers or other pricing indicators. Significant inputs into those pricing models are Level 3 in nature due to the lack of readily available market quotes. Information utilized in those pricing models include the security’s credit rating, coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected credit losses, and credit enhancement as well as certain other relevant information. Significant changes in any of these inputs in

isolation would result in a significantly different fair value measurement. Level 3 assets are generally most sensitive to the default rate and severity assumptions.

The table below presents information about the significant unobservable inputs used in the fair value measurement for the Company's Level 3 non-Agency CMBS and RMBS as of June 30, 2015:

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DYNEX CAPITAL, INC.
(amounts in thousands except share and per share data)

	Quantitative Information about Level 3 Fair Value Measurements [1]			
	Prepayment Speed	Default Rate	Severity	Discount Rate
Non-Agency CMBS	20 CPY	2.0 %	35.0 %	9.1 %
Non-Agency RMBS	10 CPR	1.0 %	20.0 %	6.5 %

(1) Data presented are weighted averages.

The activity of the instruments measured at fair value on a recurring basis using Level 3 inputs is presented in the following table for the period indicated:

	Level 3 Fair Value		
	Non-Agency CMBS	Non-Agency RMBS	Total assets
Balance as of December 31, 2014	$42,033	$1,924	$43,957
Unrealized loss included in OCI	(108)	(10)	(118)
Principal payments	(4,942)	(130)	(5,072)
Accretion	187	—	187
Balance as of June 30, 2015	$37,170	$1,784	$38,954

The following table presents a summary of the recorded basis and estimated fair values of the Company’s financial instruments as of the dates indicated:

	June 30, 2015		December 31, 2014	
	Recorded Basis	Fair Value	Recorded Basis	Fair Value
Assets:				
Mortgage-backed securities	$3,852,883	$3,852,883	$3,516,239	$3,516,239
Mortgage loans held for investment, net[1]	29,858	25,460	39,700	35,024
Derivative assets	20,804	20,804	5,727	5,727
Liabilities:				
Repurchase agreements [2]	$3,402,964	$3,402,964	$3,013,110	$3,013,110
FHLB advances [2]	108,076	108,076	—	—
Non-recourse collateralized financing [1]	8,788	8,442	10,786	10,366
Derivative liabilities	48,240	48,240	35,898	35,898

(1) The Company determines the fair value of its mortgage loans held for investment, net and its non-recourse collateralized financing using internally developed cash flow models with inputs similar to those used to estimate fair value of the Company's Level 3 non-Agency MBS.

(2) The carrying value of repurchase agreements and FHLB advances generally approximates fair value due to their short term maturities.

NOTE 8 – SHAREHOLDERS' EQUITY

Preferred Stock

The Company has 2,300,000 shares of its 8.50% Series A Preferred Stock and 2,250,000 shares of its 7.625% Series B Preferred Stock issued and outstanding as of June 30, 2015 (collectively, the "Preferred Stock"). The Preferred Stock has no maturity and will remain outstanding indefinitely unless redeemed or otherwise repurchased or converted into common stock pursuant to the terms of the Preferred Stock. Except under certain limited circumstances intended to

preserve the Company's REIT status, upon the occurrence of a change in control as defined in Article IIIA, Section 7(d) of the Company’s Articles of Incorporation,

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DYNEX CAPITAL, INC.
(amounts in thousands except share and per share data)

or to avoid the direct or indirect imposition of a penalty tax in respect of, or to protect the tax status of, any of the Company's real estate mortgage investment conduits ("REMIC") interests or a REMIC in which the Company may acquire an interest (as permitted by the Company's Articles of Incorporation), the Company may not redeem the Series A Preferred Stock prior to July 31, 2017 or the Series B Preferred Stock prior to April 30, 2018. On or after these dates, at any time and from time to time, the Preferred Stock may be redeemed in whole, or in part, at the Company's option at a cash redemption price of $25.00 per share plus any accumulated and unpaid dividends. The Series A Preferred Stock pays a cumulative cash dividend equivalent to 8.50% of the $25.00 liquidation preference per share each year and the Series B Preferred Stock pays a cumulative cash dividend equivalent to 7.625% of the $25.00 liquidation preference per share each year. Because the Preferred Stock is redeemable only at the option of the issuer, it is classified as equity on the Company's consolidated balance sheet. The Company announced that it will pay its regular quarterly dividends on its Preferred Stock for the second quarter on July 15, 2015 to shareholders of record as of July 1, 2015.

Common Stock

The following table presents a summary of the changes in the number of common shares outstanding for the periods presented:

	Six Months Ended June 30,	
	2015	2014
Balance as of beginning of period	54,739,111	54,310,484
Common stock issued under DRIP	9,688	6,543
Common stock issued under stock and incentive plans	263,829	471,210
Common stock forfeited for tax withholding on share-based compensation	(67,296)	(59,150)
Common stock repurchased during the period	(860,721)	—
Balance as of end of period	54,084,611	54,729,087

The Company had 7,416,520 shares of common stock that remain available to offer and sell through its sales agent, JMP Securities LLC, under its "at the market", or "ATM" program, as of June 30, 2015.

The Company's Dividend Reinvestment and Share Purchase Plan ("DRIP") allows registered shareholders to automatically reinvest some or all of their quarterly common stock dividends in shares of the Company's common stock and provides an opportunity for investors to purchase shares of the Company's common stock, potentially at a discount to the prevailing market price. Of the 3,000,000 shares reserved for issuance under the Company's DRIP, there were 2,440,457 shares remaining for issuance as of June 30, 2015. The Company declared a second quarter common stock dividend of $0.24 per share payable on July 31, 2015 to shareholders of record as of July 6, 2015. There was no discount for shares purchased through the DRIP during the second quarter of 2015.

Of the $50,000 authorized by the Company's Board of Directors for the repurchase of its common stock through December 31, 2016, approximately $43,311 remains available for repurchase at the Company's option as of June 30, 2015.

2009 Stock and Incentive Plan. Of the 2,500,000 shares of common stock authorized for issuance under its 2009 Stock and Incentive Plan, the Company had 999,096 available for issuance as of June 30, 2015. Total stock-based compensation expense recognized by the Company for the three and six months ended June 30, 2015 was $782 and

$1,475, respectively, compared to $683 and $1,355, respectively, for the three and six months ended June 30, 2014.

The following table presents a rollforward of the restricted stock activity for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2015	2014 [1]	2015	2014 [1]
Restricted stock outstanding as of beginning of period	696,819	723,964	731,809	520,987
Restricted stock granted	32,555	29,175	263,829	457,538
Restricted stock vested	(32,777)	(17,916)	(299,041)	(243,302)
Restricted stock outstanding as of end of period	696,597	735,223	696,597	735,223

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DYNEX CAPITAL, INC.
(amounts in thousands except share and per share data)

(1) Amounts shown for the three and six months ended June 30, 2014 have been adjusted from amounts previously disclosed to correct computational errors relating to vesting terms on grants made in the first quarter of 2013.

The combined grant date fair value of the restricted stock issued by the Company for the three and six months ended June 30, 2015 was $250 and $2,167, respectively, compared to $250 and $3,703, respectively, for the three and six months ended June 30, 2014. As of June 30, 2015, the fair value of the Company's outstanding restricted stock remaining to be amortized into compensation expense is $4,987 which will be recognized over a weighted average period of 2.0 years.

NOTE 9 – SUBSEQUENT EVENTS

Management has evaluated events and circumstances occurring as of and through the date this Quarterly Report on Form 10-Q was filed with the SEC and has determined that there have been no significant events or circumstances that qualify as a "recognized" or "nonrecognized" subsequent event as defined by ASC Topic 855.

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

The following discussion should be read in conjunction with our unaudited financial statements and the accompanying notes included in Item 1. “Financial Statements” in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the year ended December 31, 2014. References herein to “Dynex,” the “Company,” “we,” “us,” and “our” inclu Dynex Capital, Inc. and its consolidated subsidiaries, unless the context otherwise requires. In addition to current and historical information, the following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our future business, financial condition or results of operations. For a description of certain factors that may have a significant impact on our future business, financial condition or results of operations, see “Forward-Looking Statements” at the end of this discussion and analysis.

EXECUTIVE OVERVIEW

Company Overview

We are an internally managed mortgage real estate investment trust, or mortgage REIT, which invests in residential and commercial mortgage securities on a leveraged basis. Our common stock is traded on the New York Stock Exchange ("NYSE") under the symbol "DX". We also have two series of preferred stock outstanding, our 8.50% Series A Cumulative Redeemable Preferred Stock (the "Series A Preferred Stock") which is traded on the NYSE under the symbol "DXPRA", and our 7.625% Series B Cumulative Redeemable Preferred Stock (the "Series B Preferred Stock") which is traded on the NYSE under the symbol "DXPRB". Our objective is to provide attractive risk-adjusted returns to our shareholders over the long term that are reflective of a leveraged, high quality fixed income portfolio with a focus on capital preservation. We seek to provide returns to our shareholders primarily through regular quarterly dividends and also through capital appreciation.

We were formed in 1987 and commenced operations in 1988. From our inception through 2000, our operations largely consisted of originating and securitizing various types of loans, principally single-family and commercial mortgage loans and manufactured housing loans. Since 2000, we have been investing in Agency and non-Agency mortgage-backed securities (“MBS”) and are no longer originating or securitizing mortgage loans. MBS consist of residential MBS (“RMBS”) and commercial MBS (“CMBS”), including CMBS interest-only ("IO") securities. Agency MBS have a guaranty of principal payment by an agency of the U.S. government or a U.S. government-sponsored entity ("GSE") such as Fannie Mae and Freddie Mac. Non-Agency MBS have no such guaranty of payment.

Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. We invest our capital pursuant to our Operating Policies as approved by our Board of Directors which include an Investment Policy and Investment Risk Policy. For more information see Part I, Item 1 of our Annual Report on Form 10-K for the year ended December 31, 2014 under “Company Overview - Operating Policies and Restrictions.”

RMBS. Our Agency RMBS investments include MBS collateralized by adjustable-rate mortgage loans ("ARMs"), which have interest rates that generally will adjust at least annually to an increment over a specified interest rate index, and hybrid adjustable-rate mortgage loans ("hybrid ARMs"), which are loans that have a fixed rate of interest for a specified period (typically three to ten years) and then adjust their interest rate at least annually to an increment over a specified interest rate index. Agency ARMs also include hybrid Agency ARMs that are past their fixed-rate periods or within twelve months of their initial reset period. We may also invest in fixed-rate Agency RMBS from time to time.

We also invest in non-Agency RMBS, which do not carry a principal guarantee from the U.S. government or a GSE. Non-Agency RMBS are collateralized by non-conforming residential mortgage loans and credit tranched into different classes of securities with payments to junior classes subordinate to senior classes. We generally invest in senior classes of non-Agency RMBS that are of higher credit quality and which may include unrated securities that have sufficiently high collateralization to protect our investment from most credit events.

CMBS. Our Agency and non-Agency CMBS are collateralized by first mortgage loans and are primarily fixed-rate securities but also include securities with rates that reset monthly based on an index rate, such as LIBOR. Loans underlying CMBS

generally are geographically diverse, are fixed-rate, mature in ten to twelve years and have amortization terms of up to 30 years. The majority of the loans collateralizing our CMBS are secured by multifamily properties. Typically these loans have some form of prepayment protection provisions (such as prepayment lock-out) or prepayment compensation provisions (such as yield maintenance or prepayment penalty). Yield maintenance and prepayment penalty requirements are intended to create an economic disincentive for the loans to prepay.

CMBS IO. A portion of our Agency and non-Agency CMBS includes IO securities which represent the right to receive interest payments (but not principal cash flows) based on the unpaid principal balance of the underlying pool of mortgage loans. As these securities have no principal associated with them, the interest payments received are based on the unpaid principal balance of the underlying pool of mortgage loans, which is often referred to as the notional amount. CMBS IO securities generally have some level of prepayment protection in the form of lock-outs, prepayment penalties, or yield maintenance associated with the underlying loans similar to CMBS described above.

Factors that Affect Our Results of Operations and Financial Condition

The performance of our investment portfolio, including the amount of net interest income we earn and fluctuations in investment values, will depend on multiple factors, many of which are beyond our control. These factors include, but are not limited to, the absolute level of interest rates, changes in expectations with regard to future interest rates, the relative steepness of interest rate curves, actual and estimated future prepayment rates on our investments, competition for investments, economic conditions and their impact on the credit performance of our investments (including multifamily, residential and commercial mortgage markets), and market required yields as reflected by market credit spreads. In addition, the performance of our investment portfolio, the cost and availability of financing and the availability of investments at acceptable return levels could be influenced by actions and policy measures of the U.S. government including, but not limited to, the Federal Housing Finance Administration, the U. S. Department of the Treasury (the "Treasury"), and the Board of Governors of the Federal Reserve System (the "Federal Reserve") and could also be influenced by other central banks around the world.

Our business model may also be impacted by other factors such as the availability and cost of financing and the state of the overall credit markets. Reductions in the availability of financing for our investments could significantly impact our business and force us to sell assets that we otherwise would not sell, potentially at losses depending on market conditions. Recent regulatory developments impacting large U.S. domiciled banks and their broker dealer subsidiaries have in some instances reduced their capacity to lend. Broadly, U.S. and international regulators are seeking to force regulated financial institutions to hold more capital against their assets, including reverse repurchase agreements. We have not yet seen a reduction in the availability of financing. We also maintain a diverse set of counterparties including broker dealer subsidiaries of non-U.S. domiciled banks and independent dealers to attempt to mitigate this risk. Other factors also impacting our business include changes in regulatory requirements, including requirements to qualify for registration under the Investment Company Act of 1940, and REIT requirements.

As discussed above, investing in mortgage-related securities on a leveraged basis subjects us to a number of risks including interest rate risk, prepayment and reinvestment risk, credit risk, market value risk and liquidity risk, which are discussed in "Liquidity and Capital Resources" within this Item 2 and in Part I, Item 3 of this Quarterly Report on Form 10-Q as well as in Item 1A, "Risk Factors" of Part I, and in Item 7A, "Quantitative and Qualitative Disclosures about Market Risk" of Part II of our Annual Report on Form 10-K for the year ended December 31, 2014. Please see these Items for a detailed discussion of these risks and the potential impact on our results of operations and financial condition.

Highlights of the Second Quarter and First Six Months of 2015 and Outlook for Third Quarter of 2015

Comprehensive loss to common shareholders was $(11.5) million, or $(0.21) per common share, for the second quarter of 2015, and our book value declined $0.43 to $8.53 per common share as of June 30, 2015. Comprehensive

loss to common shareholders and the decline in book value per common share were impacted primarily by spread widening in hybrid ARMs and increasing interest rates during the second quarter, particularly in the 5-10 year part of the yield curve, which caused our net unrealized gain on MBS, a component of accumulated other comprehensive income ("AOCI"), to decline $40.5 million. This decline was partially offset by an increase of $18.9 million in the fair value of our derivative instruments, which consist of interest rate swaps and Eurodollar futures and are intended to hedge against our book value and net interest income exposure to changing interest rates. Net income to common shareholders, which includes changes in fair value of derivative instruments but does not

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include changes in unrealized gain (loss) on MBS, increased to $28.2 million, or $0.52 per common share for the second quarter of 2015 compared to a net loss to common shareholders of $(11.8) million for the first quarter of 2015.

Core net operating income, a non-GAAP measure which excludes changes in unrealized gain (loss) of MBS and derivative instruments as well as certain other items, was $11.6 million, or $0.21 per common share, for the second quarter of 2015. Core net operating income declined from $0.23 per common share in the first quarter of 2015 due to an increase in premium amortization on Agency RMBS of $1.8 million, or $0.03 per common share, from faster prepayment speeds as well as an increase in net periodic interest costs related to hedging activity and an increase in operating expenses during the second quarter of $0.5 million, or $0.01 per common share. Partially offsetting the additional Agency RMBS premium amortization was an increase of approximately $0.7 million, or $0.01 per common share, in net prepayment compensation on CMBS and CMBS IO received during the quarter. Actual prepayment speeds on the Company's Agency RMBS as measured by constant prepayment rate, or CPR, were 16.7% during the second quarter of 2015 versus 12.4% during the first quarter of 2015 as the decline in interest rates in the first quarter of 2015 led to faster prepayment speeds in the second quarter.

For the six months ended June 30, 2015, comprehensive loss to common shareholders was $(0.2) million and book value per common share declined $0.49, or 5%. For the first six months of 2015, the two-year U.S. Treasury rate had a high of 0.73% and a low of 0.41%, and the ten-year U. S. Treasury rate had a high of 2.48% and a low of 1.64%. The high degree of volatility in U.S. interest rates was driven by general economic uncertainty and global interest rates, particularly in the Eurozone and was also accompanied by widening in spreads in both Agency and non-Agency MBS. The combination of these two factors caused declines during the six months ended June 30, 2015 in both our MBS prices (a net unrealized loss of $18.5 million) and derivative instruments (a net change in fair value of $5.6 million), negatively impacting our comprehensive income and more than offsetting the net interest income earned on our investments. Core net operating income during the six months ended June 30, 2015 declined to $24.0 million, or $0.44 per common share, compared to $27.9 million, or $0.51 per common share, for the six months ended June 30, 2014. The decline was driven largely by lower net interest income from a smaller earning asset base and higher general and administrative expenses.

Overall leverage increased to 6.2 times total shareholders' equity as of June 30, 2015 from 5.0 times as of December 31, 2014 and 5.7 times as of March 31, 2015. This increase in leverage is due to an increase in our repurchase agreement borrowings and lower total shareholders' equity. Our repurchase agreement borrowings increased in order to finance investment purchases during the first six months of 2015. Our total shareholder's equity declined primarily because the decline in net unrealized gain on MBS, which resulted from increases in interest rates and spread widening across our portfolio, lowered our AOCI from December 31, 2014 to June 30, 2015. Additionally, additional paid-in capital declined as a result of share repurchases during the first six months of the year.

The table below provides quarterly information on weighted average effective yields by type of investment as well as cost of funds and other information. Weighted average effective yields are derived by dividing annualized interest income by the average amortized cost of the related assets, and cost of funds are derived by dividing annualized interest expense by the daily average balance of the related liabilities.

	Three Months Ended				
	June 30, 2015	March 31, 2015	December 31, 2014	September 30, 2014	June 30, 2014
Effective yield:					
RMBS	1.82%	1.88%	1.87%	1.82%	1.85%
CMBS	3.38%	3.70%	4.09%	4.45%	4.66%
CMBS IO	3.86%	3.83%	3.94%	4.14%	4.21%
All other investments	4.24%	4.13%	4.68%	5.16%	5.17%
Total effective yield	2.63%	2.62%	2.64%	2.73%	2.79%
Cost of funds	(0.66)%	(0.69)%	(0.72)%	(0.70)%	(0.75)%
GAAP net interest spread	1.97%	1.93%	1.92%	2.03%	2.04%
Total effective yield (from above)	2.63%	2.62%	2.64%	2.73%	2.79%
Effective borrowing rate (1)	(0.77)%	(0.66)%	(0.67)%	(0.80)%	(0.87)%
Adjusted net interest spread (1)	1.86%	1.96%	1.97%	1.93%	1.92%

(1) Represents a non-GAAP financial measure. Please refer to the discussion regarding the use of non-GAAP financial measures and to the corresponding reconciliations of GAAP to non-GAAP financial measures provided in "Results of Operations" within this Item 2.

As we move into the second half of 2015, the Federal Reserve Open Market Committee (the "FOMC") is likely to begin monetary policy tightening as it begins to move the targeted Federal Funds Rate higher from its current range of 0.0-0.25%. Currently, the market is pricing in four increases of 0.25% in the Federal Funds rate through 2016 and over six 0.25% increases through 2017. We believe global market conditions, including the economic slowdown in China and weakness in Japan and the Eurozone, will ultimately impact the ability of the FOMC to raise rates and should keep longer term rates in the U.S. low for the foreseeable future. We continue to maintain a positive duration gap (i.e., we are more sensitive to an increase in interest rates than a decrease in interest rates) in the expectation that global economic conditions may limit the number of interest rate increases by the FOMC. Our duration gap as currently positioned exposes us to a steeper yield curve from long-term rates rising faster than short-term rates. Reducing our duration gap, however, would expose us to risk from a sudden downward movement in interest rates, an event which we deem has a reasonable probability of occurring given the weakness in global economic conditions.

As we have noted before, if the FOMC raises the Federal Funds Rate in 2015, we expect our borrowing costs to rise and our net interest income and net interest spread to decline. A decline in our net interest income could result in a reduction of our common stock dividend depending, among other things, on the outlook for future increases in the Federal Funds rate.

From an investment point of view, we continue to focus on multifamily Agency CMBS, Agency and non-Agency CMBS IO as well as selectively investing in RMBS with an anticipated focus on re-performing and non-performing loan securitizations ("RPL/NPL securities"). We currently see less value in hybrid ARMs given the lack of supply which has increased prices and reduced available yields on this investment. From a financing point of view, with our wholly owned captive insurance subsidiary becoming a member of the FHLB system this quarter, we expect that we will expand our business with the FHLBI as a potential source of stable and lower cost financing for our high credit-quality investments. We also expect to expand our business in the next several quarters with private, direct providers of repurchase agreement financing. These providers are generally seeking to lend against high credit-quality collateral such as Agency MBS.

Trends and Recent Market Impacts

There are a number of key macroeconomic factors, conditions, and prospective trends that may impact our business. Factors, conditions, and trends that had significant developments during the first six months of 2015 are discussed below.

Interest rates remained volatile during the second quarter of 2015, more than reversing all of the declines that occurred in the first quarter of 2015. After rallying during the first quarter from 2.17% to 1.92%, the 10-year U.S. Treasury sold-off in the

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second quarter from 1.92% to 2.35%. During the second quarter of 2015, the difference between the 2-year U.S. Treasury and the 10-year U.S. Treasury, increased from 136 basis points to 170 basis points. Generally, a steeper yield curve as measured by the difference between the yield on the 2-year U.S. Treasury bonds versus the 10-year U.S. Treasury bonds suggests positive economic activity and market concerns about the potential risks of inflation. As noted above, market participants anticipate that the FOMC will begin to raise the Federal Funds Rate later this year. While the U.S. is showing positive signs of economic growth, other large and important economies around the world are experiencing weak growth and central banks in these economies are generally easing monetary conditions. The impact on longer term rates in the U.S. from the FOMC activity is unknown at this time and interest rates are likely to remain volatile for the foreseeable future.

Regulatory impacts on financial institutions, many of which are our trading and financing counterparties, continue to pose a threat in our view to the overall liquidity in the capital markets. In particular, higher capital requirements under U.S. banking regulations adopted in 2013 and 2014 and the Dodd-Frank Wall Street Reform and Consumer Protection Act’s limitations on the proprietary trading activities of large U.S. financial institutions could result in reduced liquidity in times of market stress. While the Federal Reserve continues to reinvest principal payments received on its Agency RMBS portfolio, it is unlikely that this activity will provide enough liquidity to the market in times of stress, which could result in volatile asset prices. Further, the impact on market liquidity from the FOMC actions noted above are unknown given the reduced market liquidity.

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based in large part upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of our consolidated financial statements requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. We base these estimates and judgments on historical experience and assumptions believed to be reasonable under current facts and circumstances. Actual results, however, may differ from the estimated amounts we have recorded. The discussion and analysis of our financial condition and results of operations also consider certain non-GAAP measures as described in "Non-GAAP Financial Measures" in this Part I, Item 2.
Critical accounting policies are defined as those that require management's most difficult, subjective or complex judgments, and which may result in materially different results under different assumptions and conditions. Our accounting policies that require the most significant management estimates, judgments, or assumptions, or that management believes includes the most significant uncertainties, and are considered most critical to our results of operations or financial position relate to fair value measurements, amortization of investment premiums, and other-than-temporary impairments. Our critical accounting policies are discussed in Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of our Annual Report on Form 10-K for the year ended December 31, 2014 under “Critical Accounting Policies”. There have been no significant changes in our critical accounting policies during the six months ended June 30, 2015.

FINANCIAL CONDITION

The following table presents our assets (net of associated financing in the case of investments) as a percentage of our shareholders' equity as of the dates indicated:

	June 30, 2015	March 31, 2015	December 31, 2014	September 30, 2014	June 30, 2014
RMBS	26 %	27 %	35 %	35 %	37 %
CMBS	28 %	34 %	29 %	25 %	26 %
CMBS IO	23 %	24 %	20 %	17 %	21 %
Other investments [1]	4 %	4 %	3 %	3 %	4 %
Other, net [2]	19 %	11 %	13 %	20 %	12 %
	100 %	100 %	100 %	100 %	100 %

(1) Other investments include mortgage loans held for investment, net and investment in limited partnership.
(2) Other, net consists of derivative assets and liabilities and non-investment assets and liabilities.

RMBS

Our RMBS are collateralized substantially by ARMs and hybrid ARMs. Activity related to our RMBS for the six months ended June 30, 2015 is as follows:

($ in thousands)	Agency RMBS	Non-Agency RMBS	Total
Balance as of December 31, 2014	$2,186,700	22,448	$2,209,148
Purchases	—	67,693	67,693
Principal payments	(198,268)	(16,297)	(214,565)
Sales	(158,566)	—	(158,566)
Net (amortization) accretion	(11,368)	23	(11,345)
Change in net unrealized loss	4,774	15	4,789
Balance as of June 30, 2015	$1,823,272	$73,882	$1,897,154

Our investment in RMBS as of June 30, 2015 has decreased since December 31, 2014 as principal payments and sales have outpaced purchases. Sales of Agency RMBS have consisted of certain lower yielding Agency ARMs that were at or near their interest rate reset periods and would have reset to lower coupon interest rates given the expected rates over the near term. We significantly increased our non-Agency RMBS portfolio by purchasing senior tranches of non-performing loan securities with short durations ranging between one and two years. Though not rated, these investments have substantial credit enhancement within the securitization structure, and we believe that they offer an attractive return profile with relatively stable cash flows. These non-Agency RMBS were purchased at or near par and had a weighted average yield of 3.56% for the six months ended June 30, 2015.

As of June 30, 2015, approximately 97% of our variable-rate Agency RMBS portfolio resets based on one-year LIBOR, which was 0.77% as of June 30, 2015. The following table presents the reset margin and weighted average coupon (“WAC”) by weighted average months to reset ("MTR") for the variable-rate portion of our Agency RMBS portfolio based on par value as of the dates indicated:

	June 30, 2015			December 31, 2014		
($ in thousands)	Par Value	Reset Margin	WAC	Par Value	Reset Margin	WAC
0-12 MTR	$351,767	1.81 %	2.69 %	$486,638	1.77 %	2.75 %
13-36 MTR	341,722	1.80 %	3.63 %	286,741	1.84 %	3.87 %
37-60 MTR	211,399	1.79 %	3.07 %	399,643	1.79 %	3.22 %
61-84 MTR	495,840	1.79 %	3.21 %	268,864	1.80 %	3.54 %
85-120 MTR	325,008	1.62 %	2.60 %	627,772	1.69 %	2.75 %
ARMs and Hybrid ARMs	1,725,736	1.76 %	3.06 %	2,069,658	1.77 %	3.10 %
Fixed	16,260		2.50 %	17,149		2.51 %
Total	$1,741,996		3.05 %	$2,086,807		3.09 %

CMBS

Our Agency CMBS are collateralized primarily by fixed rate mortgage loans secured by multifamily properties. Our non-Agency CMBS are collateralized by fixed rate mortgage loans secured by income producing properties such as office, retail, hotel, and multifamily. Both Agency and non-Agency CMBS will generally have some form of prepayment protection provisions (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties) to prevent early voluntary prepayment of principal.

Activity related to our CMBS for the six months ended June 30, 2015 is as follows:

($ in thousands)	Agency CMBS	Non-Agency CMBS	Total
Balance as of December 31, 2014	$335,197	$208,038	$543,235
Purchases	767,276	12,999	780,275
Principal payments	(16,060)	(9,137)	(25,197)
Sales	(99,709)	—	(99,709)
Net (amortization) accretion	(2,839)	135	(2,704)
Change in net unrealized gain	(16,962)	(100)	(17,062)
Balance as of June 30, 2015	966,903	211,935	1,178,838

Our CMBS portfolio has more than doubled since December 31, 2014 primarily due to our purchases of recently issued Agency CMBS, which are generally backed by loans on multi-family properties. In the current low yield environment, we believe these bonds offer more compelling risk-adjusted returns given their limited prepayment and extension risks when compared to RMBS, stable cash flow profile, and lower spread risk.

The following table presents the par value, amortized cost, and weighted average months to estimated maturity of our CMBS investments as of June 30, 2015 by year of origination:

CMBS by year of origination:	June 30, 2015 Par Value	Amortized Cost	Months to Estimated Maturity [1]
($ in thousands)			
2000 and prior	$51,106	$43,169	37
2001 to 2005	24,863	26,592	57
2006 to 2008	42,651	44,855	31
2009 to 2012	267,533	278,661	47
2013 to 2014	110,799	111,194	54
2015	669,590	670,018	126
	$1,166,542	$1,174,489	92

(1) Months to estimated maturity is an average weighted by the amortized cost of the investment.

The geographic diversification of the collateral underlying our non-Agency CMBS has not changed significantly since December 31, 2014.

CMBS IO

The majority of our CMBS IO investments are collateralized primarily by fixed rate mortgage loans. Agency CMBS IO are exclusively collateralized by multifamily properties and non-Agency CMBS IO are secured by income producing properties such as office, retail, and hotel. Both types of CMBS IO have some form of prepayment protection (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties). Our CMBS IO investments are investment grade-rated with the majority rated 'AAA' by at least one of the nationally recognized statistical ratings organizations.

Activity related to our CMBS IO for the six months ended June 30, 2015 is as follows:

($ in thousands)	Agency CMBS IO [1]	Non-Agency CMBS IO [1]	Total
Balance as of December 31, 2014	$438,737	$325,119	$763,856
Purchases	65,598	85,651	151,249
Sales	(27,911)	(43,402)	(71,313)
Net premium amortization	(37,354)	(23,281)	(60,635)
Change in net unrealized gain	(3,409)	(2,857)	(6,266)
Balance as of June 30, 2015	$435,661	$341,230	$776,891

(1) Amounts shown for CMBS IO represent premium only and exclude underlying notional balances.

The underlying notional balances of our Agency and non-Agency CMBS IO portfolios were $11.2 billion and $9.6 billion, respectively, as of June 30, 2015 compared to $10.5 billion and $7.9 billion, respectively, as of December 31, 2014. The following table presents the notional value, amortized cost, and weighted average months to estimated maturity of our CMBS IO investments as of June 30, 2015 by year of origination:

CMBS IO by year of origination:	June 30, 2015 Notional Value	Amortized Cost	Months to Estimated Maturity (1)
($ in thousands)			
2010	$407,016	$20,782	58
2011	2,787,589	55,386	68
2012	3,477,282	147,222	73
2013	7,613,864	168,384	92
2014	4,208,947	250,617	105
2015	2,276,984	122,753	113
	$20,771,682	$765,144	93

(1) Months to estimated maturity is an average weighted by the amortized cost of the investment.

The following table presents the geographic diversification of the collateral underlying our non-Agency CMBS IO by the top 5 states as of June 30, 2015:

($ in thousands)	June 30, 2015 Market Value of Collateral	Percentage	
California	$100,587	13.1	%
Texas	95,098	12.4	%
New York	72,089	9.4	%
Florida	64,097	8.4	%
Maryland	42,574	5.6	%
Remaining states (not exceeding 5.0% individually)	391,546	51.1	%
	$765,991	100.0	%

Derivative Assets and Liabilities

Our derivative assets and liabilities consist of interest rate swap agreements and Eurodollar futures, which we use to hedge our earnings and book value exposure to fluctuations in interest rates. Eurodollar futures represent forward starting 3-month LIBOR contracts and allow us to synthetically replicate swap curves and/or hedge specific points on the swap curve where we may have duration risk by shorting contracts at various points of the LIBOR curve. We use both pay-fixed and receive-fixed interest rate swaps to manage our overall hedge position. As of June 30, 2015, the weighted average notional amount of interest rate derivatives that will be effective for future periods are shown in the following table:

Effective Period	Pay-Fixed Interest Rate Swaps	Pay-Fixed Weighted Average Rate [1]		Receive-Fixed Interest Rate Swaps	Receive-Fixed Weighted Average Rate [1]		Eurodollar Futures	Eurodollar Futures Weighted-Average Rate [1]	
($ in thousands)									
Remainder of 2015	$1,065,000	1.59	%	$324,728	1.95	%	$—	—	%
Effective 2016	1,472,104	1.65	%	325,000	1.95	%	1,026,298	1.83	%
Effective 2017	1,378,178	1.72	%	325,000	1.95	%	1,113,767	2.99	%
Effective 2018	1,305,000	1.76	%	325,000	1.95	%	681,027	3.74	%
Effective 2019	1,164,027	1.81	%	249,863	1.96	%	487,055	4.00	%
Effective 2020	768,975	2.20	%	50,000	2.29	%	194,604	4.56	%
Effective 2021	685,000	2.45	%	25,000	2.71	%	—	—	%
Effective 2022	613,082	2.53	%	25,000	2.71	%	—	—	%
Effective 2023	492,534	2.63	%	25,000	2.71	%	—	—	%
Effective 2024	485,000	2.64	%	17,896	2.71	%	—	—	%
Effective 2025	137,671	2.80	%	—	—	%	—	—	%

(1) Weighted average rate is based on the weighted average notional outstanding.

During the six months ended June 30, 2015, we added pay-fixed interest rate swaps with a notional of $1.6 billion, net of terminated instruments, at a net weighted average pay-fixed rate of 2.08%, of which $800.0 million are forward-starting. We also added receive-fixed interest rate swaps with a notional of $50.0 million at weighted average receive-fixed rate of 1.75% during the same period. In addition, we terminated $2.6 billion of Eurodollar futures with a weighted average rate of 0.96%. Subsequent to June 30, 2015, we terminated Eurodollar futures effective in 2016 and 2017 and added $1.3 billion in 18-month forward-starting interest rate swaps, which become effective in April 2016 and have a pay-fixed weighted average rate of 1.22%. Please refer to Note 4 of the Notes to the Unaudited Consolidated Financial Statements contained in Part I, Item 1, “Financial Statements” of this Quarterly Report on Form 10-Q as well as "Loss on Derivative Instruments, Net" within "Results of Operations" contained within this Part 1, Item 2 for additional information related to our derivative assets and liabilities.

Repurchase Agreements

Our repurchase agreement borrowings increased a net $389.9 million from December 31, 2014 to June 30, 2015 in order to finance our MBS purchases, net of principal payments, of $759.5 million since December 31, 2014. The combined weighted average original term to maturity for our repurchase agreements was 88 days as of June 30, 2015 which is 56 days shorter than at December 31, 2014. In the second quarter of 2015, the cost of longer maturity borrowings increased as our lenders anticipated the Federal Reserve would soon increase the Federal Funds rate, which would have resulted in an increase in the cost of our repurchase agreements. As such, we rolled our longer term borrowings at maturity into shorter term borrowings in order to minimize costs during the quarter.

The following table presents the amount pledged and leverage against the fair value of our non-Agency MBS investments by credit rating as of June 30, 2015 and December 31, 2014:

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	June 30, 2015			December 31, 2014		
($ in thousands)	Fair Value	Amount Pledged	Related Borrowings	Fair Value	Amount Pledged	Related Borrowings
Non-Agency CMBS:						
AAA	$90,297	$79,450	$71,012	$73,553	$8,133	$7,279
AA	53,314	53,314	47,586	65,937	65,937	57,619
A	50,537	50,537	41,726	30,828	30,828	25,384
Below A/Not Rated	17,787	10,720	8,596	37,720	35,318	24,613
	$211,935	$194,021	$168,920	$208,038	$140,216	$114,895
Non-Agency CMBS IO:						
AAA	$303,429	$303,419	$255,470	$321,154	$311,184	$263,510
AA	35,051	26,361	22,329	1,057	1,057	1,005
Below A/Not Rated	2,750	2,750	2,326	2,908	2,908	2,467
	$341,230	$332,530	$280,125	$325,119	$315,149	$266,982
Non-Agency RMBS:						
Below A/Not Rated	$73,882	$69,906	$57,775	$22,448	$21,787	$17,594
	$73,882	$69,906	$57,775	$22,448	$21,787	$17,594

Please refer to Note 3 of the Notes to the Unaudited Consolidated Financial Statements contained within Part I, Item 1 of this Quarterly Report on Form 10-Q as well as "Interest Expense, Cost of Funds, and Effective Borrowings Costs" within "Results of Operations" and “Liquidity and Capital Resources” contained within this Part 1, Item 2 for additional information relating to our borrowings.

RESULTS OF OPERATIONS

The discussions that follow provide information on certain items on our consolidated statements of comprehensive income (loss) and include non-GAAP financial measures which management uses in its internal analysis of financial and operating performance. Please read the section "Non-GAAP Financial Measures" contained at the end of this section for additional important information.

Interest Income and Asset Yields

Interest income includes gross interest earned from the coupon rate on the securities, effects of premium amortization and discount accretion, and other interest income resulting from prepayment penalty income or other yield maintenance items. The following tables present information regarding interest income earned and effective yield on our MBS by collateral type for the periods indicated:

	Three Months Ended June 30,							
	2015				2014			
($ in thousands)	Interest Income	Average Balance [1]	Effective Yield [2]		Interest Income	Average Balance [1]	Effective Yield [2]	
RMBS:								
Agency	$7,932	$1,978,302	1.75	%	$11,137	$2,508,651	1.83	%
Non-Agency	687	75,436	3.63	%	166	14,664	4.48	%
	8,619	2,053,738	1.82	%	11,303	2,523,315	1.85	%
CMBS:								
Agency	5,772	705,410	3.07	%	3,211	331,274	3.62	%
Non-Agency	2,312	207,530	4.46	%	5,114	364,961	5.59	%
	8,084	912,940	3.38	%	8,325	696,235	4.66	%
CMBS IO:								
Agency	4,169	418,476	3.83	%	5,103	450,087	4.28	%
Non-Agency	3,324	331,801	3.89	%	2,264	220,115	4.06	%
	7,493	750,277	3.86	%	7,367	670,202	4.21	%
Total MBS portfolio:	$24,196	$3,716,955	2.62	%	$26,995	$3,889,752	2.76	%

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($ in thousands)	Six Months Ended June 30, 2015 Interest Income	Average Balance (1)	Effective Yield (2)	2014 Interest Income	Average Balance (1)	Effective Yield (2)
RMBS:						
Agency	$18,370	$2,057,763	1.79 %	$23,032	$2,572,087	1.82 %
Non-Agency	1,054	57,357	3.67 %	674	15,123	6.70 %
	19,424	2,115,120	1.85 %	23,706	2,587,210	1.85 %
CMBS:						
Agency	9,368	562,895	3.21 %	6,081	324,685	3.63 %
Non-Agency	4,623	205,880	4.48 %	10,157	363,186	5.58 %
	13,991	768,775	3.55 %	16,238	687,871	4.66 %
CMBS IO:						
Agency	8,041	420,303	3.81 %	9,932	451,088	4.31 %
Non-Agency	6,467	326,170	3.92 %	4,021	191,694	4.12 %
	14,508	746,473	3.86 %	13,953	642,782	4.25 %
Total MBS portfolio:	$47,923	$3,630,368	2.62 %	$53,897	$3,917,863	2.74 %

(1) Average balances are calculated as a simple average of the daily amortized cost and exclude unrealized gains and losses as well as securities pending settlement if applicable.
(2) Effective yields are weighted by average balance of the investments and based on annualized amounts. Recalculation of effective yields may not be possible using data provided because certain components of interest income use a 360-day year for the calculation while others use actual number of days in the year.

The following tables present the estimated impact of changes in average balances and average yields on interest income for the periods indicated:

($ in thousands)	Three Months Ended June 30, 2015 vs. June 30, 2014 Increase (Decrease)	Due to Change in Average Balance	Effective Yield	Six Months Ended June 30, 2015 vs. June 30, 2014 Increase (Decrease)	Due to Change in Average Balance	Effective Yield
RMBS	$(2,684)	$(2,188)	$(496)	$(4,282)	$(4,406)	$124
CMBS	(241)	2,510	(2,752)	(2,247)	1,865	(4,112)
CMBS IO	126	829	(703)	555	2,159	(1,604)
Total	$(2,799)	$1,151	$(3,951)	$(5,974)	$(382)	$(5,592)

Interest income from RMBS decreased $2.7 million for the second quarter of 2015 compared to the second quarter of 2014 primarily because of the decline in the average balance of RMBS as a result of reinvesting the majority of the principal payments and sale proceeds from Agency RMBS into CMBS and CMBS IO. In addition, interest income from RMBS decreased because additional amortization expense as a result of higher prepayment speeds during the second quarter of 2015 had an unfavorable impact of $1.0 million, or 5 basis points of effective yield, compared to an unfavorable impact of $0.6 million, or 2 basis points of effective yield, during the second quarter of 2014.

A larger percentage of our total interest income for the second quarter of 2015 resulted from CMBS and CMBS IO compared to the second quarter of 2014 because of the shift in our investment mix toward higher concentrations of CMBS and CMBS IO. These investments have limited prepayment risk, limited extension risk, stable cash flow, and lower spread risk, offering us better risk-adjusted returns given the lower yield and volatile investment environment

we have been experiencing for an extended period of time. With respect to CMBS, interest income is lower for second quarter of 2015 compared to the second quarter of 2014 because our CMBS portfolio composition shifted toward Agency product and away from non-Agency product as well as declines in the yield for both Agency and non-Agency CMBS. The decline in the Agency CMBS yield is primarily related to the Agency

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CMBS we purchased since June 30, 2014, which have yields lower than the average yield on Agency CMBS at June 30, 2014. The recently purchased Agency CMBS were acquired when rates and spreads were at lower levels than those existing when the investments existing at June 30, 2014 were acquired, which resulted in the lower yields on the more recently acquired securities. The decrease in the non-Agency CMBS yield is primarily related to the sale of certain securities during the second half of 2014, which we sold to reduce our exposure to the risk of credit spreads widening on those assets. With respect to CMBS IO, the impact of a larger average balance only slightly outweighed the impact of a lower effective yield, resulting in an increase in interest income of $0.1 million for second quarter of 2015 compared to second quarter of 2014. Effective yields for CMBS IO were lower for the second quarter of 2015 compared to the second quarter of 2014 because the yields on the CMBS IO purchased since June 30, 2014 were lower than the portfolio average yield as of June 30, 2014.

Interest income from RMBS decreased $4.3 million for the six months ended June 30, 2015 compared to the same period in 2014 primarily because of the decline in average balance as noted above for the quarterly comparison.

Interest income from CMBS decreased for the six months ended June 30, 2015 compared to the same period in 2014 primarily because of lower effective yields as higher yielding non-Agency CMBS sold in the second half of 2014 were replaced by purchases of lower yielding Agency CMBS primarily in the first half of 2015. As mentioned above, the effective yield for the total CMBS portfolio was impacted by the shift in the composition of the CMBS portfolio toward Agency product and away from non-Agency product.

Interest income from CMBS IO increased for the six months ended June 30, 2015 compared to the same period in 2014 primarily because of an increase of $103.7 million in the average balance outstanding. Partially offsetting the benefit of a larger average balance, the effective yield for CMBS IO was approximately 39 basis points lower for the six months ended June 30, 2015 compared to the same period in 2014. Similar to its quarterly comparison above, effective yields for CMBS IO were lower for the six months ended June 30, 2015 compared to the same period in 2014 because the yields on the CMBS IO purchased since June 30, 2014 were lower than the portfolio average yield as of June 30, 2014.

The following tables present information regarding net premium amortization by collateral type for the periods indicated:

	Three Months Ended June 30,			
	2015		2014	
($ in thousands)	Net Premium Amortization	Average Balance of Unamortized Premium, Net	Net Premium Amortization	Average Balance of Unamortized Premium, Net
RMBS	$6,269	$101,535	$7,649	$135,971
CMBS	1,487	8,447	975	2,943
CMBS IO	$29,902	750,277	26,085	670,203
	$37,658	$860,259	$34,709	$809,117

	Six Months Ended June 30,			
	2015		2014	
($ in thousands)	Net Premium Amortization	Average Balance of Unamortized Premium, Net	Net Premium Amortization	Average Balance of Unamortized Premium, Net
RMBS	11,345	$106,065	$15,639	$141,026
CMBS	2,704	9,105	1,683	2,186

CMBS IO	60,636	746,473	49,683	642,782
	$74,685	$861,643	$67,005	$785,994

The rate at which we amortize the premiums we pay for our investments is impacted by the current and forecasted constant prepayment rate ("CPR"). The following table provides the actual CPRs for our Agency RMBS for the periods indicated:

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	Three Months Ended				
	June 30, 2015	March 31, 2015	December 31, 2014	September 30, 2014	June 30, 2014
Agency RMBS	16.7 %	12.4 %	12.5 %	15.3 %	14.1 %

As mentioned above, our projected prepayment speed on our Agency RMBS increased, resulting in approximately $1.0 million of additional premium amortization expense for the second quarter of 2015. Our actual CPR increased during the second quarter of 2015 due to the impact of falling rates during the first quarter of 2015.

We also recorded $0.4 million and $1.2 million in additional premium amortization expense during the second quarter of 2015 for our CMBS and CMBS IO portfolios, respectively, but these expenses were offset by yield maintenance and other prepayment compensation income of $0.8 million and $1.5 million, respectively.

Interest Expense, Cost of Funds, and Effective Borrowing Cost

The following table summarizes the components of interest expense as well as average balances and cost of funds for the periods indicated:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in thousands)	2015	2014	2015	2014
Interest expense on repurchase agreement borrowings	$4,643	$4,940	$8,932	$10,263
Interest expense on FHLB advances	6	—	6	—
Amortization of de-designated cash flow hedges (1)	857	1,608	1,914	3,896
Non-recourse collateralized financing and other interest expense	36	24	61	46
Total interest expense	$5,542	$6,572	$10,913	$14,205
Average balance of repurchase agreements	$3,301,590	$3,454,884	$3,201,915	$3,475,909
Average balance of FHLB advances	9,667	—	4,860	—
Average balance of non-recourse collateralized financing	9,503	11,767	10,074	11,988
Average balance of borrowings	$3,320,760	$3,466,651	$3,216,849	$3,487,897
Cost of funds	0.66 %	0.75 %	0.67 %	0.81 %

(1) Amount recorded in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.

The majority of the outstanding debt used to finance our investments are repurchase agreement borrowings. The following table presents the estimated impact of changes in the average balance of repurchase agreement borrowings and average borrowing rates on the decrease in interest expense for the comparative periods presented:

	Three Months Ended June 30, 2015 vs. June 30, 2014			Six Months Ended June 30, 2015 vs. June 30, 2014		
		Due to Change in			Due to Change in	
($ in thousands)	Decrease in Interest Expense	Average Balance	Average Borrowing Rate	Decrease in Interest Expense	Average Balance	Average Borrowing Rate
Repurchase agreements	$(297)	$(219)	$(78)	$(1,331)	$(809)	$(522)

The average balance of repurchase agreement borrowings were lower for the three and six months ended June 30, 2015 compared to the same periods in 2014 due to the lower average balance of our investment portfolio for the three and six months ended June 31, 2015 versus the same periods in 2014. Our repurchase agreement borrowing rates were also lower for three and six months ended June 30, 2015 compared to the same periods in 2014 because of the tighter

spread environment, the continuing low interest rate environment, and the ample liquidity in the financing markets that has increased competition for borrowers among our repurchase agreement counterparties.

Our wholly owned subsidiary, which provides captive insurance services to the Company, became a member of the Federal Home Loan Bank of Indianapolis ("FHLBI") during the second quarter of 2015. As a member, the subsidiary has access to various services offered by the FHLB including secured advances which we may use to finance certain of our investments. We had FHLB advances of $108.1 million outstanding as of June 30, 2015 at a weighted average borrowing rate of 0.22%.

Because we use derivative instruments as economic hedges of our interest rate risk exposure, management considers net periodic interest costs from effective derivative instruments to be an additional cost of financing investments. As such, management utilizes a non-GAAP financial measure "effective borrowing cost" which includes the net periodic interest costs of our effective derivative instruments excluded from GAAP interest expense. The tables below present the reconciliation of GAAP interest expense and cost of funds to our effective borrowing cost and rate for the periods indicated:

	Three Months Ended June 30,			
	2015		2014	
($ in thousands)	Amount	Rate	Amount	Rate
GAAP interest expense/cost of funds	$5,542	0.66 %	$6,572	0.75 %
Amortization of de-designated cash flow hedges [1]	(857)	(0.10)%	(1,608)	(0.18)%
Net periodic interest costs of derivative instruments	1,793	0.21 %	2,672	0.30 %
Effective borrowing cost/rate	$6,478	0.77 %	$7,636	0.87 %

	Six Months Ended June 30,			
	2015		2014	
($ in thousands)	Amount	Rate	Amount	Rate
GAAP interest expense/cost of funds	$10,913	0.67 %	$14,205	0.81 %
Amortization of de-designated cash flow hedges [1]	(1,914)	(0.12)%	(3,896)	(0.22)%
Net periodic interest costs of derivative instruments	2,655	0.16 %	4,883	0.28 %
Effective borrowing cost/rate	$11,654	0.71 %	$15,192	0.87 %

(1) Amount recorded as a portion of "interest expense" in accordance with GAAP and is related to the amortization of the balance in accumulated other comprehensive loss as of June 30, 2013 related to the derivatives for which we discontinued cash flow hedge accounting.

The decline in our effective borrowing costs for the three and six months ended June 30, 2015 compared to the same periods in 2014 was primarily related to the lower net periodic interest costs on our derivative instruments and to a lesser extent, lower interest expense from our repurchase agreements as a result of lower rates and a lower average balance. Our net periodic interest costs were lower for the respective periods because we held a lower net average notional balance of derivative instruments at a lower net pay-fixed rate for the three and six months ended June 30, 2015 compared to the same periods in 2014.

Net Interest Income and Net Interest Spread

The tables below present net interest income and related net interest spread pursuant to GAAP, and also present the non-GAAP measures "adjusted net interest income" and "adjusted net interest spread" for the periods indicated. "Adjusted net interest income" and "adjusted net interest spread" are calculated using the non-GAAP measure "effective borrowing cost/rate" reconciled in the table above, and therefore include net periodic interest cost of derivative instruments whereas GAAP net interest income and GAAP net interest spread do not.

	Three Months Ended June 30,					
	2015			2014		
($ in thousands)	Amount	Yield		Amount	Yield	
GAAP interest income	$24,527	2.63	%	$27,718	2.79	%
GAAP interest expense	5,542	0.66	%	6,572	0.75	%
Net interest income/spread	18,985	1.97	%	21,146	2.04	%
Amortization of de-designated cash flow hedges [1]	857	0.10	%	1,608	0.18	%
Net periodic interest costs of derivative instruments	(1,793)	(0.21	)%	(2,672)	(0.30	)%
Adjusted net interest income/spread	$18,049	1.86	%	$20,082	1.92	%
Average interest earning assets [2]	$3,749,528			$3,944,154		
Average balance of borrowings [3]	$3,320,760			$3,466,651		

	Six Months Ended June 30,					
	2015			2014		
($ in thousands)	Amount	Yield		Amount	Yield	
GAAP interest income	$48,626	2.63	%	$55,359	2.77	%
GAAP interest expense	10,913	0.67	%	14,205	0.81	%
Net interest income/spread	37,713	1.96	%	41,154	1.96	%
Amortization of de-designated cash flow hedges [1]	1,914	0.12	%	3,896	0.22	%
Net periodic interest costs of derivative instruments	(2,655)	(0.16	)%	(4,883)	(0.28	)%
Adjusted net interest income/spread	$36,972	1.92	%	$40,167	1.90	%
Average interest earning assets [2]	$3,664,061			$3,973,039		
Average balance of borrowings [3]	$3,216,849			$3,487,897		

(1) Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.

(2) Average balances are calculated as a simple average of the daily amortized cost and exclude unrealized gains and losses as well as securities pending settlement if applicable.

(3) Average balances are calculated as a simple average of the daily borrowings outstanding for both repurchase agreement and non-recourse collateralized financing.

GAAP interest income in the tables above includes interest income from our other investments in addition to MBS. Total net interest income and adjusted net interest income for the three and six months ended June 30, 2015 decreased compared to the same periods in 2014 due to the lower average balance of interest-earnings assets that were also earning lower weighted average effective yields. Lower weighted average effective yields for the three months ended June 30, 2015 were partially offset by lower costs of funds and effective borrowing costs, resulting in a decrease to net interest spread and adjusted net interest spread of 7 basis points and 6 basis points, respectively, compared to net interest spread and adjusted net interest spread for the three months ended June 30, 2014. Net interest spread for the six months ended June 30, 2015 was unchanged compared to the same period in 2014 due to a 14 basis point decline in average yield on earning assets being offset by a 14 basis point decline in average cost of funds. Adjusted net interest spread for the six months ended June 30, 2015 increased compared to the same period in 2014 because the decrease in effective borrowing rate of 16 basis points, which was driven by lower costs associated with our derivative instruments, more than offset the reduction in weighted average effective yield of 14 basis points.

Gain (Loss) on Derivative Instruments, Net

The following table provides information on the components of our "loss on derivative instruments, net" for the periods indicated:

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($ in thousands)	Three Months Ended June 30, 2015			2014		
Type of Derivative Instrument	Net Periodic Interest Costs	Change in Fair Value (1)	Total	Net Periodic Interest Costs	Change in Fair Value	Total
Receive-fixed interest rate swaps	$1,176	$(2,922)	$(1,746)	$—	$—	$—
Pay-fixed interest rate swaps	(2,969)	19,232	16,263	(2,672)	(9,022)	(11,694)
Eurodollar futures	—	2,573	2,573	—	(11,380)	(11,380)
Gain (loss) on derivative instruments, net	$(1,793)	$18,883	$17,090	$(2,672)	$(20,402)	$(23,074)

($ in thousands)	Six Months Ended June 30, 2015			2014		
Type of Derivative Instrument	Net Periodic Interest Costs	Change in Fair Value (1)	Total	Net Periodic Interest Costs	Change in Fair Value	Total
Receive-fixed interest rate swaps	$2,372	$410	$2,782	$—	$—	$—
Pay-fixed interest rate swaps	(5,027)	7,927	2,900	(4,883)	(15,819)	(20,702)
Eurodollar futures	—	(13,915)	(13,915)	—	(15,794)	(15,794)
Loss on derivative instruments, net	$(2,655)	$(5,578)	$(8,233)	$(4,883)	$(31,613)	$(36,496)

(1) Amount shown is net of realized gains (losses) from instruments terminated prior to their effective date.

We experienced a net gain on derivative instruments for the second quarter of 2015 primarily because of increases in the fair value of our pay-fixed interest rate swaps as a result of increasing interest rates during the second quarter of 2015. Conversely, we experienced a net loss on derivative instruments for the six months ended June 30, 2015 primarily because of a decline in the fair value of our Eurodollar futures as a result of an expected decrease in the 3-month LIBOR during 2016, 2017, and 2018, which was the period covered by the majority of our Eurodollar futures.

We experienced net losses on derivative instruments for the three and six months ended June 30, 2014 as a result of the overall decline in interest rates during the first half of 2014, primarily in the longer end of the Treasury and interest rate swap curves where the preponderance of our derivative instruments were economically hedging our interest rate risk.

The notional amount of derivative instruments we have outstanding from period to period fluctuate based on the composition of our investment portfolio and the current interest rate environment as well as management's expectation of future interest rates. During the three and six months ended June 30, 2015, we held an average effective notional amount of derivative instruments of $658.4 million and $520.6 million, respectively, compared to $744.0 million and $711.5 million for the same periods in 2014.

Loss on Sale of Investments, Net

Sales of our investments occur in the ordinary course of business as we manage our risk profile and as we allocate capital to preferred investment opportunities. The following tables provide information related to our loss on sale of investments, net for the periods indicated:

	Three Months Ended June 30,			
	2015		2014	
($ in thousands)	Amortized cost basis sold	(Loss) gain on sale of investments, net	Amortized cost basis sold	(Loss) gain on sale of investments, net
Type of Investment				
Agency RMBS	$97,900	$(1,875)	$11,691	$(763)
Agency CMBS	99,709	(822)	—	—
Non-Agency CMBS	—	—	3,902	217
Agency CMBS IO	—	—	21,017	69
Non-Agency CMBS IO	30,766	1,206	—	—
	$228,375	$(1,491)	$36,610	$(477)

	Six Months Ended June 30,			
	2015		2014	
($ in thousands)	Amortized cost basis sold	(Loss) gain on sale of investments, net	Amortized cost basis sold	(Loss) gain on sale of investments, net
Type of Investment				
Agency RMBS	$158,566	$(2,196)	$68,492	$(4,289)
Agency CMBS	99,709	(822)	—	—
Non-Agency CMBS	—	—	9,881	417
Agency CMBS IO	27,911	1,474	21,343	88
Non-Agency CMBS IO	43,403	1,361	—	—
	$329,589	$(183)	$99,716	$(3,784)

General and Administrative Expenses

General and administrative expenses were $4.8 million for the three months ended June 30, 2015 compared to $3.8 million for the three months ended June 30, 2014 due to increased legal and consulting expenses. General and administrative expenses were $9.0 million for the six months ended June 30, 2015 compared to $7.9 million for the six months ended June 30, 2014. Compensation and benefits expenses decreased due to lower bonus expenses while other general and administrative expenses increased primarily due to increased legal and consulting expenses.

Non-GAAP Financial Measures

In addition to our operating results presented in accordance with GAAP, this Quarterly Report on Form 10-Q contains certain non-GAAP financial measures. Management presents certain of this information because net income (loss) includes fair value adjustments on our derivatives but does not include corresponding fair value adjustments on investments. In addition, net interest income and net interest spread exclude the net periodic interest costs of our

derivative instruments. Management believes these non-GAAP measures coupled with the GAAP measures more clearly explain our performance from period to period. Management uses these measures in its internal analysis of financial and operating performance and believes that it provides better transparency to our investors of management's view of our economic performance. Management also believes the presentation of

these measures, when analyzed in conjunction with the Company's GAAP operating results, allows investors to more effectively evaluate and compare our performance to that of our peers even though peer companies may present its non-GAAP measures on a different basis than we do. Because these non-GAAP financial measures exclude certain items used to compute GAAP net income to common shareholders and GAAP interest expense, these non-GAAP measures should be considered as a supplement to, and not as a substitute for, our GAAP results as reported on the consolidated statements of comprehensive income. In addition, because not all companies use identical calculations, our presentation of core net operating income, effective borrowing cost and rate, adjusted net interest income, and adjusted net interest spread may not be comparable to other similarly-titled measures of other companies.

Schedules reconciling effective borrowing cost, adjusted net interest income, and adjusted net interest spread to their related GAAP financial measures are provided within "Results of Operations" within Part 1, Item 2 of this Quarterly Report on Form 10-Q. The following table presents a reconciliation of our GAAP net income (loss) to our core net operating income for the periods presented:

	Three Months Ended June 30,		Six Months Ended June 30,	
($ in thousands, except per share amounts)	2015	2014	2015	2014
GAAP net loss to common shareholders	$28,168	$(8,293)	$16,402	$(11,321)
Amortization of de-designated cash flow hedges [1]	857	1,608	1,914	3,896
Change in fair value of derivative instruments, net	(18,883)	20,402	5,578	31,613
Loss on sale of investments, net	1,491	477	183	3,784
Fair value adjustments, net	(20)	(88)	(59)	(119)
Core net operating income to common shareholders	$11,613	$14,106	$24,018	$27,853
Core net operating income per common share	$0.21	$0.26	$0.44	$0.51

(1) Amount recorded as a portion of "interest expense" in accordance with GAAP related to the amortization of the balance remaining in accumulated other comprehensive loss as of June 30, 2013 as a result of our discontinuation of cash flow hedge accounting.

LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity include borrowings under repurchase arrangements, monthly principal and interest payments we receive on our investments, unencumbered Agency MBS, and unencumbered cash. Additional sources may also include FHLB advances, proceeds from the sale of investments, unencumbered non-Agency MBS, equity offerings, issuances of collateralized financings, and payments received from counterparties from interest rate swap agreements. We use our liquidity to fund our investment purchases and other operating costs, to pay down borrowings, to meet margin calls from our lenders, to make payments to counterparties as required under interest rate swap agreements, and to pay dividends on our common stock.

Our available liquid assets as of June 30, 2015 were $177.9 million compared to $215.8 million as of December 31, 2014. As of June 30, 2015, our liquid assets consisted of unrestricted cash and cash equivalents of $56.5 million, receivable for securities sold of $96.2 million, and unencumbered Agency MBS of $25.3 million. Generally, we seek to maintain enough liquidity to meet potential margin calls from lenders (as discussed further below), particularly in times of market stress. In addition to the $177.9 million of liquid assets as of June 30, 2015, we also had unencumbered non-Agency MBS of $30.6 million, which we may pledge to lenders as collateral for margin calls. We consider these assets to be less liquid than Agency MBS because they are less likely to be accepted as collateral by lenders during periods of market stress.

We continually monitor our current and forecasted available liquidity. Our liquid assets may fluctuate from period to period based on our investment activities and whether we have recently raised, but not yet deployed, equity capital. However, we seek to maintain sufficient liquidity based on the sensitivity analysis and debt-to-equity requirements

discussed below, to support our operations and meet our anticipated liquidity needs.

We perform sensitivity analysis on our liquidity based on changes in the value of our investments due to changes in interest rates, credit spreads, lender haircuts and prepayment speeds. We also closely monitor our debt-to-invested equity ratio (which is the ratio of debt financing to invested equity for any investment) as part of our liquidity management process as well as our overall enterprise level debt-to-equity. We also monitor the ratio of our available liquidity to outstanding repurchase agreement borrowings, which fluctuates due to changes in the fair value of collateral we have pledged to our lenders. On an enterprise level

basis, our current operating policies limit our total liabilities-to-shareholders' equity to seven (7) times our shareholders' equity. At the individual investment level, our targeted leverage ranges from three (3) to ten (10) times our invested equity capital depending on the investment type. The maximum targets represent fixed limits for leveraging our investment capital. We may change our leverage targets based on market conditions and our perceptions of the liquidity of our investments.

Our total liabilities increased to 6.2 times shareholders' equity as of June 30, 2015 from 5.1 times as of December 31, 2014 due to an increase in our repurchase agreement and FLHB borrowings to partially finance investment purchases coupled with lower shareholder's equity resulting from declines in the unrealized gain (loss) of MBS and lower additional paid-in capital as a result of share repurchases.

We have historically had ample sources of liquidity to fund our activities and operations. The ability to fund our operations in the future depends in large measure on the availability of credit through repurchase agreement financing and the liquidity of our investments. Credit markets in general are stable, and currently there is ample availability. However, these markets and the liquidity of our investments remain susceptible to extreme market volatility as was experienced in 2008 and 2009. In addition, in recent quarters U.S. financial regulatory agencies (such as the Office of Financial Research in the U.S. Treasury and the Federal Reserve) have expressed some concern about the stability of repurchase agreement financing for mortgage REITs in a rising interest rate environment, and regulatory reform in the form of certain provisions of the Basel III capital framework (and supplemental bank capital rules) and the Dodd-Frank Wall Street Reform and Consumer Protection Act could impact the overall availability of credit by restricting the number of repurchase agreement lenders and the credit made available by such lenders. In times of severe market stress, repurchase agreement availability could be rapidly reduced and the terms on which we can borrow could be materially altered, particularly given the focus on these markets by the federal financial and banking regulators. Competition from other REITs, banks, hedge funds, and the federal government for capacity with our repurchase agreement lenders could also reduce our repurchase agreement availability. While we do not anticipate such events in the near term, a reduction in our borrowing capacity could force us to sell assets in order to repay our lenders or could otherwise restrict our ability to operate our business.

Depending on our liquidity levels, the condition of the credit markets, and other factors, we may from time to time consider the issuance of debt, equity, or other securities, or sell investments, the proceeds of which could provide additional liquidity for our operations. While we will attempt to avoid dilutive or otherwise costly issuances, depending on market conditions, in order to manage our liquidity we could be forced to issue equity or debt securities which are dilutive to our capital base or our profitability.

Repurchase Agreements

The following table presents information regarding the balances of our repurchase agreement borrowings for the periods indicated:

($ in thousands)	Balance Outstanding As of Quarter End	Average Balance Outstanding For the Quarter Ended	Maximum Balance Outstanding During the Quarter Ended
June 30, 2015	$3,402,964	$3,301,590	$3,447,628
March 31, 2015	3,185,843	3,101,133	3,239,247
December 31, 2014	3,013,110	3,043,298	3,137,204
September 30, 2014	3,150,254	3,352,599	3,469,491
June 30, 2014	3,447,050	3,454,884	3,496,521
March 31, 2014	3,485,544	3,497,167	3,580,997

Our repurchase agreement borrowings are generally renewable at the discretion of our lenders without guaranteed roll-over terms. Given the short-term and uncommitted nature of most of our repurchase agreement financing, we

attempt to maintain unused capacity under our existing repurchase agreement credit lines with multiple counterparties which helps protect us in the event of a counterparty's failure to renew existing repurchase agreements either with favorable terms or at all. As of June 30, 2015, we had repurchase agreement borrowings outstanding with 21 of our 32 available repurchase agreement counterparties at a weighted average borrowing rate of 0.56% compared to 0.55% as of December 31, 2014. Our repurchase agreement borrowings generally carry a rate of interest based on a spread to an index such as LIBOR.

For our repurchase agreement borrowings, we are required to post and maintain margin to the lender (i.e., collateral in excess of the repurchase agreement financing) in order to support the amount of the financing. This excess collateral is often referred to as a "haircut" (and which we also refer to as equity at risk). As the collateral pledged is generally MBS, the fair value of the collateral can fluctuate with changes in market conditions. If the fair value of the collateral falls below the haircut required

by the lender, the lender has the right to demand additional margin, or collateral, to increase the haircut back to the initial amount. These demands are typically referred to as "margin calls". Declines in the value of investments occur for any number of reasons including but not limited to changes in interest rates, changes in ratings on an investment, changes in actual or perceived liquidity of the investment, or changes in overall market risk perceptions. Additionally, values in Agency RMBS will also decline from the payment delay feature of those securities. Agency RMBS have a payment delay feature whereby Fannie Mae and Freddie Mac announce principal payments on Agency RMBS but do not remit the actual principal payments and interest for 20 days in the case of Fannie Mae and 40 days in the case of Freddie Mac. Because these securities are financed with repurchase agreements, the repurchase agreement lender generally makes a margin call for an amount equal to the product of their advance rate on the repurchase agreement and the announced principal payments on the Agency RMBS. This causes a temporary use of our liquidity to meet the margin call until we receive the principal payments and interest 20 to 40 days later.

The following table presents the weighted average minimum haircut contractually required by our counterparties for Agency and non-Agency MBS pledged as collateral for our repurchase agreement borrowings as of the dates indicated:

	June 30, 2015		March 31, 2015		December 31, 2014		September 30, 2014		June 30, 2014	
Agency MBS	6.4	%	6.6	%	6.8	%	6.8	%	6.6	%
Non-Agency MBS	14.7	%	15.9	%	16.0	%	16.9	%	18.5	%

The counterparties with whom we have the greatest amounts of equity at risk may vary significantly during any given period due to the short-term and generally uncommitted nature of the repurchase agreement borrowings. Equity at risk is defined as the amount pledged as collateral to the counterparty in excess of the borrowed amount outstanding. The following tables present the five counterparties with whom we had the greatest amounts of equity at risk as of June 30, 2015 and as of December 31, 2014:

	June 30, 2015	
($ in thousands)	Amount Outstanding	Equity at Risk
Well Fargo Bank, N.A. and affiliates	$296,718	$55,936
JP Morgan Securities, LLC	322,538	47,696
South Street Financial Corporation	556,567	32,581
Royal Bank of Canada	180,863	17,996
BNP Paribas	101,061	15,972
Remaining counterparties	1,945,217	117,009
	$3,402,964	$287,190

	December 31, 2014	
($ in thousands)	Amount Outstanding	Equity at Risk
Well Fargo Bank, N.A. and affiliates	$286,574	$53,949
JP Morgan Securities, LLC	289,931	48,484
South Street Financial Corporation	608,000	36,483
Bank of America Securities LLC	181,593	15,711
Credit Suisse Securities LLC	103,078	13,258
Remaining counterparties	1,543,934	93,603
	$3,013,110	$261,488

The following table discloses our repurchase agreement amounts outstanding and the value of the related collateral pledged by geographic region of our counterparties as of June 30, 2015:

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($ in thousands)	Amount Outstanding	Market Value of Collateral Pledged
North America	$2,325,268	$2,509,582
Asia	502,514	528,013
Europe	575,182	652,560
	$3,402,964	$3,690,155

Our repurchase agreement counterparties require us to comply with various operating and financial covenants. The financial covenants include requirements that we maintain minimum shareholders' equity (usually a set minimum, or a percentage of the highest amount of shareholders' equity since the date of the agreement), maximum decline in shareholders' equity (expressed as a percentage decline in any given period), and limits on maximum leverage (as a multiple of shareholders' equity). Operating requirements include, among other things, requirements to maintain our status as a REIT and to maintain our listing on the NYSE. Violations of one or more of these covenants could result in the lender declaring an event of default which would result in the termination of the repurchase agreement and immediate acceleration of amounts due thereunder. In addition, some of the agreements contain cross default features, whereby default with one lender simultaneously causes default under agreements with other lenders. Violations could also restrict us from paying dividends or engaging in other transactions that are necessary for us to maintain our REIT status.

We monitor and evaluate on an ongoing basis the impact these customary financial covenants may have on our operating and financing flexibility. Currently, we do not believe we are subject to any covenants that materially restrict our financing flexibility. We have one repurchase agreement lender which requires that we maintain our enterprise level leverage as of quarter end at less than 7 times our shareholders' equity.

FHLB Advances

As of June 30, 2015, our wholly-owned captive insurance subsidiary, Mackinaw, had $108,076 in outstanding secured advances with a weighted average borrowing rate of 0.22% and a maximum borrowing capacity of approximately $575,000. We had Agency CMBS with a fair value of $113,991 pledged as collateral for these advances with a haircut requirement of 5%. As of June 30, 2015, our FHLB advances were all due within 30 days.

The ability to borrow from the FHLB is subject to the Company’s continued creditworthiness, pledging of sufficient eligible collateral to secure advances, and compliance with certain agreements with the FHLB. Each advance requires approval by the FHLB and is secured by collateral in accordance with the FHLB’s credit and collateral guidelines. The FHLB retains the right to mark the underlying collateral for FHLB advances to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral.

Please refer to Part II, Item 1A, "Risk Factors" for additional information related to Mackinaw's membership in the FHLBI.

Derivative Instruments

Our derivative instruments require us to post initial margin at inception and variation margin based on subsequent changes in the fair value of the derivatives. The collateral posted as margin by us is typically in the form of cash or Agency MBS. Generally, as interest rates decline due to market changes, we will be required to post collateral with counterparties on our pay-fixed derivative instruments and receive collateral from our counterparties on our receive-fixed derivative instruments, and vice versa as interest rates increase. As of June 30, 2015, we had Agency MBS with a fair value of $1.9 million and cash of $57.9 million posted as credit support under these agreements.

Dividends

As a REIT, we are required to distribute to our shareholders amounts equal to at least 90% of our REIT taxable income for each taxable year after consideration of our tax NOL carryforwards. We generally fund our dividend distributions through our cash flows from operations. If we make dividend distributions in excess of our operating cash flows during the period, whether for purposes of meeting our REIT distribution requirements or other strategic reasons, those distributions are generally funded either through our existing cash balances or through the return of principal from our investments (either through repayment or sale). Our estimated NOL carryfoward available as of December 31, 2014 is approximately $90.0 million.

Contractual Obligations

The following table summarizes our contractual obligations by payment due date as of June 30, 2015:

($ in thousands)	Payments due by period				
Contractual Obligations:	Total	< 1 year	1-3 years	3-5 years	> 5 years
Repurchase agreements [1]	$3,404,369	$3,404,369	$—	$—	$—
FHLB advances [1]	108,442	108,442	—	—	—
Non-recourse collateralized financing [2]	8,932	2,357	3,166	1,803	1,606
Operating lease obligations	941	99	202	208	432
Total	$3,522,684	$3,515,267	$3,368	$2,011	$2,038

(1) Includes estimated interest payments calculated using interest rates in effect as of June 30, 2015.
(2) Amounts shown are for principal only and exclude interest obligations as those amounts are not significant. Non-recourse collateralized financing represents securitization financing that is payable solely from loans and securities pledged as collateral. Payments due by period were estimated based on the principal repayments forecasted for the underlying loans and securities, substantially all of which is used to repay the associated financing outstanding.

Other Matters

As of June 30, 2015, we do not believe that any off-balance sheet arrangements exist that are reasonably likely to have a material effect on our current or future financial condition, results of operations, or liquidity. In addition, we do not have any material commitments for capital expenditures and have not obtained any commitments for funds to fulfill any capital obligations.

RECENT ACCOUNTING PRONOUNCEMENTS

There are no recently issued accounting pronouncements which have had or are expected to have a material impact on the Company's consolidated financial statements.

FORWARD-LOOKING STATEMENTS

Certain written statements in this Quarterly Report on Form 10-Q that are not historical facts constitute “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 (the "Exchange Act"). Statements in this report addressing expectations, assumptions, beliefs, projections, future plans and strategies, future events, developments that we expect or anticipate will occur in the future, and future operating results are forward-looking statements. Forward-looking statements are based upon management’s beliefs, assumptions, and expectations as of the date of this report regarding future events and operating performance, taking into account all information currently available to us, and are applicable only as of the date of this report. Forward-looking statements generally can be identified by use of words such as “believe”, “expect”, “anticipate”, “estimate”, “plan” “may”, “will”, “intend”, “should”, “could” or similar expressions. We caution readers not to pl undue reliance on our forward-looking statements, which are not historical facts and may be based on projections, assumptions, expectations, and anticipated events that do not materialize. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statement whether as a result of new information, future events, or otherwise.

Forward-looking statements in this Quarterly Report on Form 10-Q may include, but are not limited to:

- Our business and investment strategy including our ability to generate acceptable risk-adjusted returns and our target investment allocations;

- Monetary policy and regulatory initiatives of the Federal Reserve (including the FOMC) and other financial regulators;
- Our financing strategy including our target leverage ratios and anticipated trends in financing costs, and our hedging strategy including changes to the derivative instruments to which we are a party, and changes to government regulation of hedging instruments and our use of these instruments;
- Our investment portfolio composition and target investments;
- Our investment portfolio performance, including the fair value, yields, and forecasted prepayment speeds of our investments;

- Our liquidity and ability to access financing, including FHLB advances, and the anticipated availability and cost of financing;
- Our use of and restrictions on using our tax NOL carryfoward;
- The status of pending litigation;
- The competitive environment in the future, including competition for investments and the availability of financing;
- Estimates of future interest expenses, including related to the Company's repurchase agreements and derivative instruments;
- The status of regulatory rule-making or review processes and the status of reform efforts and other business developments in the repurchase agreement financing market;
- Market, industry and economic trends, how these trends and related economic data may impact the behavior of market participants and financial regulators; and
- Interest rates.

Forward-looking statements are inherently subject to risks, uncertainties and other factors that could cause our actual results to differ materially from historical results or from any results expressed or implied by such forward-looking statements. Not all of these risks and other factors are known to us. New risks and uncertainties arise over time, and it is not possible to predict those events or how they may affect us. The projections, assumptions, expectations or beliefs upon which the forward-looking statements are based can also change as a result of these risks or other factors. If such a risk or other factor materializes in future periods, our business, financial condition, liquidity and results of operations may vary materially from those expressed or implied in our forward-looking statements.

While it is not possible to identify all factors, some of the factors that may cause actual results to differ from historical results or from any results expressed or implied by forward-looking statements, or that may cause our projections, assumptions, expectations or beliefs to change, include the following:

- the risks and uncertainties referenced in this Quarterly Report on Form 10-Q, particularly those set forth under and incorporated by reference into Part II, Item 1A, “Risk Factors”;
- our ability to find suitable reinvestment opportunities;
- changes in economic conditions;
- changes in interest rates and interest rate spreads, including the repricing of interest-earning assets and interest-bearing liabilities;
- our investment portfolio performance particularly as it relates to cash flow, prepayment rates and credit performance;
- actual or anticipated changes in Federal Reserve monetary policy;
- adverse reactions in financial markets related to the budget deficit or national debt of the United States government; potential or actual default by the United States government on Treasury securities; and potential or actual downgrades to the sovereign credit rating of the United States;
- the cost and availability of financing, including the future availability of financing due to changes to regulation of, and capital requirements imposed upon, financial institutions;
- the cost and availability of new equity capital;
- changes in our use of leverage;
- the quality of performance of third-party servicer providers of our loans and loans underlying our securities;
- the level of defaults by borrowers on loans we have securitized;
- changes in our industry;
- increased competition;
- changes in government regulations affecting our business;
- changes in the repurchase agreement financing markets and other credit markets;
- changes to the market for interest rate swaps and other derivative instruments, including changes to margin requirements on derivative instruments;
- government initiatives to support the U.S financial system and U.S. housing and real estate markets; or to reform the U.S. housing finance system including by imposing standards for originating residential mortgage loans;

- GSE reform or other government policies and actions;
- ownership shifts under Section 382 that further limit the use of our tax NOL carryforward; and

- exposure to current and future claims and litigation.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We seek to manage various risks inherent in our business strategy, which include interest rate, prepayment, reinvestment, market value, credit, and liquidity risks. These risks can and do cause fluctuations in our book value per common share and comprehensive income. We attempt to manage these risks and earn an acceptable return for our shareholders as discussed below.

Interest Rate Risk

Investing in interest-rate sensitive investments on a leveraged basis subjects our results to interest rate risk primarily from the mismatch between interest-rate reset dates (or maturity) of our assets and the maturity of our liabilities. Borrowing costs on our liabilities are generally based on prevailing market rates and reset more frequently than interest rates on our assets. During a period of rising interest rates (particularly short term rates in a flattening yield curve environment), our borrowing costs will increase faster than our asset yields, negatively impacting our net interest income. The amount of the impact will depend on the composition of portfolio and on the effectiveness of our hedge instruments at the time, as well as the magnitude and the duration of the increase in interest rates. In addition, our adjustable rate assets may have limits or caps on the amount that an interest rate may reset while our liabilities do not have rate reset caps. Changes in interest rates, particularly rapid changes, may also negatively impact the market value of our investments which reduces our book value. In addition to the information set forth in the tables below, see "Market Value Risk" below for further discussion of the risks to the market value of our investments.

While having interest rate risk is a basic tenet of our investment strategy, we attempt to manage our exposure to changes in interest rates by investing in instruments that have short maturities/interest reset dates, entering into derivative instruments (such as interest rate swaps and Eurodollar futures) to hedge this risk and by managing our investment portfolio within interest rate risk tolerances set by our Board of Directors. Our current goal is to maintain a net portfolio duration (a measure of interest rate risk) within a range of 0.5 to 1.5 years. Our portfolio duration may drift outside of our target range at various times due to changes in market conditions, changes in actual or expected prepayment rates on our investments, changes in interest rates, changes in credit spreads, and activity in our investment portfolio. In addition, duration is driven by model inputs, and in the case of Agency RMBS, the most important inputs include anticipated prepayment speeds. Estimates of prepayment speeds can vary significantly by investor for the same security and therefore estimates of security and portfolio duration can vary significantly.

Effect of Changes in Interest Rates on Adjusted Net Interest Income and Market Value. The table below shows the projected sensitivity of our adjusted net interest income and the market value of our investments and derivative instruments carried at fair value as they existed as of June 30, 2015 based on an instantaneous parallel shift in market interest rates as set forth in the table below. In light of the low interest rate environment at June 30, 2015, and because we believe it is unlikely that absolute rates will move lower from rates at June 30, 2015, the only declining rate scenario that we present is a downward shift of 25 basis points. In order to include the impact of changes in interest rates on our effective derivative instruments, we are presenting the percentage change in adjusted net interest income (instead of net interest income) because net interest income does not include the net interest payments/receipts on these instruments.

The "percentage change in adjusted net interest income" includes the impact of changes in expected prepayment speeds on our investments and assumes that net proceeds received from pay downs on the investment portfolio are reinvested in MBS in amounts proportionate to the portfolio composition that existed as of June 30, 2015 and at yields consistent with those as of that date, adjusted for the parallel shift in the rates below. Changes in types of investments, future interest rates, credit spreads, the shape of the yield curve, the availability of financing, and/or the mix of our investments and financings including derivative instruments may cause actual results to differ significantly from the modeled results. There can be no assurance that assumed events used for the model below will occur, or that other events will not occur, that will affect the outcomes; therefore, the tables below and all related disclosures constitute

forward-looking statements.

Parallel Shift in Interest Rates	Percentage change in market value [(1)]	Percentage change in adjusted net interest income
+100	(0.86)%	(22.35)%
+50	(0.39)%	(10.29)%
-25	0.16%	3.99%

(1) Includes changes in market value of our investments and derivative instruments, but excludes changes in market value of our financings because they are not carried at fair value on our balance sheet. The projections for market value do not assume any change in credit spreads.

Management also considers changes in the shape of the interest rate curves in assessing and managing portfolio interest rate risk. Often interest rates do not move in a parallel fashion from quarter to quarter. The table below shows the projected change in market value of our investment portfolio net of hedges for changes in the shape of the U.S. Treasury curve (with similar changes to the interest rate swap curve and Eurodollar curves) as of June 30, 2015.

Basis point change in 2-year yield	Basis point change in 10-year yield	Percentage change in market value
0	+25	(0.05)%
+10	+50	(0.13)%
+10	+75	(0.22)%
+25	+75	(0.23)%
+25	+0	(0.01)%
+50	+0	(0.04)%
-10	-50	0.02%

Our adjustable rate investments have interest rates which are predominantly based on one-year LIBOR and contain periodic (or interim) and lifetime interest rate caps which limit the amount by which the interest rate may reset on the investment. The following table presents information about the lifetime and interim interest rate caps (where interim interest rate caps include both initial adjustments of interest rates which generally are 5% as well as periodic adjustments which generally are 2%) on our adjustable-rate Agency MBS portfolio as of June 30, 2015:

Lifetime Interest Rate Caps			Interim Interest Rate Caps		
	% of Total			% of Total	
>7.4% to 10.0%	87.5	%	1.0%	1.9	%
>10.0% to 11.0%	8.5	%	2.0%	25.6	%
>11.0% to 12.1%	4.0	%	5.0%	72.5	%
	100.0	%		100.0	%

Market Value Risk

Market value risk generally represents the risk of loss in value of our investment securities and derivative instruments due to fluctuations in interest rates, prepayment rates, credit spreads, and other factors. Fluctuations in the market values of securities we hold impact our reported book value per common share. MBS in our investment portfolio and derivative instruments are reflected at their estimated fair value on our consolidated balance sheet. With respect to the consolidated statement of comprehensive income, changes in the fair value of our derivative instruments are recorded within "net income" while changes in the fair value of our investments (as indicated by changes in unrealized gain or loss on investments) are recorded within "other comprehensive income". As demonstrated in the tables above in the discussion of interest rate risk, in a rising interest rate environment, the fair value of our MBS tends to decrease; conversely, in a decreasing interest rate environment, the fair value of our securities tends to

increase. The fair value of our securities will also fluctuate due to changes in credit spreads (which represent the market's valuation of the perceived riskiness of assets relative to risk-free rates), changes in actual prepayments or expected prepayments, the perceived liquidity of the investment, actual or expected credit performance, and other factors. We attempt to manage market value risk by managing our exposure to these factors (although we may not actively attempt to manage market value risk from changes in credit spreads). For example, the types of derivative instruments we are currently using to hedge the interest rates on our debt tend to increase in value when our investment portfolio decreases in value, although not a one-to-one correlation.

Fluctuations in credit spreads typically vary based on the type of investments. Though market conditions and technical factors such as FOMC monetary policy may impact Agency MBS credit spreads, they will generally have less volatility than non-Agency MBS. This is due to the fact that market participants generally view these securities, given their guarantee of principal by GSEs, as more liquid (i.e., more easily converted into cash) than non-Agency MBS. The table below is an estimate of the projected change in our portfolio market value given the indicated change in market credit spreads as of June 30, 2015:

Basis Point Change in Market Credit Spreads	Percentage change in market value of investments
+50	(2.2)%
+25	(1.1)%
-25	1.1%
-50	2.3%

Prepayment and Reinvestment Risk

Prepayment risk is the risk of an early, unscheduled return of principal on an investment. We are subject to prepayment risk from premiums paid on investments which we acquire. Purchase premiums on our investments are amortized as a reduction in interest income using the effective yield method under GAAP, adjusted for the actual and anticipated prepayment activity of the investment. An increase in the actual or expected rate of prepayment will typically accelerate the amortization of purchase premiums, thereby reducing the yield/interest income earned on such assets. Principal prepayments on our investments are influenced by changes in market interest rates and a variety of economic, geographic, government policy and other factors beyond our control.

Prepayment risk results from our RMBS, CMBS, and CMBS IO investments. The majority of the loans underlying our RMBS are ARMs or hybrid ARMs and do not have any specific prepayment protection. Prepayments on these loans generally accelerate in a declining interest rate environment, as the loans age, and as the loans near their respective interest rate reset dates, particularly the initial reset date. Our prepayment models anticipate acceleration of prepayments in these events. To the extent the actual prepayments exceed our modeled prepayments, or if we change our future prepayment expectations, we will record adjustments to our premium amortization which may negatively impact our net interest income and could impact the fair value of our RMBS.

As an indication of our prepayment risk on our RMBS portfolio, the following table summarizes information for our Agency RMBS portfolio regarding the net premium and weighted average coupon by months until interest rate reset ("MTR") or

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until maturity in the case of fixed-rate securities as of the end of the past four quarters:

	June 30, 2015		March 31, 2015		December 31, 2014		September 30, 2014	
($ in thousands)	Net Premium	WAC	Net Premium	WAC	Net Premium	WAC	Net Premium	WAC
0-12 MTR	$20,752	2.69%	$27,953	2.74%	$31,428	2.75%	$33,582	2.93%
13-24 MTR	8,262	4.02%	3,774	5.01%	4,985	4.27%	5,229	4.05%
25-60 MTR	24,738	3.26%	33,845	3.39%	36,502	3.41%	38,807	3.42%
> 60 MTR	36,501	2.97%	38,789	2.97%	40,729	2.98%	43,059	2.99%
Fixed rate	(9)	2.50%	(9)	2.50%	(9)	2.51%	(10)	2.50%
Total premium, net	$90,244	3.05%	$104,352	3.08%	$113,635	3.09%	$120,667	3.14%
Par balance	$1,741,996		$1,942,332		$2,086,807		$2,200,149	
Premium, net as a % of par value	5.2%		5.4%		5.4%		5.5%	

Loans underlying our CMBS and CMBS IO securities typically have some form of prepayment protection provisions (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties). Yield maintenance and prepayment penalty requirements are intended to create an economic disincentive for the loans to prepay; however, the amount of the prepayment penalty required to be paid may decline over time, and as loans age, interest rates decline, or market values of collateral supporting the loans increase, prepayment penalties may lessen as an economic disincentive to the borrower. Generally, our experience has been that prepayment lock-out and yield maintenance provisions result in stable prepayment performance from period to period. There are no prepayment protections, however, if the loan defaults and is partially or wholly repaid earlier as a result of loss mitigation actions taken by the underlying loan servicer. Historically, we have experienced low default rates on loans underlying CMBS and CMBS IO.

Because CMBS IO consist of rights to interest on the underlying commercial mortgage loan pools and do not have rights to principal payments on the underlying loans, prepayment risk on these securities would be particularly acute without these prepayment protection provisions. CMBS IO prepayment protection and compensation provisions vary by issuer of the security, (i.e. Freddie Mac, Fannie Mae, Ginnie Mae, or non-Agency). The majority of our Agency CMBS IO are issued by Freddie Mac and these securities generally have initial prepayment lock-outs followed by a defeasance period which on average extends to within six months of the stated maturities of the underlying loans. Non-Agency CMBS IO generally have prepayment protection in the form of prepayment lock-outs and defeasance provisions. The following table details the fair value of our CMBS IO portfolio by issuer as of the end of the periods indicated:

($ in thousands)	June 30, 2015	December 31, 2014
Fannie Mae	$26,560	$28,765
Freddie Mac	409,101	408,698
Ginnie Mae	—	1,274
Non-Agency CMBS IO	341,230	325,119
	$776,891	$763,856

We seek to manage our prepayment risk on our MBS by diversifying our investments, seeking investments which we believe will have superior prepayment performance, and investing in securities which have some sort of prepayment prohibition or yield maintenance (as is the case with CMBS and CMBS IO). With respect to RMBS, we will seek to invest in RMBS where we believe the underlying loans have favorable prepayment characteristics such as lower loan balances or favorable origination, borrower or geographic characteristics.

We are also subject to reinvestment risk as a result of the prepayment, repayment and sales of our investments. Yields on assets in which we invest now are generally lower than yields on existing assets that we may sell or which may be repaid, due to lower overall interest rates and more competition for these as investment assets. As a result, our interest income may decline in

the future, thereby reducing earnings per share. In order to maintain our investment portfolio size and our earnings, we need to reinvest our capital into new interest-earning assets. If we are unable to find suitable reinvestment opportunities, interest income on our investment portfolio and investment cash flows could be negatively impacted.

Credit Risk

Credit risk is the risk that we will not receive all contractual amounts due on investments that we own due to default by the borrower or due to a deficiency in proceeds from the liquidation of the collateral securing the obligation. We are also particularly exposed to credit risk on investments that we own at a premium. For investments owned at premiums, defaults on the underlying loan typically result in the complete loss of any remaining unamortized premium we paid.

We attempt to mitigate our credit risk by purchasing Agency MBS and higher quality non-Agency MBS. Agency MBS have credit risk to the extent that Fannie Mae or Freddie Mac fails to remit payments on the MBS for which they have issued a guaranty of payment. Given the improved financial performance and conservatorship of these entities and the continued support of the U.S. government, we believe this risk is low. For our non-Agency MBS, we seek to purchase investment grade securities (rated 'BBB' or better by a least one of the nationally recognized statistical ratings organizations) or securities that we believe are short-duration and which will have strong credit performance. We do not currently seek to purchase heavily discounted, credit sensitive MBS.

The majority of our non-Agency securities are CMBS and CMBS IO. The return we earn on these securities is dependent on the credit performance of the underlying commercial loans. In particular, since investments in CMBS IO pay interest from the underlying commercial mortgage loan pools, returns are more negatively impacted by liquidations of loans in the underlying loan pool. In order to manage our exposure to credit performance, we generally invest in securities with higher credit ratings and in securities where we have evaluated the credit profile of the underlying loan pool and can monitor its credit performance. With respect to non-Agency RMBS, we have been purchasing very short duration MBS backed by pools of re-performing or non-performing loans.

The following table presents information on our non-Agency MBS by credit rating as of June 30, 2015:

	June 30, 2015					
($ in thousands)	CMBS	CMBS IO	RMBS	Total	Percentage	
AAA	$90,297	$303,429	$—	$393,726	62.8	%
AA	53,314	35,051	—	88,365	14.1	%
A	50,537	—	—	50,537	8.1	%
Below A or not rated	17,787	2,750	73,882	94,419	15.0	%
	$211,935	$341,230	$73,882	$627,047	100.0	%

Liquidity Risk

We have liquidity risk principally from the use of recourse repurchase agreements to finance our ownership of securities. In general, our repurchase agreements provide a source of uncommitted short-term financing that finances a longer-term asset, thereby creating a mismatch between the maturity of the asset and of the associated financing. Our repurchase agreements are renewable at the discretion of our lenders and do not contain guaranteed roll-over terms. If we fail to repay the lender at maturity, the lender has the right to immediately sell the collateral and pursue us for any shortfall if the sales proceeds are inadequate to cover the repurchase agreement financing. In addition, repurchase agreements are collateral based and declines in the market value of our investments subject us to liquidity risk.

For further information, including how we attempt to mitigate liquidity risk and monitor our liquidity position, please refer to “Liquidity and Capital Resources” in Part 1, Item 2 of this Quarterly Report on Form 10-Q.

ITEM 4. CONTROLS AND PROCEDURES
Disclosure controls and procedures.

Our management evaluated, with the participation of our Principal Executive Officer and Principal Financial Officer, the effectiveness of our disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), as of the end of the period covered by this report. Based on that evaluation, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective as of June 30, 2015 to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting.

Our management is also responsible for establishing and maintaining adequate internal control over financial reporting as defined in Exchange Act Rule 13a-15(f). There were no changes in our internal control over financial reporting during the three months ended June 30, 2015 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company and its subsidiaries are parties to various legal proceedings. Although the ultimate outcome of these legal proceedings cannot be ascertained at this time, and the results of legal proceedings cannot be predicted with certainty, the Company believes, based on current knowledge, that the resolution of any of these proceedings will not have a material adverse effect on the Company's consolidated financial condition or liquidity. However, the resolution of any of the proceedings could have a material impact on consolidated results of operations or cash flows in a given future reporting period as the proceedings are resolved.

With respect to the putative class action lawsuit that was filed in June 2012 in the Court of Common Pleas of Allegheny County, Pennsylvania (the "Court"), and to which GLS Capital, Inc. and the Company are named defendants (as such lawsuit is described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2014), on May 14, 2015, the Commonwealth Court of Pennsylvania affirmed the trial court's dismissal of the plaintiffs' complaint in its entirety.

There have been no material changes during the three or six months ended June 30, 2015 for the legal proceedings discussed in the Annual Report on Form 10-K for the year ended December 31, 2014 other than those disclosed above.

ITEM 1A. RISK FACTORS

Risks and uncertainties identified in our forward-looking statements contained in this Quarterly Report on Form 10-Q together with those previously disclosed in the Annual Report on Form 10-K for the year ended December 31, 2014 or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations and cash flows. See "Forward-Looking Statements" contained in Part I, Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" within this Quarterly Report on Form 10-Q as well as Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2014.

If the membership of our wholly-owned captive insurance subsidiary, Mackinaw, in the FHLB of Indianapolis is terminated, any advances outstanding to it from the FHLB of Indianapolis would need to be immediately repaid, which could result in material losses and have a material adverse effect on our business.

In September 2014, the Federal Housing Financing Authority ("FHFA") issued a Notice of Proposed Rulemaking and Request for Comments Involving Proposed Changes to Regulations Concerning Federal Home Loan Bank Membership Criteria (the "Proposed Rule"). If enacted, the Proposed Rule, among other things, would immediately terminate the membership of captive insurance companies that became members of the FHLB system after publication of the Proposed Rule, which would include Mackinaw. If the Proposed Rule is adopted, all advances previously made to our captive insurance subsidiary would be required to be promptly repaid to the FHLB. If the Company is unable to replace the advances with alternate financing, we may be forced to liquidate the collateral in order to repay the advances, which could result in material losses and have a material adverse effect on our liquidity, and further could have a material adverse effect on our business to the extent we are then relying on FHLB advances for liquidity. In addition, the Proposed Rule provides that the FHLBI would have up to five years to redeem FHLBI stock purchased by our subsidiary as a result of its membership and level of FHLB advances activity.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Issuer Purchases of Equity Securities

The Company has been authorized by its Board of Directors to repurchase up to $50 million of its outstanding shares of common stock through December 31, 2016. Subject to applicable securities laws and the terms of the Series A Preferred Stock designation and the Series B Preferred Stock designation, both of which are contained in our Articles of Incorporation, future repurchases of common stock will be made at times and in amounts as the Company deems appropriate, provided that the repurchase price per share is less than the Company's estimate of the current net book value of a share of common stock. Repurchases may be suspended or discontinued at any time.

The following table summarizes repurchases of our common stock that occurred during the three months ended June 30, 2015:

	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs ($ in thousands)
April 1, 2015 - April 30, 2015	—	$—	—	$49,868
May 1, 2015 - May 31, 2015	525,176	$7.79	525,176	45,778
June 1, 2015 - June 30, 2015	320,788	$7.72	319,405	43,311
Total	845,964	$7.76	844,581	$43,311

(1) A portion of these shares were withheld from certain employees to satisfy tax withholding obligations arising upon the vesting of restricted shares. Accordingly, these shares are not included in the calculation of approximate dollar value of shares that may yet be purchased under the $50 million repurchase plan authorized by the Company's Board of Directors.

ITEM 3. DEFAULTS UPON SENIOR SECURITES

None.

ITEM 4. MINE SAFETY DISCLOSURES

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

Exhibit No.	Description
3.1	Restated Articles of Incorporation, effective June 2, 2014 (incorporated herein by reference to Exhibit 3.1 to Dynex's Registration Statement on Form S-8 filed September 17, 2014).
3.2	Amended and Restated Bylaws, amended as of December 12, 2013 (incorporated herein by reference to Exhibit 3.2 to Dynex's Annual Report on Form 10-K filed March 4, 2014).
31.1	Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
31.2	Certification of principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
32.1	Certification of principal executive officer and principal financial officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
101	The following materials from Dynex Capital, Inc.'s Quarterly Report on Form 10-Q for the three months ended June 30, 2015, formatted in XBRL (Extensible Business Reporting Language), filed herewith: (i) Consolidated Balance Sheets (unaudited), (ii) Consolidated Statements of Comprehensive Income (Loss) (unaudited), (iii) Consolidated Statements of Shareholders' Equity (unaudited), (iv) Consolidated Statements of Cash Flows (unaudited), and (v) Notes to the Unaudited Consolidated Financial Statements.

SIGNATURES

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

DYNEX CAPITAL, INC.

Date: August 10, 2015	/s/ Byron L. Boston Byron L. Boston Chief Executive Officer, President, Co-Chief Investment Officer, and Director (Principal Executive Officer)
Date: August 10, 2015	/s/ Stephen J. Benedetti Stephen J. Benedetti Executive Vice President, Chief Financial Officer and Chief Operating Officer (Principal Financial Officer)