

LUMINENT MORTGAGE CAPITAL INC

Form 10-Q

May 10, 2004

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

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**FORM 10-Q**

**Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934  
for the quarterly period ended: March 31, 2004**

**or**

**Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**

**for the transition period from      to**

**Commission File Number: 000-31828**

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**LUMINENT MORTGAGE CAPITAL, INC.**

(Exact name of registrant as specified in its charter)

**Maryland**

(State or Other Jurisdiction of Incorporation or  
Organization)

**06-1694835**

(I.R.S. Employer  
Identification No.)

**909 Montgomery Street, Suite 500, San Francisco,  
California**

(Address of Principal Executive Offices)

**94133**

(Zip Code)

**(415) 486-2110**

(Registrant's Telephone Number, Including Area Code)

**N/A**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

The number of shares of our common stock outstanding on April 30, 2004 was 36,927,339.

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**CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains certain forward-looking statements. Forward looking statements are those which are not historical in nature. They can often be identified by their inclusion of words such as will, anticipate, estimate, should, expect, believe, intend and similar expressions. Any projection of revenues, earnings, losses, capital expenditures, distributions, capital structure or other financial terms is a forward-looking statement.

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

our limited operating history and the lack of experience of Seneca Capital Management LLC in managing a REIT;

interest rate mismatches between our mortgage-backed securities and our borrowings used to fund such purchases;

changes in interest rates and mortgage prepayment rates;

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

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

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

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

our board's ability to change our operating policies and strategies without notice to you or stockholder approval;

Seneca Capital Management LLC's motivation to recommend riskier investments in an effort to maximize its incentive compensation under the management agreement;

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

the other important factors described in this Quarterly Report on Form 10-Q, including those under the captions Management's Discussion and Analysis of Financial Condition and Results of Operations, Risk Factors, and Quantitative and Qualitative Disclosures about Market Risk.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the events described by our forward-looking events might not occur. We qualify any and all of our forward-looking statements by these cautionary factors. In addition, you should carefully review the risk factors described in other documents we file from time to time with the Securities and Exchange Commission.

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

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PART I

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

**INDEX TO FINANCIAL STATEMENTS**

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Table of Contents**LUMINENT MORTGAGE CAPITAL, INC.****CONDENSED BALANCE SHEETS****(Unaudited)**

<b>(in thousands, except share and per share amounts)</b>	<b>March 31, 2004</b>	<b>December 31, 2003</b>
<b>Assets:</b>		
Cash and cash equivalents	\$ 8,669	\$ 7,219
Mortgage-backed securities available-for-sale, at fair value	1,231,822	352,123
Mortgage-backed securities available-for-sale, pledged as collateral, at fair value	2,839,550	1,809,822
Interest receivable	13,152	7,345
Principal receivable	5,723	2,313
Offering proceeds receivable	157,865	
Other assets	1,234	518
	<hr/>	<hr/>
Total assets	\$4,258,015	\$2,179,340
	<hr/>	<hr/>
<b>Liabilities:</b>		
Repurchase agreements	\$2,695,774	\$1,728,973
Unsettled security purchases	1,079,154	156,127
Cash distribution payable	10,433	5,267
Futures contracts, at fair value	3,399	157
Accrued interest expense	5,262	3,777
Management fee payable, incentive fee payable and other related party liabilities	2,172	1,088
Insurance note payable		92
Accounts payable and accrued expenses	1,278	1,363
	<hr/>	<hr/>
Total liabilities	3,797,472	1,896,844
<b>Stockholders Equity:</b>		
Preferred stock, par value \$0.001: 10,000,000 shares authorized; no shares issued and outstanding as of March 31, 2004 and December 31, 2003		
Common stock, par value \$0.001: 100,000,000 shares authorized; 36,841,146 and 24,814,000 shares issued and outstanding as of March 31, 2004 and December 31, 2003, respectively	37	25
Additional paid-in capital	475,228	317,339
Deferred compensation	(286)	

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Accumulated other comprehensive loss	(6,445)	(26,510)
Accumulated distributions in excess of accumulated earnings	(7,991)	(8,358)
	<u>          </u>	<u>          </u>
Total stockholders' equity	460,543	282,496
	<u>          </u>	<u>          </u>
Total liabilities and stockholders' equity	\$4,258,015	\$2,179,340
	<u>          </u>	<u>          </u>

See notes to financial statements



Table of Contents**LUMINENT MORTGAGE CAPITAL, INC.****CONDENSED STATEMENT OF OPERATIONS****(Unaudited)**

	<b>For the Quarter Ended March 31, 2004</b>
<b>(in thousands, except share and per share amounts)</b>	
<b>Revenues:</b>	
Net interest income:	
Interest income	\$ 20,204
Interest expense	6,827
	<hr/>
Net interest income	13,377
<b>Expenses:</b>	
Management fee expense to related party	787
Incentive fee expense to related parties	846
Salaries and benefits	96
Professional services	417
Board of directors expense	56
Insurance expense	220
Custody expense	67
Other general and administrative expenses	88
	<hr/>
Total expenses	2,577
	<hr/>
Net income	\$ 10,800
	<hr/>
Net income per share basic	\$ 0.43
	<hr/>
Net income per share diluted	\$ 0.43
	<hr/>
Weighted-average number of shares outstanding basic	25,077,736
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Weighted-average number of shares outstanding diluted	25,085,784

See notes to financial statements

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Table of Contents**LUMINENT MORTGAGE CAPITAL, INC.****CONDENSED STATEMENT OF STOCKHOLDERS EQUITY****(Unaudited)**

	<b>Common Stock</b>		<b>Additional Paid-in Capital</b>	<b>Deferre Compensation</b>	<b>Other Comprehensive Income /(Loss)</b>	<b>Accumulated Distributions in Excess of Accumulated Comprehensive Earnings Income/(Loss)</b>		<b>Total</b>
	<b>Shares</b>	<b>Par Value</b>				<b>Earnings</b>	<b>/(Loss)</b>	
<b>(in thousands)</b>								
Balance, December 31, 2003	24,814	\$ 25	\$317,339	\$	\$(26,510)	\$ (8,358)	\$	\$282,496
Net income						10,800	10,800	10,800
Mortgage-backed securities available-for-sale, fair value adjustment					23,710		23,710	23,710
Futures contracts, fair value adjustment					(3,645)		(3,645)	(3,645)
Comprehensive income							\$ 30,865	
Distributions to stockholders						(10,433)		(10,433)
Issuance of common stock	12,027	12	157,887	(286)				157,613
Amortization of stock options			2					2
Balance, March 31, 2004	36,841	\$ 37	\$475,228	\$(286)	\$(6,445)	\$(7,991)		\$460,543

See notes to financial statements

Table of Contents**LUMINENT MORTGAGE CAPITAL, INC.****CONDENSED STATEMENT OF CASH FLOWS****(Unaudited)**

	<b>For the Quarter Ended March 31, 2004</b>
<b>(in thousands)</b>	
<b>Cash flows from operating activities:</b>	
Net income	\$ 10,800
Adjustments to reconcile net income to net cash provided by operating activities:	
Amortization of premium/discount on mortgage-backed securities available-for-sale	5,208
Amortization of stock options	2
Ineffectiveness of cash flow hedges	10
Changes in operating assets and liabilities:	
Increase in interest receivable, net of purchased interest	(632)
Increase in other assets	(1,003)
Decrease in accounts payable and accrued expenses	(85)
Increase in interest payable	1,485
Increase in management fee payable, incentive fee payable and other related party liabilities	1,474
	<hr/>
Net cash provided by operating activities	17,259
	<hr/>
<b>Cash flows from investing activities:</b>	
Purchase of mortgage-backed securities available-for-sale	(1,116,022)
Principal payments of mortgage-backed securities	139,539
Realized losses on Eurodollar futures contracts	(412)
	<hr/>
Net cash used in investing activities	(976,895)
	<hr/>
<b>Cash flows from financing activities:</b>	
Offering costs related to issuance of common stock	(356)
Borrowings under repurchase agreements	11,141,921
Principal payments on repurchase agreements	(10,175,120)
Payment of cash dividends	(5,267)
Other	(92)
	<hr/>

Net cash provided by financing activities	961,086
	<hr/>
<b>Net increase in cash and cash equivalents</b>	1,450
<b>Cash and cash equivalents, beginning of the period</b>	7,219
	<hr/>
<b>Cash and cash equivalents, end of the period</b>	<b>\$ 8,669</b>
	<hr/>
<b>Supplemental disclosure of cash flow information:</b>	
Interest paid	\$ 5,328
<b>Non-cash transactions:</b>	
Increase in unsettled security purchases	\$ 923,026
Increase in offering proceeds receivable	(157,865)
Increase in principal receivable	(3,410)
Distributions declared	(10,433)
Incentive fees payable settled through issuance of restricted stock	390
Deferred compensation reclassified to stockholders equity upon issuance of restricted stock	(286)

See notes to financial statements



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% of total	4.1%	94.6%	1.3%	100.0%
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Table of Contents**LUMINENT MORTGAGE CAPITAL, INC.****NOTES TO FINANCIAL STATEMENTS Continued****(Unaudited)**

Actual maturities of mortgage-backed securities are generally shorter than stated contractual maturities. Actual maturities of the Company's mortgage-backed securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal, and prepayments of principal. The following table summarizes the Company's mortgage-backed securities on March 31, 2004 according to their estimated weighted-average life classifications:

<b>Weighted-Average Life</b>	<b>Fair Value</b>	<b>Amortized Cost</b>	<b>Weighted- Average Coupon</b>
	<b>(in thousands)</b>		
Less than one year	\$ 345,832	\$ 348,251	3.61%
Greater than one year and less than five years	3,725,540	3,725,764	3.97
Greater than five years	_____	_____	
<b>Total</b>	<b>\$4,071,372</b>	<b>\$4,074,015</b>	<b>3.96%</b>

The weighted-average lives of the mortgage-backed securities at March 31, 2004 in the table above are based upon data provided through subscription-based financial information services, assuming constant principal prepayment rates to the balloon or reset date for each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loan, loan age, margin and volatility.

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

At March 31, 2004, unsettled security purchases totaled \$1.1 billion.

The following table shows the Company's investments' fair value and gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2004:

<b>Less than 12 Months</b>	<b>12 Months or More</b>	<b>Total</b>
<b>Gross</b>	<b>Gross</b>	<b>Gross</b>
_____	_____	_____



	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>
			(in thousands)			
Agency-backed mortgage-backed securities	\$1,519,130	\$(11,633)	\$	\$	\$1,519,130	\$(11,633)
Non-agency-backed mortgage-backed securities	599,462	(4,953)	-	-	599,462	(4,953)
Total temporarily impaired securities	\$2,118,592	\$(16,586)	\$	\$	\$2,118,592	\$(16,586)

At March 31, 2004, the Company was only invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities. The temporary impairment of the available-for-sale securities results from the fair value of the securities falling below the amortized cost basis. As of March 31, 2004, none of the securities held had been downgraded by a credit rating agency since their purchase. Management intends to hold the securities until

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maturity, allowing for the anticipated recovery in fair value of the securities held. As such, management does not believe any of the securities held are other-than-temporarily impaired at March 31, 2004.

**NOTE 3-REPURCHASE AGREEMENTS AND OTHER BORROWINGS**

The Company has entered into repurchase agreements with third party financial institutions to finance most of its mortgage-backed securities. The repurchase agreements are short-term borrowings that bear interest rates that have historically moved in close relationship to the three-month London Interbank Offered Rate, or LIBOR. At March 31, 2004, the Company had an outstanding amount of \$2.7 billion with weighted-average borrowing rates of 1.15%. At March 31, 2004 securities pledged as collateral for repurchase agreements had estimated fair values of \$2.8 billion.

At March 31, 2004, the repurchase agreements had remaining maturities as summarized below:

	<b>Overnight (1 day or less)</b>	<b>Between 2 and 30 days</b>	<b>Between 31 and 90 days</b>	<b>Between 91 and 335 days</b>	<b>Total</b>
	(in thousands)				
<b>Agency-backed mortgage-backed securities:</b>					
Amortized cost of securities sold, including accrued interest	\$	\$61,787	\$ 970,726	\$ 883,482	\$1,915,995
Fair market value of securities sold, including accrued interest		62,338	976,324	880,572	1,919,234
Repurchase agreement liabilities associated with these securities		60,207	920,831	846,895	1,827,933
Average interest rate of repurchase agreement liabilities	0.00%	1.24%	1.09%	1.18%	1.14%
<b>Non-agency-backed mortgage-backed securities:</b>					
Amortized cost of securities sold, including accrued interest	\$31,134	\$31,828	\$ 597,230	\$ 272,408	\$ 932,600
Fair market value of securities sold, including accrued interest	30,934	31,797	595,016	272,587	930,334
Repurchase agreement liabilities associated with	29,076	30,352	552,771	255,642	867,841

these securities

Average interest rate of  
repurchase agreement

liabilities	1.16%	1.17%	1.18%	1.22%	1.19%
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**Total:**

Amortized cost of securities

sold, including accrued

interest	\$31,134	\$93,615	\$1,567,956	\$1,155,890	\$2,848,595
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Fair market value of securities

sold, including accrued

interest	30,934	94,135	1,571,340	1,153,159	2,849,568
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Repurchase agreement

liabilities associated with

these securities	29,076	90,559	1,473,602	1,102,537	2,695,774
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Average interest rate of

repurchase agreement

liabilities	1.16%	1.21%	1.12%	1.19%	1.15%
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**Table of Contents****LUMINENT MORTGAGE CAPITAL, INC.****NOTES TO FINANCIAL STATEMENTS Continued****(Unaudited)**

At March 31, 2004, the repurchase agreements had the following counterparties, amounts at risk and weighted-average remaining maturities:

<b>Repurchase Agreement Counterparties</b>	<b>Amount at Risk<sup>(1)</sup></b>	<b>Weighted-Average Maturity of Repurchase Agreements</b>
	<b>(in thousands)</b>	<b>(in days)</b>
Banc of America Securities LLC	\$ 12,703	30
Bear Stearns & Co.	30,331	73
Countrywide Securities Corporation	1,833	1
Credit Suisse First Boston LLC	21,314	97
Deutsche Bank Securities Inc.	1,518	55
Federal Home Loan Mortgage Corporation	(94)	62
Goldman Sachs & Co.	4,860	58
J.P. Morgan Securities Inc.	1,293	86
Lehman Brothers Inc.	2,689	62
Merrill Lynch Government Securities Inc./Merrill Lynch		
Pierce, Fenner & Smith Inc.	15,020	66
Morgan Stanley & Co. Inc.	2,134	62
Salomon Smith Barney	29,698	164
UBS Securities LLC	19,379	124
Wachovia Securities, LLC	5,853	68
	<hr/>	
Total	\$ 148,531	97
	<hr/>	

<sup>(1)</sup> Equal to the fair value of securities sold, plus accrued interest income, minus (1) repurchase agreement liabilities, plus accrued interest expense.

The Company has a margin lending facility with its primary custodian where it may borrow money in connection with the purchase or sale of securities. The terms of the borrowings, including the rate of interest payable, are agreed to with the custodian for each amount borrowed. Borrowings are repayable immediately upon demand of the custodian. At March 31, 2004, there were no outstanding borrowings under the margin lending facility.

**NOTE 4-CAPITAL STOCK AND NET INCOME PER SHARE**

The Company had 100,000,000 shares of par value \$0.001 common stock authorized and 36,841,146 shares were issued and outstanding as of March 31, 2004. Of the 100,000,000 shares of par value \$0.001 common stock

authorized, 10,000,000 shares are reserved for issuance in order to pay incentive fees in connection with the Management Agreement. As of March 31, 2004, 9,974,349 shares remain reserved for issuance. The Company had 10,000,000 shares of par value \$0.001 preferred stock authorized and none outstanding as of March 31, 2004.

In two closings on June 11 and June 19, 2003, the Company completed a private offering of 11,092,473 shares of common stock, \$0.001 par value at an offering price of \$15.00 per share, including the exercise by the initial purchaser/placement agent of its over-allotment option to purchase 1,500,000 shares of common stock. In addition, on June 11, 2003 the Company issued 407,527 shares of common stock, par value \$0.001, at an offering price net of the initial purchaser's discount of \$13.95 per share, to employees and affiliates of the Manager, and other persons selected by the Manager. The Company received proceeds from these transactions in the amount of \$159.7 million, net of underwriting discount and other offering costs.

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On December 18, 2003, the Company completed an initial public offering of 13,110,000 shares of its common stock, \$0.001 par value at an offering price of \$13.00 per share, including the exercise by the underwriter of its over-allotment option to purchase 1,710,000 shares of common stock. The Company received proceeds from the initial public offering in the amount of \$157.0 million, net of underwriting discount and other offering costs.

The Company filed a resale shelf registration statement with the SEC for up to 11,500,000 shares of its common stock issued in the June 11, 2003 and June 19, 2003 private offerings. The registration statement was declared effective by the SEC on February 13, 2004.

On March 29, 2004, the Company completed a public offering of 12,000,000 shares of its common stock, \$0.001 par value at an offering price of \$14.00 per share. On April 2, 2004, the Company received proceeds from the public offering in the amount of \$157.5 million, net of underwriting discount and other offering costs.

The Company calculates basic net income per share by dividing net income for the period by weighted-average shares of its common stock outstanding for that period. Diluted net income per share takes into account the effect of dilutive instruments, such as stock options and unvested restricted stock, but uses the average share price for the period in determining the number of incremental shares that are to be added to the weighted-average number of shares outstanding.

The following table presents a reconciliation of basic and diluted net income per share for the quarter ended March 31, 2004:

	<b>Basic</b>	<b>Diluted</b>
	<hr/>	<hr/>
Net income (in thousands)	\$ 10,800	\$ 10,800
Weighted-average number of common shares outstanding	25,077,736	25,077,736
Additional shares due to assumed conversion of dilutive instruments		8,048
	<hr/>	<hr/>
Adjusted weighted-average number of common shares outstanding	25,077,736	25,085,784
	<hr/>	<hr/>
Net income per share	\$ 0.43	\$ 0.43
	<hr/>	<hr/>

**NOTE 5-2003 STOCK INCENTIVE PLANS**

The Company adopted a 2003 Stock Incentive Plan, effective June 4, 2003, and a 2003 Outside Advisors Stock Incentive Plan, effective June 4, 2003, pursuant to which up to 1,000,000 shares of the Company's common stock is authorized to be awarded at the discretion of the Compensation Committee of the Board of Directors. The plans provide for the grant of a variety of long-term incentive awards to employees and officers of the Company, individual consultants or advisors who render or have rendered bona fide services, and officers, employees or directors of the Manager as an additional means to attract, motivate, retain and reward eligible persons. These plans provide for the grant of awards that meet the requirements of Section 422 of the Code, non-qualified stock options, stock appreciation rights, restricted stock, stock units and other stock-based awards, and dividend equivalent rights. The maximum term of each grant is determined on the grant date by the Compensation Committee and shall not exceed 10 years. The exercise price and the vesting requirement of each grant is determined on the grant date by the Compensation Committee.

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The following table illustrates the common stock available for grant as of March 31, 2004:

	<b>2003 Stock Incentive Plan</b>	<b>2003 Outside Advisors Stock Incentive Plan</b>	<b>Total</b>
	<hr/>	<hr/>	<hr/>
Shares reserved for issuance			1,000,000 <sup>(1)</sup>
Granted	56,495		56,495
Forfeited			
Expired			<hr/>
Total available for grant			943,505 <sup>(2)</sup>
			<hr/> <hr/>

(1) At June 4, 2003, adoption date of both stock incentive plans, the maximum number of shares of common stock that may be delivered pursuant to awards granted under these combined plans is 1,000,000 shares.

(2) At March 31, 2004, the maximum number of shares of common stock that may be delivered pursuant to awards granted under these combined plans is 943,505 shares.

At March 31, 2004, the Company had outstanding options under the plans with expiration dates of 2013. The following table illustrates stock option transactions during the quarter ended March 31, 2004:

	<b>Number of Options</b>	<b>Weighted- Average Exercise Price</b>
	<hr/>	<hr/>
Outstanding at December 31, 2003	55,000	\$ 14.82
Granted		
Exercised		
Forfeited		
	<hr/>	<hr/>
Outstanding at March 31, 2004	55,000	\$ 14.82
	<hr/> <hr/>	<hr/> <hr/>



The following table illustrates information about stock options outstanding at March 31, 2004:

Range of Exercise Prices	Outstanding		Exercisable	
	Number of Options	Weighted-Average Remaining Life (in years)	Weighted-Average Exercise Price	Weighted-Average Exercise Price
\$13.00-\$14.00	5,000	9.8	\$13.00	
\$14.01-\$15.00	50,000	9.6	\$15.00	-
	<u>55,000</u>			<u>-</u>

Total stock-based employee compensation expense related to stock options for the quarter ended March 31, 2004 was \$2 thousand.

**Table of Contents****LUMINENT MORTGAGE CAPITAL, INC.****NOTES TO FINANCIAL STATEMENTS Continued****(Unaudited)**

The following table illustrates restricted common stock transactions during the quarter ended March 31, 2004:

	<b>Number of Restricted Common Shares</b>	<b>Weighted- Average Issue Price</b>
	<hr/>	<hr/>
Outstanding at December 31, 2003		
Issued	1,495	\$ 13.90
Repurchased		
	<hr/>	<hr/>
Outstanding at March 31, 2004	1,495	\$ 13.90
	<hr/>	<hr/>

**NOTE 6-THE MANAGEMENT AGREEMENT**

The Company has entered into a Management Agreement with the Manager that provides, among other things, that the Company will pay to the Manager, in exchange for investment management and certain administrative services, certain fees and reimbursements, summarized as follows:

a base management fee equal to a percentage of average net worth during each fiscal year as defined in the Management Agreement (1% of the first \$300 million plus 0.8% of the amount in excess of \$300 million);

incentive compensation based on the excess of a tiered percentage (as defined in the Management Agreement as the weighted-average of the following rates based upon average net invested assets: (1) 20% for the first \$400 million of average net invested assets; and (2) 10% for the average net invested assets in excess of \$400 million) of the difference between the Company's net income (defined in the Management Agreement as taxable income before incentive compensation, net operating losses from prior periods, and items permitted by the Internal Revenue Code when calculating taxable income for a REIT) and the threshold return (the amount of net income for the period that would produce an annualized return on equity, calculated by dividing the net income, as defined in the Management Agreement, by the average net invested assets, as defined in the Management Agreement, equal to the 10-year U.S. Treasury rate for the period plus 2.0%) for the fiscal period; and

out-of-pocket expenses and certain other costs incurred by the Manager and related directly to the Company.

The base management fee and incentive compensation will be paid quarterly and are subject to adjustment at the end of each fiscal year based on annual results. One-half of the incentive compensation will be paid to the Manager in cash and one-half will be paid in the form of a restricted stock award. The number of shares issued is based on

(a) one-half of the total incentive compensation for the period, divided by (b) the average of the closing prices of the common stock over the 30-day period ending three days prior to the grant date, less a fair market value discount determined by the Company's Board of Directors. These shares are restricted shares for varying periods of time, and are forfeitable if the Manager ceases to perform management services for the Company before the end of the restriction periods. The Company's restrictions lapse and full rights of ownership vest for one-third of the shares on the first anniversary of the end of the period in which the incentive compensation is calculated, for one-third of the shares on the second anniversary and for the last one-third of the shares on the third anniversary. Vesting is predicated on the continuing involvement of the Manager in providing services to the Company.

From and after June 11, 2004, the Company is entitled to terminate the Management Agreement without cause provided that the Company gives the Manager 60 days' prior written notice and pays a termination fee and

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**LUMINENT MORTGAGE CAPITAL, INC.**

**NOTES TO FINANCIAL STATEMENTS Continued**

**(Unaudited)**

other unpaid costs and expenses reimbursable to the Manager. If the Company terminates the Management Agreement without cause, the Company is required to pay the Manager a termination fee as follows:

If the Company terminates the Management Agreement without cause in connection with a decision to manage its portfolio internally, rather than by an external manager, the amount of the termination fee shall be equal to the amount of the highest annual base fee and the highest annual incentive compensation, for a particular year, earned by the Manager during any of the three years (or on an annualized basis if a lesser period) preceding the effective date of the termination, plus accelerated vesting on the equity component of all incentive compensation.

If the Company terminates the Management Agreement without cause for any other reason, the amount of the termination fee shall be equal to two times the amount of the highest annual base fee and the highest annual incentive compensation, for a particular year, earned by the Manager during any of the three years (or on an annualized basis if a lesser period) preceding the effective date of the termination, plus all deferred payments, including accelerated vesting on the equity component of all incentive compensation.

The Company is also entitled to terminate the Management Agreement with cause, in which case the Company is only obligated to reimburse the Manager for its unpaid costs and expenses.

The Management Agreement contains certain provisions requiring the Company to indemnify the Manager for costs (e.g., legal costs) the Manager could potentially incur in fulfilling its duties prescribed in the Management Agreement or in other agreements related to the Company's activities. The indemnification provisions do not apply under all circumstances (e.g., if the Manager is grossly negligent, acted with reckless disregard or engaged in willful misconduct or active fraud). The provisions contain no limitation on maximum future payments. The Company has evaluated the impact of these guarantees on its financial statements and determined that it is immaterial.

The base management fee for the quarter ended March 31, 2004 was \$787 thousand.

Incentive compensation is earned by the Manager when REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) relative to the average net invested assets for the period, as defined in the Management Agreement, exceeds the threshold return taxable income that would have produced an annualized return on equity equal to the sum of the 10-year U.S. Treasury rate plus 2.0% for the same period. For the quarter ended March 31, 2004, REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) was \$11.2 million and was greater than the threshold return taxable income of \$4.7 million.

For the quarter ended March 31, 2004, total incentive fees earned by the Manager were \$1.3 million, one-half payable in cash and one-half payable in the form of the Company's common stock as described above. The cash portion of the incentive fee of \$652 thousand for the quarter ended March 31, 2004 was expensed in that period. In accordance with SFAS No. 123, and related interpretations, and EITF 96-18, 15.2% of the restricted stock portion of the incentive fees, or \$99 thousand, was expensed in the quarter ended March 31, 2004. Included in other assets at March 31, 2004 is \$553 thousand of deferred compensation which will be reclassified to stockholders' equity after the restricted stock is issued and will be expensed over the three-year vesting period of the restricted stock.

In accordance with the terms of his employment agreement, the Company's Chief Financial Officer earned an incentive fee of \$65 thousand for the quarter ended March 31, 2004. This incentive fee is also payable one-half in cash and one-half in the form of a restricted stock award under the Company's 2003 Stock Incentive Plan. The shares are payable and vest over the same vesting schedule as the stock issued to the Manager. The cash portion of the incentive fee of \$33 thousand for the quarter ended March 31, 2004 was expensed in that period. In accordance with SFAS No. 123, and related interpretations, and EITF 96-18, 15.2% of the restricted stock portion of the

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**NOTES TO FINANCIAL STATEMENTS    Continued**

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incentive fees, or \$5 thousand, was expensed in the quarter ended March 31, 2004. Included in other assets at March 31, 2004 is \$28 thousand of deferred compensation which will be reclassified to stockholders' equity after the restricted stock is issued and will be expensed over the three-year vesting period of the restricted stock.

**NOTE 7-RELATED PARTY TRANSACTIONS**

At March 31, 2004, the Company was indebted to the Manager for base management fees of \$787 thousand and incentive fees of \$1.3 million. At March 31, 2004, the Company was indebted to the Company's Chief Financial Officer for incentive fees of \$65 thousand and to officers and employees of the Company for bonuses and expense reimbursement of \$16 thousand. These amounts are included in management fee payable, incentive fee payable and other related party liabilities.

The Manager's financial relationship with the Company is governed by the Management Agreement. Under the Management Agreement, the Manager shall be responsible for all expenses of the personnel employed by the Manager, and all facilities and overhead expenses of the Manager required for the day-to-day operations of the Company, and the expenses of a sub-manager, if any. The Company shall reimburse the Manager for its pro-rata portion of facilities and overhead expenses to the extent that the Company's employees (who are not also employed by the Manager) use such facilities or incur such expenses pursuant to a cost-sharing agreement entered into between the Company and the Manager. As of March 31, 2004, there were no expenses payable to the Manager pursuant to the cost-sharing agreement. During the quarter ended March 31, 2004, the Company paid the Manager \$6 thousand pursuant to the cost-sharing agreement. The Company shall pay all other expenses on behalf of the Company, and shall reimburse the Manager for all direct expenses incurred on the Company's behalf that are not the Manager's specific responsibility as defined in the Management Agreement.

**NOTE 8-FAIR VALUE OF FINANCIAL INSTRUMENTS**

SFAS No. 107, *Disclosure About Fair Value of Financial Instruments*, requires disclosure of the fair value of financial instruments for which it is practicable to estimate that value. The fair value of mortgage-backed securities available-for-sale and futures contracts is equal to their carrying value presented in the balance sheet. The fair value of cash and cash equivalents, interest receivable, repurchase agreements, unsettled security purchases, and accrued interest expense, approximates cost as of March 31, 2004 due to the short-term nature of these instruments.

Table of Contents**LUMINENT MORTGAGE CAPITAL, INC.****NOTES TO FINANCIAL STATEMENTS Continued****(Unaudited)****NOTE 9-ACCUMULATED OTHER COMPREHENSIVE LOSS**

The following is a summary of the components of accumulated other comprehensive loss as of March 31, 2004:

	<b>Net Unrealized Gains/(Losses) on Mortgage-backed Securities Available-for-Sale</b>	<b>Net Realized and Unrealized Losses on Cash Flow Hedges</b>	<b>Accumulated Other Comprehensive Income/(Loss)</b>
	<b>(in thousands)</b>		
Beginning Balance	\$(26,353)	\$ (157)	\$(26,510)
Change during the period	<u>23,710</u>	<u>(3,645)</u>	<u>20,065</u>
Ending Balance	<u>\$ (2,643)</u>	<u>\$ (3,802)</u>	<u>\$ (6,445)</u>

See Note 10 for further discussion regarding derivative instruments and hedging activities.

**NOTE 10-DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

The Company seeks to manage its interest rate risk exposure to protect the Company's repurchase agreement liabilities against the effects of major interest rate changes. Such interest rate risk may arise from the issuance and forecasted rollover and repricing of short-term liabilities with fixed rate cash flows or from liabilities with a contractual variable rate based on LIBOR. Among other strategies, the Company may use Eurodollar futures contracts and interest rate swaps to manage this interest rate risk. Derivative instruments are carried at fair value.

The following table is a summary of derivative instruments held as of March 31, 2004:

	<b>Unrealized Gains</b>	<b>Unrealized Losses</b>	<b>Estimated Fair Value</b>
	<b>(in thousands)</b>		
Eurodollar futures contracts sold short	\$	\$(3,399)	\$(3,399)

*Cash Flow Hedging Strategies*

Hedging instruments are designated as cash flow hedges, as appropriate, based upon the specifically identified exposure, which may be an individual item or a group of similar items. The hedged transaction is the forecasted interest expense on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements for a specified future time period and the hedged risk is the variability in those payments due to changes in the benchmark rate. Hedging transactions are structured at inception so that the notional amounts of the hedge are matched with an equal amount of repurchase agreements forecasted to be outstanding in that specified period for which the borrowing rate is not yet fixed. Cash flow hedging strategies include the utilization of Eurodollar futures contracts and interest rate swaps. Any ineffectiveness which arises during the hedging relationship is recognized in interest expense during the period in which it arises. Prior to the end of the specified hedge time period the effective portion of all contract gains and losses (whether realized or unrealized) is recorded in other comprehensive income or loss. Realized gains and losses are reclassified into earnings as an adjustment to interest expense during the specified hedge time period. Hedging instruments under these strategies are deemed to be broadly designated to the outstanding repurchase portfolio and the forecasted rollover thereof. Such forecasted rollovers would also include other types of borrowing arrangements that may replace the repurchase funding during



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**LUMINENT MORTGAGE CAPITAL, INC.**

**NOTES TO FINANCIAL STATEMENTS    Continued**

**(Unaudited)**

the identified hedge time periods. At March 31, 2004, the maximum length of time over which the Company is hedging its exposure is 12 months.

The Company may use Eurodollar futures contracts to hedge the forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements for a specified future time period, which is defined as the calendar quarter immediately following the contract expiration date. Gains and losses on each contract are associated with forecasted interest expense for the specified future period.

The Company may use interest rate swaps to hedge the forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements for the period defined by maturity of the interest rate swap. Cash flows that occur each time the swap is repriced will be associated with forecasted interest expense for a specified future period, which is defined as the calendar period preceding each repricing date with the same number of months as the repricing frequency.

For the quarter ended March 31, 2004, losses of \$14 thousand were recognized in interest expense due to ineffectiveness. Based upon the amounts included in accumulated other comprehensive loss at March 31, 2004, the Company expects to recognize an increase of \$3.8 million in interest expense during 2004, of which \$412 thousand is due to positions closed during the quarter and \$3.4 million is due to unrealized losses on open positions at March 31, 2004. This amount could differ from amounts actually realized due to changes in the benchmark rate between March 31, 2004 and when the Eurodollar futures contracts held at March 31, 2004 are closed, as well as the addition of other hedges subsequent to March 31, 2004.

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

*The following discussion of our financial condition and results of operations should be read in conjunction with the financial statements and notes to those statements included elsewhere in this document. This discussion may contain forward-looking statements that involve risks and uncertainties. The words believe, expect, anticipate, estimate, may, will, or could and similar expressions or the negatives of these words or phrases are intended to identify forward-looking statements. As a result of many factors, such as those set forth under Risk Factors and elsewhere in this document, our actual results may differ materially from those anticipated in such forward-looking statements.*

**General**

Luminent Mortgage Capital, Inc. is a REIT headquartered in San Francisco, California. We were incorporated in April 2003 to invest primarily in U.S. agency and other highly-rated, single-family, adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage-backed securities, which we acquire in the secondary market. Substantive operations began mid-June 2003, after completing two private placements of our common stock. Our strategy is to acquire mortgage-related assets, finance these purchases in the capital markets and use leverage in order to provide an attractive return on stockholders' equity. Through this strategy, we seek to earn income, which is generated from the spread between the yield on our earning assets and our costs, including the interest cost of the funds we borrow. We have acquired and will seek to acquire additional assets that will produce competitive returns, taking into consideration the amount and nature of the anticipated returns from the investment, our ability to pledge the investment for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments.

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

- interest rate mismatches between our adjustable-rate and hybrid adjustable-rate mortgage-backed securities and our borrowings used to fund our purchases of mortgage-backed securities;
- increasing or decreasing levels of prepayments on the mortgages underlying our mortgage-backed securities;
- the potential for increased borrowing costs related to repurchase agreements;
- interest rate caps related to our adjustable-rate and hybrid adjustable-rate mortgage-backed securities;
- the overall leverage of our portfolio;
- our ability or inability to use derivatives to mitigate our interest rate and prepayment risks;
- the impact that increases in interest rates would have on our book value;
- maintaining adequate borrowing capacity so that we can purchase mortgage-related assets and reach our desired amount of leverage;
- if we fail to obtain or renew sufficient funding on favorable terms or at all, we will be limited in our ability to acquire mortgage-related assets;

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

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

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

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

Management has established interest rate risk and other policies for managing the portfolio of mortgage-backed securities and the related borrowings outstanding. These policies include, without limitation, evaluating the level of risk we assume when purchasing adjustable-rate or hybrid adjustable-rate mortgage-backed securities which are subject to periodic and lifetime interest rate caps, matching the interest rates on our assets and liabilities, acquiring new mortgage-backed securities to replace prepaid securities, purchasing mortgage-backed securities that we believe to have favorable-risk adjusted expected returns relative to the market interest rates at the time of purchase, borrowing between eight and 12 times the amount of our stockholders' equity, entering into derivative transactions to protect us from rising interest rates on our repurchase agreements, and monitoring our qualification as a REIT.

Refer to the section titled "Risk Factors" for additional discussion regarding these and other risk factors which affect our business. Refer to the section "Interest Rate Risk" of Item 3 of Part I, "Quantitative and Qualitative Disclosure About Market Risk," for additional interest rate risk discussion.

## **Critical Accounting Policies**

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. These accounting principles require us to make some complex and subjective decisions and assessments. Our most critical accounting policies involve decisions and assessments which could significantly affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our financial statements are based were reasonable at the time made based upon information available to us at that time. Descriptions of the significant accounting policies of the Company are included in Note 1 to financial statements in the Company's 2003 Annual Report on Form 10-K. There have been no significant changes to these policies during 2004. Management has identified our most critical accounting policies to be the following:

### *Classifications of Investment Securities*

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

### *Valuations of Mortgage-backed Securities*

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

When the fair value of an available-for-sale security is less than amortized cost, management considers whether there is an other-than-temporary impairment in the value of the security. If, in management's judgment, an other-than-temporary impairment exists, the cost basis of the security is written down to the then-current fair value,

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and the unrealized loss is transferred from accumulated other comprehensive loss as an immediate reduction of current earnings (as if the loss had been realized in the period of impairment). The determination of other-than-temporary impairment is a subjective process, and different judgments and assumptions could affect the timing of loss realization.

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

the length of the time and the extent to which the market value has been less than the amortized cost;

whether the security has been downgraded by a rating agency; and

our intent to hold the security for a period of time sufficient to allow for any anticipated recovery in market value.

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

*Interest Income Recognition*

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

*Accounting for Derivative Financial Instruments and Hedging Activities*

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

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

These contracts, or hedge instruments, have been designated as cash flow hedges and are evaluated at inception and on an ongoing basis in order to determine whether they qualify for hedge accounting under SFAS No. 133, as amended and interpreted. The hedge instrument must be highly effective in achieving offsetting changes in the hedged item attributable to the risk being hedged in order to qualify for hedge accounting. In order to determine whether the hedge instrument is highly effective, we use regression methodology to assess the effectiveness of our hedging strategies. Specifically, at the inception of each new hedge and on an ongoing basis, we assess effectiveness using ordinary least squares regression to evaluate the correlation between the rates consistent with the hedge instrument and the underlying hedged items. A hedge instrument is highly effective if the changes in the fair value of the derivative provide offset of at least 80% and not more than 120% of the changes in fair value or cash flows of the

hedged item attributable to the risk being hedged. The futures contracts are carried on the balance sheet at fair value. Any ineffectiveness which arises during the hedging relationship, is recognized in interest expense during the period in which it arises. Prior to the end of the specified hedge time period the effective portion of all contract gains and losses (whether realized or unrealized) is recorded in other comprehensive income or loss. Realized gains and

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losses are reclassified into earnings as an adjustment to interest expense during the specified hedge time period. For REIT taxable net income purposes, realized gains and losses are reclassified into earnings immediately when positions are closed or have expired.

We are not required to account for the futures contracts using hedge accounting as described above. If we decided not to designate the futures contracts as hedges and to monitor their effectiveness as hedges, or if we entered into other types of financial instruments that did not meet the criteria to be designated as hedges, changes in the fair values of these instruments would affect periodic earnings immediately.

*Management Incentive Compensation Expense*

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

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

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

This restricted stock portion of the incentive compensation will be paid or issued to the Manager on a quarterly basis pursuant to the terms of the Management Agreement. The number of shares issued is based on (a) one-half of the total incentive compensation for the period, divided by (b) the average of the closing prices of the common stock over the 30-day period ending three days prior to the grant date, less a fair market value discount determined by our board of directors to account for the transfer restrictions during the vesting period. During periods of lower stock prices, we will issue more restricted common stock to the Manager under the Management Agreement to pay for the same amount of incentive compensation earned in periods that had higher stock prices. Over the vesting period, any additional shares issued would have a dilutive effect on book value and net income per share.

On the date of each restricted stock payment or issuance to the Manager under the Management Agreement, the fair market value of the common stock shall be recorded in the stockholders' equity section of our balance sheet as



common stock and additional paid-in capital. The corresponding portion of any restricted stock payment that is not expensed will be reflected in the stockholders' equity section of our balance sheet as deferred compensation. Each quarter's incentive compensation restricted stock payment or issuance to the Manager will be divided into three tranches. The first tranche will vest over a one-year period and be expensed over a five-quarter

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period, beginning in the quarter in which it was earned. The second tranche will vest over a two-year period and be expensed over a nine-quarter period beginning in the quarter in which it was earned. The third tranche will vest over a three-year period and be expensed over a thirteen-quarter period beginning in the quarter in which it was earned. As a result of this vesting schedule for the restricted stock issued to the Manager, we will incur incentive compensation expense in each of the periods following the issuance of the restricted stock over a three-year period. We will continue to incur incentive compensation expense related to each restricted stock payment, even in subsequent periods in which the Manager did not earn incentive compensation under the Management Agreement.

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

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

We also pay an incentive fee, in the form of cash and restricted stock, to our Chief Financial Officer, in accordance with the terms of his employment agreement. The incentive fee is accounted for in the same manner as the incentive fee earned by the Manager.

## **Financial Condition**

### *Mortgage-Backed Securities*

At March 31, 2004, we held \$4.1 billion of mortgage-backed securities at fair value, net of unrealized gains of \$13.9 million and unrealized losses of \$16.6 million. As of March 31, 2004, all of the mortgage-backed securities in our portfolio were purchased at a premium to their par value and our portfolio had a weighted-average amortized cost of 101.8% of face amount.

Certain of the securities held at March 31, 2004 are impaired as the fair value of the securities is below amortized cost. At March 31, 2004, our entire portfolio was invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities. None of the securities held had been downgraded by a credit rating agency since their purchase. In addition, we intend to hold the securities until maturity, allowing for the anticipated recovery in fair value of the securities held. As such, we do not believe any of the securities held are other-than-temporarily impaired at March 31, 2004.



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

<b>Asset</b>	<b>Weighted-Average Final Maturity</b>	<b>% of Total</b>
Adjustable-Rate Mortgage-Backed Securities	2033	4.1%
Hybrid Adjustable-Rate Mortgage-Backed Securities	2033	94.6%
Balloon Mortgage-Backed Securities	2033	1.3%
Fixed-Rate Mortgage-Backed Securities	N/A	N/A

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

The principal payment rate on our mortgage-backed securities, an annual rate of principal paydowns for our mortgage-backed securities relative to the outstanding principal balance of our mortgage-backed securities, was 20% for the quarter ended March 31, 2004. The principal payment rate attempts to predict the percentage of principal that will paydown over the next 12 months based on historical principal paydowns. As interest rates have risen, the rate of refinancings has declined, which we believe may result in lower rates of prepayments and, as a result, a lower portfolio principal payment rate.

As of March 31, 2004, the weighted-average effective duration of the securities in our overall investment portfolio, assuming constant prepayment rates, or CPR, to the balloon or reset date, or the CPB duration, was 1.45 years. CPR is a measure of the rate of prepayment for our mortgage-backed securities, expressed as an annual rate relative to the outstanding principal balance of our mortgage-backed securities. CPB is similar to CPR except that it also assumes that the hybrid adjustable-rate mortgage-backed securities prepay in full at their next reset date. As of March 31, 2004, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities had fixed interest rates for a weighted-average of approximately 43 months, after which time the interest rates reset and become adjustable. The average length of time until maturity of those mortgages was 30 years. Those mortgages are also subject to interest rate caps that limit the amount that the applicable interest rate can increase during any year, known as an annual cap, and through the maturity of the applicable security, known as a lifetime cap. As of March 31, 2004, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities had average annual caps of 2.48% and average lifetime caps of 10.01%.

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

<b>Weighted-Average Life</b>	<b>Fair Value</b>	<b>Amortized Cost</b>	<b>Weighted- Average Coupon</b>
		(in thousands)	
Less than one year	\$ 345,832	\$ 348,251	3.61%
Greater than one year and less than five years	3,725,540	3,725,764	3.97

Greater than five years	_____	_____	
Total	\$4,071,372	\$4,074,015	3.96%

The weighted-average lives of the mortgage-backed securities at March 31, 2004 in the table above are based upon data provided through a subscription-based financial information service provided by a major investment bank, assuming constant principal prepayment rates to the balloon or reset date for each security. At March 31, 2004, the weighted-average lives were calculated using estimated prepayment speeds or actual prepayment speed history. The weighted-average lives for some of the mortgage-backed securities included in the

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table above were estimated using expected prepayment speeds for pools, since certain pools were new issues and did not have historical performance data available. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loan, loan age, margin and volatility.

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

### *Equity Securities*

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

### *Unsettled Securities Purchases*

At March 31, 2004, we had unsettled securities purchases of \$1.1 billion. Of the \$1.1 billion of unsettled securities purchases, \$942.6 million are related to to be announced, or TBA, mortgage-backed securities.

### *Other Assets*

We had other assets of \$178.0 million at March 31, 2004. Other assets consist primarily of offering proceeds receivable of \$157.9 million, interest receivable of \$13.2 million, principal receivable of \$5.7 million, prepaid directors and officers liability insurance of \$548 thousand and deferred compensation of \$585 thousand. On April 2, 2004, the Company received the proceeds from the public offering which was completed on March 29, 2004.

### *Hedging Instruments*

There can be no assurance that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Moreover, no hedging activity can completely insulate us from the risks associated with changes in interest rates and prepayment rates.

Hedging involves risk and typically involves costs, including transaction costs. The costs of hedging increase dramatically as the period covered by the hedging increases and during periods of rising and volatile interest rates. We may increase our hedging activity and, thus, increase our hedging costs during such periods when interest rates are volatile or rising. We generally intend to hedge as much of the interest rate risk as our manager determines is in the best interest of our stockholders, after considering the cost of such hedging transactions and our desire to maintain our status as a REIT. Our policies do not contain specific requirements as to the percentages or amount of interest rate risk that our manager is required to hedge.

At March 31, 2004, we have engaged in short sales of Eurodollar futures contracts as a means of mitigating our interest rate risk on forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements, or hedged item, for a specified future time period, which is defined as the calendar quarter immediately following the contract expiration date. We sold short 9,600 Eurodollar futures contracts, which expire in June 2004, September 2004 and December 2004 with a notional amount totaling \$9.6 billion. The value of these futures contracts is marked-to-market daily in our margin account with the custodian. Based upon the daily market value of these futures contracts, we either receive funds into, or wire funds into, our margin account with the custodian to ensure that an appropriate margin account balance is maintained at all times through the expiration of the contracts. At March 31, 2004, the unrealized loss on the

Eurodollar futures contracts was \$3.4 million.

**Table of Contents***Liabilities*

We have entered into repurchase agreements to finance some of our acquisitions of mortgage-backed securities. None of the counterparties to these agreements are affiliates of the Manager or us. These agreements are secured by our mortgage-backed securities and bear interest rates that have historically moved in close relationship to LIBOR. As of March 31, 2004 we had established 17 borrowing arrangements with various investment banking firms and other lenders, 14 of which were in use on March 31, 2004.

At March 31, 2004, we had outstanding \$2.7 billion of repurchase agreements with a weighted-average current borrowing rate of 1.15%, \$119.6 million of which matures within 30 days, \$1.5 billion of which matures between 31 and 90 days and \$1.1 billion of which matures in greater than 90 days. It is our present intention to seek to renew these repurchase agreements as they mature under the then-applicable borrowing terms of the counterparties to our repurchase agreements. At March 31, 2004, the repurchase agreements were secured by mortgage-backed securities with an estimated fair value of \$2.8 billion and had a weighted-average maturity of 97 days. The net amount at risk, defined as fair value of securities sold, plus accrued interest income, minus repurchase agreement liabilities, plus accrued interest expense, with all counterparties was \$148.5 million.

After consideration of the duration on our Eurodollar futures contracts, our weighted-average maturity of our total liabilities was 313 days.

We had \$1.1 billion of other liabilities at March 31, 2004. Other liabilities consisted primarily of \$1.1 billion of unsettled securities purchases, \$10.4 million of cash distribution payable, \$5.3 million of accrued interest expense on repurchase agreements, and \$2.2 million of management fee payable, incentive fee payable and other related party liabilities.

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

*Stockholders' Equity*

Stockholders' equity at March 31, 2004 was \$460.5 million and included \$2.6 million of unrealized losses on mortgage-backed securities available-for-sale and \$3.8 million of realized and unrealized losses on cash flow hedges presented as accumulated other comprehensive loss.

Weighted-average stockholders' equity and return on average equity were \$302.5 million and 14.36%, respectively, for the quarter ended March 31, 2004. Return on average equity is defined as annualized net income divided by weighted-average stockholders' equity.

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

<b>Total Stockholders Equity</b>	<b>Book Value per Share (1)</b>
<hr/>	<hr/>
(in thousands)	



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Total stockholders' equity (GAAP)	\$460,543	\$ 12.50
<i>Addback</i>		
Accumulated other comprehensive loss on mortgage-backed securities	<u>2,643</u>	<u>0.07</u>
Total stockholders' equity, excluding accumulated other comprehensive loss on mortgage-backed securities (NON-GAAP)	<u>\$463,186</u>	<u>\$ 12.57</u>

(1) Based on 36,841,146 shares outstanding on March 31, 2004

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

## **Results of Operations**

For the quarter ended March 31, 2004, net income was \$10.8 million or \$0.43 per weighted-average share outstanding (basic and diluted). For the same period, interest income, net of premium amortization, was approximately \$20.2 million, and was primarily earned from investments in mortgage-backed securities. Interest expense on short-term borrowings was \$6.8 million. On March 29, 2004, we completed a public offering of 12,000,000 shares of common stock. Because of the timing of this offering, interest income for the quarter ended March 31, 2004 does not reflect the impact of this offering. In addition, prepayment activity declined due to the changing interest rate environment and resulted in decreased premium amortization and increased yield on average earning assets.

For the quarter ended March 31, 2004, the weighted-average yield on average earning assets, net of amortization of premium was 3.20% and the weighted-average interest rate on our repurchase agreement liabilities was 1.20% resulting in a net interest spread of 2.00%, 39 basis points higher than our net interest spread for the fourth quarter of 2003.

Operating expenses for the quarter ended March 31, 2004 were \$2.6 million.

Base management fees to the Manager under the Management Agreement, which were \$787 thousand for the quarter ended March 31, 2004, are based on a percentage of our average net worth. Average net worth for these purposes is calculated on a monthly basis and equals the difference between the aggregate book value of our consolidated assets prior to accumulated depreciation and other non-cash items, including the fair market value adjustment on mortgage-backed securities, minus the aggregate book value of our consolidated liabilities.

Incentive fee expense to related parties for the quarter ended March 31, 2004 was \$846 thousand. Incentive compensation is earned by related parties when REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) relative to the average net invested assets for the period, as defined in the Management Agreement, exceeds the threshold return taxable income that would have produced an annualized return on equity equal to the sum of the 10-year U.S. Treasury rate plus 2.0% for the same period. For the quarter ended March 31, 2004, REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) was \$11.2 million and was greater than the threshold return taxable income of \$4.7 million.

For the quarter ended March 31, 2004, total incentive compensation earned by the Manager was \$1.3 million, one-half payable in cash and one-half payable in the form of the Company's common stock as described above. The cash portion of the incentive fee of \$652 thousand for the quarter ended March 31, 2004 was expensed in that period as well as 15.2% of the restricted stock portion of the incentive fees, or \$99 thousand. In accordance with the terms of his employment agreement, the Company's Chief Financial Officer earned an incentive fee for the quarter ended March 31, 2004 of \$65 thousand. This portion of the incentive fee is also payable one-half in cash and one-half in the form of a restricted stock award under the Company's 2003 Stock Incentive Plan. The shares are payable and vest over the same vesting schedule as the stock issued to the Manager. The cash portion of the incentive fee of \$33 thousand for the quarter ended March 31, 2004 was expensed in that period as well as 15.2% of the restricted stock portion of the incentive fees, or \$5 thousand. The remaining incentive fee for the quarter ended March 31, 2004 consists primarily of the change in fair value of unvested restricted stock awards.

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Professional services expense for the quarter ended March 31, 2004 of \$417 thousand includes legal, accounting and other professional services provided to us. Included in this balance are costs related to the filing of our resale shelf registration statement totaling \$111 thousand. The insurance expense for the same period of \$220 thousand represents amortization of prepaid directors and officers insurance. Custody expense of \$67 thousand for the quarter ended March 31, 2004 includes the services provided by our primary custodian. These expenses may

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vary based on levels of activity within the portfolio. Included in the other general and administrative expenses of \$88 thousand for the quarter ended March 31, 2004 are printing costs related to the filing of our resale shelf registration statement totaling \$18 thousand.

REIT taxable net income is calculated according to the requirements of the Internal Revenue Code, rather than GAAP. The following table reconciles GAAP net income to REIT taxable net income for the quarter ended March 31, 2004 (in thousands):

GAAP net income	\$10,800
Adjustments to GAAP net income:	
Amortization of organizational costs	(8)
Addback of stock compensation expense for unvested options	2
Addback of stock compensation expense for unvested restricted stock	161
Addback of hedge ineffectiveness expense	10
Subtract dividend equivalent rights on restricted stock	(12)
Subtract realized losses on Eurodollar futures contracts	(412)
	<hr/>
Net adjustments to GAAP net income	(259)
	<hr/>
REIT taxable net income	\$10,541
	<hr/>

We believe that the presentation of our REIT taxable net income is useful to investors because it is directly related to the distributions we are required to make in order to retain our REIT status and to the calculations of the incentive compensation payable to related parties (before deducting incentive compensation, net operating losses and certain other items). There are limitations associated with REIT taxable net income. For example, this measure does not reflect net capital losses during the period and, thus, by itself is an incomplete measure of our financial performance over any period. As a result, our REIT taxable net income should be considered in addition to, and not as a substitute for, our GAAP-based net income as a measure of our financial performance.

**Contractual Obligations and Commitments**

As of March 31, 2004, we had entered into a Management Agreement with our Manager. See Note 6 to the financial statements for significant terms of the Management Agreement.

**Off-Balance Sheet Arrangements**

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

**Liquidity and Capital Resources**

Our primary source of funds as of March 31, 2004 consisted of repurchase agreements totaling \$2.7 billion with a weighted-average current borrowing rate of 1.15% which we used to finance acquisition of mortgage-related assets. We expect to continue to borrow funds in the form of repurchase agreements. As of March 31, 2004 we had established 17 borrowing arrangements with various investment banking firms and other lenders, 14 of which were in use on March 31, 2004. Increases in short-term interest rates could negatively impact the valuation of our mortgage-related assets, which could limit our borrowing ability or cause our lenders to initiate margin calls. Amounts due upon maturity of our repurchase agreements will be funded primarily through the rollover/reissuance of repurchase agreements and monthly principal and interest payments received on our mortgage-backed securities.

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We generally seek to borrow between eight and 12 times the amount of our equity. Our leverage ratio, defined as total repurchase agreements divided by total stockholders' equity, at March 31, 2004 was 5.9. At March 31, 2004, net proceeds of \$157.9 million were receivable from the underwriter of our public offering which was completed on March 29, 2004. The net proceeds were received on April 2, 2004. At March 31, 2004, we had not fully levered our portfolio to within our target range of eight to 12 times the amount of our equity. As a result, the total amount of mortgage-backed securities and repurchase agreement liabilities as of March 31, 2004 were lower than they will be once our portfolio is fully levered through additional repurchase agreement liabilities and related mortgage-backed security purchases.

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

For liquidity, we also rely on the cash flow from operations, primarily monthly principal and interest payments to be received on our mortgage-backed securities, as well as any primary securities offerings authorized by our board of directors.

On April 26, 2004, we paid a cash distribution of \$0.42 per share to our stockholders of record on March 19, 2004. The distribution was paid to stockholders of the 24,841,146 shares outstanding on the record date, which was prior to the completion of our March 29, 2004 public offering. This distribution is a taxable dividend and is not considered a return of capital. This distribution was funded with cash flow from our ongoing operations, including principal and interest payments received on our mortgage-backed securities. We did not distribute \$282 thousand of our REIT taxable net income for the period from April 26, 2003 through December 31, 2003. We intend to declare a spillback distribution in this amount during 2004.

We believe that equity capital, combined with the cash flow from operations and the utilization of borrowings, will be sufficient to enable us to meet anticipated liquidity requirements. However, an increase in prepayment rates substantially above our expectations could cause a liquidity shortfall. If our cash resources are at any time insufficient to satisfy our liquidity requirements, we may be required to liquidate mortgage-backed securities or sell debt or additional equity securities. If required, the sale of mortgage-backed securities at prices lower than the carrying value of such assets would result in losses and reduced income.

We intend to increase our capital resources by making additional offerings of equity and debt securities, possibly including classes of preferred stock, common stock, commercial paper, medium-term notes, collateralized mortgage obligations and senior or subordinated notes. Such financing will depend on market conditions for capital raises and for the investment of any proceeds. All debt securities, other borrowings, and classes of preferred stock will be senior to the common stock in a liquidation of our Company.

## **Inflation**

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with accounting principles generally accepted in the United States and our distributions are determined by our board of directors based primarily by our net income as calculated for tax purposes; in each case, our activities and balance sheet are measured with reference to historical cost and or fair market value without considering inflation.



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**Risk Factors**

*Risks Related to Our Business*

**We have a limited operating history and might not be able to operate our business or implement our operating policies and strategies successfully.**

We began operations in June of 2003, and we have a limited operating history. The results of our operations will depend on many factors, including the availability of opportunities for the acquisition of mortgage-related assets, the level and volatility of interest rates, readily accessible short- and long-term funding alternatives in the financial markets and economic conditions. Moreover, delays in fully leveraging and investing our net proceeds of our public offerings may cause our performance to be weaker than other fully leveraged and invested mortgage REITs pursuing comparable investment strategies. You will not have the opportunity to evaluate the manner in which we invest or the economic merits of particular assets to be acquired. Furthermore, we face the risk that we might not successfully operate our business or implement our operating policies and strategies as described in this Quarterly Report on Form 10-Q.

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

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

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

We invest primarily in adjustable-rate and hybrid adjustable-rate mortgage-backed securities. The mortgages underlying adjustable-rate mortgage-backed securities have interest rates that reset periodically, typically every six months or on an annual basis, based upon market-based indices of interest rates such as U.S. Treasury bonds or LIBOR. The mortgages underlying hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan-typically three, five, seven or 10 years-and thereafter their interest rates reset periodically similar to the mortgages underlying adjustable-rate mortgage-backed securities. We have funded our acquisitions and expect to fund our future acquisitions of adjustable-rate and hybrid adjustable-rate mortgage-backed securities in part with borrowings that have interest rates based on indices and repricing terms similar to, but with shorter maturities than, the interest rate indices and repricing terms of the adjustable-rate and hybrid adjustable-rate mortgage-backed securities. On March 31, 2004, 98.7% of our investment portfolio was invested in adjustable-rate or hybrid adjustable-rate mortgage-backed securities having a weighted-average term to next rate adjustment of approximately 42 months, while our borrowings had a weighted-average term of approximately 97 days. After



consideration of the duration on our Eurodollar futures contracts, our weighted-average maturity was 313 days. The phrase "weighted average term to next rate adjustment" refers to the average of the periods of time that must elapse before the interest rates adjust for all of the mortgages underlying our adjustable-rate and hybrid adjustable-rate mortgage-backed securities in our portfolio, which average is weighted in proportion to the book values of the applicable securities. During periods of changing interest rates, this interest rate

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mismatch between our assets and liabilities could reduce or eliminate our net income and distributions to our stockholders and could cause us to suffer a loss.

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

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

The mortgage-backed securities that we acquire generally represent interests in pools of mortgage loans. The principal and interest payments we receive from our mortgage-backed securities are generally funded by the payments that mortgage borrowers make on those underlying mortgage loans. When borrowers pre-pay their mortgage loans sooner than expected, corresponding prepayments on the mortgage-backed securities occur sooner than expected by the marketplace. Sooner-than-expected prepayments could harm our results of operations in the following ways, among others:

We seek to purchase mortgage-backed securities that we believe to have favorable risk-adjusted expected returns relative to market interest rates at the time of purchase. If the coupon interest rate for a mortgage-backed security is higher than the market interest rate at the time it is purchased, then that mortgage-backed security will be acquired at a premium to its par value. In accordance with applicable accounting rules, we are required to amortize any premiums or discounts related to our mortgage-backed securities over their expected terms. The amortization of a premium reduces interest income, while the amortization of a discount increases interest income. The expected terms for mortgage-backed securities are a function of the prepayment rates for the mortgages underlying the mortgage-backed securities. Mortgage-backed securities that are at a premium to their par value are more likely to experience prepayment of some or all of their principal through refinancings. If the mortgages underlying our premium mortgage-backed securities are prepaid in whole or in part more quickly than their respective maturity dates, then we must also amortize their respective premiums more quickly, which would decrease our net interest income and harm our profitability.

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

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

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

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

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

the movement of interest rates;

the availability of financing in the market; and

the value and liquidity of our mortgage-backed securities.

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

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

The mortgages underlying our adjustable-rate and hybrid adjustable-rate mortgage-backed securities are typically subject to periodic and lifetime interest rate caps. Periodic interest rate caps limit the amount that the interest rate of a mortgage can increase during any given period. Lifetime interest rate caps limit the amount an interest rate can increase through the maturity of a mortgage. As of March 31, 2004, 98.7% of our mortgage-backed securities were based on adjustable-rate or hybrid adjustable-rate mortgages, substantially all of which were subject to interest rate caps. The percentage of adjustable-rate and hybrid adjustable-rate mortgage-backed securities in our investment portfolio which are subject to periodic interest rate caps every six months or annually were 12.5% and 86.2%, respectively.

Our borrowings are not subject to similar restrictions. The periodic adjustments to the interest rates of the mortgages underlying our adjustable-rate and hybrid adjustable-rate mortgage-backed securities are based on changes in an objective index. Substantially all of the mortgages underlying our adjustable-rate and hybrid adjustable-rate mortgage-backed securities adjust their interest rates based on one of two main indices, the U.S. Treasury index, a monthly or weekly average yield of benchmark U.S. Treasury securities as published by the Federal Reserve Board, or LIBOR, the interest rate that banks in London offer for deposits in London of U.S. dollars. The percentages of the mortgages underlying the adjustable-rate and hybrid adjustable-rate mortgage-backed securities in our investment portfolio as of March 31, 2004 with interest rates that reset based on the U.S. Treasury or LIBOR indices were 26.3% and 72.4%, respectively.

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

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

A significant portion of our investment portfolio consists of hybrid adjustable-rate mortgage-backed securities. As of March 31, 2004, 94.6% of our investment portfolio consisted of hybrid adjustable-rate mortgage-backed securities. We may also invest in fixed-rate mortgage-backed securities from time to time, however, as of March 31, 2004, none of our portfolio consisted of fixed-rate mortgage-backed securities. We fund our acquisition

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of fixed-rate mortgage-backed securities, including those based on balloon maturity and hybrid adjustable-rate mortgages, in part with short-term repurchase agreements and term loans. During periods of rising interest rates, our costs associated with borrowings used to fund the acquisition of fixed-rate mortgage-backed securities are subject to increases while the income we earn from these assets remains substantially fixed. This would reduce and could eliminate the net interest spread between the fixed-rate mortgage-backed securities that we purchase and our borrowings used to purchase them, which would reduce our net interest income and could cause us to suffer a loss.

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

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

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

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

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

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

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

Our policies permit us to enter into interest rate swaps, caps and floors and other derivative transactions to help us reduce our interest rate and prepayment risks. As of March 31, 2004, we were engaged in short sales of Eurodollar futures contracts in order to hedge the impact of changes in interest rates on our liability costs. In the future, these transactions might mitigate our interest rate and prepayment risks, but cannot eliminate these risks. Moreover, the use of derivative transactions could have a negative impact on our earnings and our status as a REIT, and, therefore, our use of such derivatives could be limited.

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

Our policies permit us to, but we are not required to, enter into derivative transactions such as interest rate swaps, caps and floors and other derivative transactions to help us seek to reduce our interest rate and prepayment risks. The effectiveness of any derivative transactions will depend significantly upon whether we correctly quantify

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the interest rate or prepayment risks being hedged, our execution of and ongoing monitoring of our hedging activities, and the treatment of such hedging activities for GAAP accounting purposes.

As of March 31, 2004, we were engaged in short sales of Eurodollar futures contracts in order to hedge the impact of changes in interest rates on our liability costs. In the case of these hedges, and any other future efforts to hedge the effects of interest rate changes on our liability costs, if we enter into hedging instruments that have higher interest rates embedded in them as a result of the forward yield curve, and at the end of the term of these hedging instruments the spot market interest rates for the liabilities that we hedged are actually lower, then we will have locked in higher interest rates for our liabilities than would be available in the spot market at the time and this could result in a narrowing of our net interest rate spread or result in losses. In some situations, we may sell assets or hedging instruments at a loss in order to maintain adequate liquidity.

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

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

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

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

We may acquire leveraged mortgage derivative securities that expose us to a high level of interest rate risk. The characteristics of leveraged mortgage derivative securities cause those securities to experience greater volatility in their market prices. Thus, acquisition of leveraged mortgage derivative securities will expose us to the risk of greater volatility in our portfolio, which could reduce our net income and harm our overall results of operations.

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

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

borrowings on favorable terms or at all, we might have to sell our mortgage-related assets under adverse market conditions, which would harm our results of operations and may result in permanent losses.



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

Possible market developments, including a sharp or prolonged rise in interest rates, a change in prepayment rates or increasing market concern about the value or liquidity of one or more types of mortgage-backed securities in which our portfolio is concentrated, might reduce the market value of our portfolio, which might cause our lenders to require additional collateral. Any requirement for additional collateral might compel us to liquidate our assets at inopportune times and at disadvantageous prices, thereby harming our operating results. If we sell mortgage-backed securities at prices lower than the carrying value of the mortgage-backed securities, we would experience losses.

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

Our borrowings under repurchase agreements may qualify for special treatment under the bankruptcy code, giving our lenders the ability to avoid the automatic stay provisions of the bankruptcy code and to take possession of and liquidate our collateral under the repurchase agreements without delay if we file for bankruptcy. Furthermore, the special treatment of repurchase agreements under the bankruptcy code may make it difficult for us to recover our pledged assets in the event that our lender files for bankruptcy. Thus, the use of repurchase agreements exposes our pledged assets to risk in the event of a bankruptcy filing by either our lender or us.

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

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

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

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

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

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

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

We bear the risk of any losses resulting from any defaults on the mortgage loans underlying the mortgage-backed securities in our investment portfolio. Many of the mortgage-backed securities that we obtain will have one or more forms of credit enhancement provided by third parties, such as insurance against risk of loss due to default on the underlying mortgage loans or bankruptcy, fraud and special hazard losses. To the extent that third parties

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have been contracted to insure against these types of losses, the value of such insurance will depend in part on the creditworthiness and claims-paying ability of the insurer and the timeliness of reimbursement in the event of a default on the underlying obligations. Further, the insurance coverage for various types of losses is limited in amount, and losses in excess of these limitations would be borne by us.

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

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

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

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

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

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

Under our asset acquisition policy, we are permitted to invest up to a maximum of 10% of our total assets in assets other than mortgage-backed securities guaranteed by federal agencies or federally chartered entities such as Fannie

Mae, Freddie Mac or Ginnie Mae, or rated as at least investment grade by a nationally recognized statistical rating agency. Mortgage loans fall outside of this category of investments under our investment guidelines and are subject to the 10% limitation. If we elect in the future to purchase mortgage loans, we may require that each of the mortgage loans that we purchase include comprehensive insurance covering the underlying real property, including

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liability, fire and extended coverage. There are certain types of losses, however, generally of a catastrophic nature, such as earthquakes, floods and hurricanes, that may be uninsurable or not economically insurable. Inflation, changes in building codes and ordinances, environmental considerations, and other factors also might make it infeasible to use insurance proceeds to replace a property if it is damaged or destroyed. Under such circumstances, the insurance proceeds, if any, might not be adequate to restore the economic value of the underlying real property, which might impair our security and decrease the value of our assets.

**Distressed mortgage loans have higher risk of future default.**

If we elect in the future to purchase mortgage loans, we may purchase distressed mortgage loans as well as mortgage loans that have had a history of delinquencies. These distressed mortgage loans may be in default or may have a greater than normal risk of future defaults and delinquencies, as compared to a pool of newly-originated, high quality loans of comparable type, size and geographic concentration. Returns on an investment of this type depend on accurate pricing of such investment, the borrower's ability to make required payments or, in the event of default, the ability of the loan's servicer to foreclose and liquidate the mortgage loan. We cannot assure you that the servicer will be able to liquidate a defaulted mortgage loan in a cost-effective manner, at an advantageous price or in a timely manner.

**Subordinated loans on real estate are subject to higher risks.**

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

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

We depend on the diligence, experience and skill of our officers and the people working on behalf of our manager for the selection, acquisition, structuring and monitoring of our mortgage-related assets and associated borrowings. Our key officers include Gail Seneca, Albert Gutierrez, Christopher Zyda, Andrew Chow and Troy Grande. We have not entered into employment agreements with our senior officers other than Mr. Zyda, who is our Senior Vice President and Chief Financial Officer. With the exception of Mr. Zyda, we do not currently employ other senior officers dedicated solely to our business, and our officers are free to engage in competitive activities in our industry. The loss of any key person could harm our business, financial condition, cash flow and results of operations.

***Risks Related to Our Manager***

**The Manager has not managed a REIT and we cannot assure you that the Manager's past experience will be sufficient to successfully manage our business as a REIT.**

Seneca Capital Management LLC has not previously managed a REIT, and does not have any experience in complying with the income, asset and other limitations imposed by the REIT provisions of the Internal Revenue Code. Those provisions are complex and the failure to comply with those provisions in a timely manner could prevent us from qualifying as a REIT or could force us to pay unexpected taxes and penalties. In such event, our net income would be reduced and we could incur a loss.

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

In addition to managing us and having at least two of its designees as members of our board, the Manager provides advice on our operating policies and strategies. The Manager may also cause us to engage in future

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transactions with the Manager and its affiliates, subject to the approval of, or guidelines approved by, the independent members of our board of directors. Our directors, however, rely primarily on information supplied by our manager in reaching their determinations. Accordingly, our manager has significant influence over our affairs, and may cause us to engage in transactions which are not in our best interest.

**Our manager and its affiliates might allocate mortgage-related opportunities to other entities, and thus might divert attractive investment opportunities away from us.**

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

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

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

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

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

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

**We may be obligated to pay the Manager incentive compensation even if we incur a loss.**

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





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

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

**Because the Manager might receive a significant fee if we terminate the Management Agreement, economic considerations might preclude us from terminating the Management Agreement in the event that the Manager fails to meet our expectations.**

If we terminate the Management Agreement without cause or because we decide to manage our company internally or if the Manager terminates the management in the event of a change of control, then we will have to pay a significant fee to the Manager. The amount of the fee depends on whether:

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

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

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

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

The Manager may be entitled to substantial fees pursuant to the Management Agreement. The Manager's base management fee is calculated as a percentage of our average net worth. The Manager's incentive compensation is calculated as a tiered percentage of our taxable income (before deducting certain items) in excess of a threshold amount of taxable income and is indeterminable in advance of a particular period. Since future payments of base management fees, incentive compensation and expense reimbursements are determined at future dates based upon our then-applicable average net worth, results of operations and actual expenses incurred by the Manager, such fees and expense reimbursements cannot be estimated with mathematical certainty. Any base management fees, incentive

compensation or expense reimbursements payable to the Manager may be materially greater or less than the historical amounts and we can provide no assurance at this time as to the amount of any such base management fee, incentive compensation or expense reimbursements that may be payable to the Manager in the future.

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

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

**The Manager's liability is limited under the Management Agreement, and we have agreed to indemnify the Manager against certain liabilities.**

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

*Legal and Tax Risks*

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

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

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

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

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

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

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

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

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

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

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

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

In order to qualify as a REIT, we must ensure that at the end of each calendar quarter at least 75% of the value of our assets consists of cash, cash items, government securities and qualified REIT real estate assets. The remainder of our investment in securities generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, generally, no more than 5% of the value of our assets can consist of the securities of any one issuer. If we fail to comply with these requirements, we must dispose of a portion of our assets within 30 days after the end of the calendar quarter in order to avoid losing our REIT status and suffering adverse tax consequences.

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

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



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

We intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act of 1940, as amended. If we fail to qualify for this exemption, our ability to use leverage would be substantially reduced and we would be unable to conduct our business as described in this Quarterly Report on Form 10-Q.

The Investment Company Act exempts entities that are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Under the current interpretation of the SEC staff, in order to qualify for this exemption, we must maintain at least 55% of our assets directly in these qualifying real estate interests. Mortgage-backed securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as separate from the underlying mortgage loans and, thus, may not qualify for purposes of the 55% requirement. Therefore, our ownership of these mortgage-backed securities is limited by the provisions of the Investment Company Act.

In satisfying the 55% requirement under the Investment Company Act, we treat as qualifying interests mortgage-backed securities issued with respect to an underlying pool as to which we hold all issued certificates. If the SEC or its staff adopts a contrary interpretation of such treatment, we could be required to sell a substantial amount of our mortgage-backed securities under potentially adverse market conditions. Further, in our attempts to ensure that we at all times qualify for the exemption under the Investment Company Act, we might be precluded from acquiring mortgage-backed securities if their yield is higher than the yield on mortgage-backed securities that could be purchased in a manner consistent with the exemption. These factors may lower or eliminate our net income.

**Misplaced reliance on legal opinions or statements by issuers of mortgage-backed securities could result in a failure to comply with REIT income or assets tests.**

When purchasing mortgage-backed securities, we may rely on opinions of counsel for the issuer or sponsor of such securities, or statements made in related offering documents, for purposes of determining whether and to what extent those securities constitute REIT real estate assets for purposes of the REIT asset tests and produce income that qualifies under the REIT gross income tests. The inaccuracy of any such opinions or statements may adversely affect our REIT qualification and result in significant corporate-level tax.

**One-action rules may harm the value of the underlying property.**

Several states have laws that prohibit more than one action to enforce a mortgage obligation, and some courts have construed the term "action" broadly. In such jurisdictions, if the judicial action is not conducted according to law, there may be no other recourse in enforcing a mortgage obligation, thereby decreasing the value of the underlying property.

**We may be harmed by changes in various laws and regulations.**

Changes in the laws or regulations governing the Manager or its affiliates may impair the Manager's or its affiliates' ability to perform services in accordance with the Management Agreement. Our business may be harmed by changes to the laws and regulations affecting our manager or us, including changes to securities laws and changes to the Internal Revenue Code applicable to the taxation of REITs. New legislation may be enacted into law or new interpretations, rulings or regulations could be adopted, any of which could harm us, our manager and our stockholders, potentially with retroactive effect.

Legislation was recently enacted that reduces the maximum tax rate of non-corporate taxpayers for capital gains (for taxable years ending on or after May 6, 2003 and before January 1, 2009) and for dividends (for taxable years

beginning after December 31, 2002 and before January 1, 2009) to 15%. Generally, dividends paid by REITs are not eligible for the new 15% federal income tax rate, with certain exceptions discussed at United States Federal Income Tax Considerations-Taxation of Taxable United States Stockholders-Distributions Generally. Although this legislation does not adversely affect the taxation of REITs or dividends paid by REITs, the more favorable



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treatment of regular corporate dividends could cause investors who are individuals to consider stocks of other corporations that pay dividends as more attractive relative to stocks of REITs. It is not possible to predict whether this change in perceived relative value will occur, or what the effect will be on the market price of our common stock.

In addition, legislation was recently introduced in the United States House of Representatives and the United States Senate that would amend certain rules relating to REITs. Among other changes, the proposed legislation would provide the Internal Revenue Service with the ability to impose monetary penalties, rather than a loss of REIT status, for reasonable cause violations of certain tests relating to REIT qualification, and would change the formula for calculating the tax imposed for certain violations of the income tests discussed at United States Federal Income Tax Considerations-Requirements for Qualification as a REIT-Income Tests. In general, the changes would apply to taxable years beginning after the date the legislation is enacted. As of the date hereof, it is not possible to predict with any certainty whether the proposed legislation will be enacted in its current form.

**We may incur excess inclusion income that would increase the tax liability of our stockholders.**

In general, dividend income that a tax-exempt entity receives from us should not constitute unrelated business taxable income as defined in Section 512 of the Internal Revenue Code. If we realize excess inclusion income and allocate it to stockholders, this income cannot be offset by net operating losses. If the stockholder is a tax-exempt entity, then this income would be fully taxable as unrelated business taxable income under Section 512 of the Internal Revenue Code. If the stockholder is foreign, it would be subject to U.S. federal income tax withholding on this income without reduction pursuant to any otherwise applicable income-tax treaty.

Excess inclusion income could result if we held a residual interest in a real estate mortgage investment conduit, or REMIC. Excess inclusion income also would be generated if we were to issue debt obligations with two or more maturities and the terms of the payments on these obligations bore a relationship to the payments that we received on our mortgage-backed securities securing those debt obligations. We generally structure our borrowing arrangements in a manner designed to avoid generating significant amounts of excess inclusion income. We do, however, enter into various repurchase agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities if we default on our obligations. The IRS may determine that these borrowings give rise to excess inclusion income that should be allocated among stockholders. Furthermore, some types of tax-exempt entities, including voluntary employee benefit associations and entities that have borrowed funds to acquire their shares of our common stock, may be required to treat a portion of or all of the dividends they may receive from us as unrelated business taxable income. Finally, we may invest in equity securities of other REITs and it is possible that we might receive excess inclusion income from those investments.

***Risks Related to Investing in Our Common Stock***

**We have not established a minimum distribution payment level, and we cannot assure you of our ability to make distributions to our stockholders in the future.**

We intend to make quarterly distributions to our stockholders in amounts such that we distribute all or substantially all of our taxable income in each year, subject to certain adjustments. This, along with other factors, should enable us to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. We have not established a minimum distribution payment level and our ability to make distributions might be harmed by the risk factors described in this prospectus. All distributions will be made at the discretion of our board of directors and will depend on our earnings, our financial condition, maintenance of our REIT status and such other factors as our board of directors may deem relevant from time to time. We cannot assure you that we will have the ability to make distributions to our stockholders in the future.

**Restrictions on ownership of a controlling percentage of our capital stock might limit your opportunity to receive a premium on our stock.**

For the purpose of preserving our REIT qualification and for other reasons, our charter prohibits direct or constructive ownership by any person of more than 9.8% of the lesser of the total number or value of the outstanding

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shares of our common stock or more than 9.8% of the outstanding shares of our preferred stock. The constructive ownership rules in our charter are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of less than 9.8% of the outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of 9.8% of the outstanding stock, and thus be subject to the ownership limit in our charter. Any attempt to own or transfer shares of our common or preferred stock in excess of the ownership limit without the consent of our board of directors shall be void, and will result in the shares being transferred by operation of law to a charitable trust. These provisions might inhibit market activity and the resulting opportunity for our stockholders to receive a premium for their shares that might otherwise exist if any person were to attempt to assemble a block of shares of our stock in excess of the number of shares permitted under our charter and which may be in the best interests of our stockholders.

### **Certain provisions of Maryland law and our charter and bylaws could hinder, delay or prevent a change in control of our company.**

Certain provisions of Maryland law, our charter and our bylaws have the effect of discouraging, delaying or preventing transactions that involve an actual or threatened change in control of our company. These provisions include the following:

*Classified Board of Directors.* Our board of directors is divided into three classes with staggered terms of office of three years each. The classification and staggered terms of office of our directors make it more difficult for a third party to gain control of our board of directors. At least two annual meetings of stockholders, instead of one, generally would be required to effect a change in a majority of the board of directors.

*Removal of Directors.* Under our charter, subject to the rights of one or more classes or series of preferred stock to elect one or more directors, a director may be removed only for cause and only by the affirmative vote of at least two-thirds of all votes entitled to be cast by our stockholders generally in the election of directors.

*Number of Directors, Board Vacancies, Term of Office.* We have elected to be subject to certain provisions of Maryland law which vest in the board of directors the exclusive right to determine the number of directors and the exclusive right, by the affirmative vote of a majority of the remaining directors, to fill vacancies on the board even if the remaining directors do not constitute a quorum. These provisions of Maryland law, which are applicable even if other provisions of Maryland law or the charter or bylaws provide to the contrary, also provide that any director elected to fill a vacancy shall hold office for the remainder of the full term of the class of directors in which the vacancy occurred, rather than the next annual meeting of stockholders as would otherwise be the case, and until his or her successor is elected and qualifies.

*Limitation on Stockholder-Requested Special Meetings.* Our bylaws provide that our stockholders have the right to call a special meeting only upon the written request of stockholders entitled to cast not less than a majority of all the votes entitled to be cast by the stockholders at such meeting.

*Advance Notice Provisions for Stockholder Nominations and Proposals.* Our bylaws require advance written notice for stockholders to nominate persons for election as directors at, or to bring other business before, any meeting of stockholders. This bylaw provision limits the ability of stockholders to make nominations of persons for election as directors or to introduce other proposals unless we are notified in a timely manner prior to the meeting.

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*Exclusive Authority of our Board to Amend the Bylaws.* Our bylaws provide that our board of directors has the exclusive power to adopt, alter or repeal any provision of the bylaws or to make new bylaws. Thus, our stockholders may not effect any changes to our bylaws.

*Preferred Stock.* Under our charter, our board of directors has authority to issue preferred stock from time to time in one or more series and to establish the terms, preferences and rights of any such series of preferred stock, all without approval of our stockholders.

*Duties of Directors with Respect to Unsolicited Takeovers.* Maryland law provides protection for Maryland corporations against unsolicited takeovers by limiting, among other things, the duties of the directors in unsolicited takeover situations. The duties of directors of Maryland corporations do not require them to (1) accept, recommend or respond to any proposal by a person seeking to acquire control of the corporation, (2) authorize the corporation to redeem any rights under, or modify or render inapplicable, any stockholders rights plan, (3) make a determination under the Maryland Business Combination Act or the Maryland Control Share Acquisition Act, or (4) act or fail to act solely because of the effect of the act or failure to act may have on an acquisition or potential acquisition of control of the corporation or the amount or type of consideration that may be offered or paid to the stockholders in an acquisition. Moreover, under Maryland law the act of the directors of a Maryland corporation relating to or affecting an acquisition or potential acquisition of control is not subject to any higher duty or greater scrutiny than is applied to any other act of a director. Maryland law also contains a statutory presumption that an act of a director of a Maryland corporation satisfies the applicable standards of conduct for directors under Maryland law.

*Ownership Limit.* In order to preserve our status as a REIT under the Internal Revenue Code, our charter generally permits any single stockholder, or any group of affiliated stockholders, from beneficially owning more than 9.8% of our outstanding common or preferred stock unless our board of directors waives or modifies this ownership limit.

*Maryland Business Combination Act.* The Maryland Business Combination Act provides that unless exempted, a Maryland corporation may not engage in business combinations, including mergers, dispositions of 10% or more of its assets, certain issuances of shares of stock and other specified transactions, with an interested stockholder or an affiliate of an interested stockholder for five years after the most recent date on which the interested stockholder became an interested stockholder, and thereafter unless specified criteria are met. An interested stockholder is generally a person owning or controlling, directly or indirectly, 10% or more of the voting power of the outstanding stock of a Maryland corporation. Our board of directors has adopted a resolution exempting our company from this statute. However, our board of directors may repeal or modify this resolution in the future, in which case the provisions of the Maryland Business Combination Act will be applicable to business combinations between our company and other persons.

*Maryland Control Share Acquisition Act.* Maryland law provides that control shares of a corporation acquired in a control share acquisition shall have no voting rights except to the extent approved by a vote of two-thirds of the votes eligible to be cast on the matter under the Maryland Control Share Acquisition Act. Control shares means shares of stock that, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors within one of the following ranges of the voting power: one-tenth or more but less than one-third, one-third or more but less than a majority or a majority or more of all voting power. A control share acquisition means the acquisition of control shares, subject to certain exceptions. If voting rights of control shares acquired in a control share acquisition are not approved at a stockholders meeting, then subject to certain conditions and limitations, the issuer may redeem any or all of the control shares for fair value. If voting rights of such control shares are approved at a stockholders meeting and the acquiror becomes entitled to vote a majority of the shares of stock entitled to vote, all other stockholders may exercise appraisal

rights. Our bylaws contain a provision exempting acquisitions of our            shares from the Maryland Control Share Acquisition Act. However, our board of directors may amend our bylaws in the future to repeal or modify this exemption, in which case any control shares of our company acquired in a control share acquisition will be subject to the Maryland Control Share Acquisition Act.

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**Future offerings of debt securities, which would be senior to our common stock upon liquidation, or equity securities, which would dilute our existing stockholders and may be senior to our common stock for the purposes of distributions, may harm the value of our common stock.**

In the future, we may attempt to increase our capital resources by making additional offerings of debt or equity securities, including commercial paper, medium-term notes, senior or subordinated notes and classes of preferred stock or common stock. Upon the liquidation of our company, holders of our debt securities and shares of preferred stock and lenders with respect to other borrowings will receive a distribution of our available assets prior to the holders of our common stock. Additional equity offerings by us may dilute the holdings of our existing stockholders or reduce the value of our common stock, or both. Our preferred stock, if issued, would have a preference on distributions that could limit our ability to make distributions to the holders of our common stock. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus, our stockholders bear the risk of our future offerings reducing the market price of our common stock and diluting their stock holdings in us.

**The market price and trading volume of our common stock may be volatile.**

Even if an active trading market develops for our common stock after this offering, the market price of our common stock may be highly volatile and be subject to wide fluctuations. In addition, the trading volume in our common stock may fluctuate and cause significant price variations to occur. If the market price of our common stock declines significantly, you may be unable to resell your shares at or above your purchase price. We cannot assure you that the market price of our common stock will not fluctuate or decline significantly in the future. Some of the factors that could negatively affect our stock price or result in fluctuations in the price or trading volume of our common stock include:

actual or anticipated variations in our quarterly operating results or distributions;

changes in our funds from operations or earnings estimates or publication of research reports about us or the real estate industry, although there can be no assurance that any research reports about us will be published;

increases in market interest rates that lead purchasers of our shares to demand a higher yield; changes in market valuations of similar companies;

adverse market reaction to any increased indebtedness we incur in the future;

additions or departures of key management personnel;

actions by institutional stockholders;

speculation in the press or investment community; and

general market and economic conditions.

**Broad market fluctuations could harm the market price of our common stock.**

The stock market has experienced extreme price and volume fluctuations that have affected the market price of many companies in industries similar or related to ours and that have been unrelated to these companies' operating performances. These broad market fluctuations could reduce the market price of our common stock. Furthermore, our operating results and prospects may be below the expectations of public market analysts and investors or may be lower than those of companies with comparable market capitalizations, which could harm the market price of our

common stock.

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**Shares of our common stock eligible for future sale may harm our stock price.**

We cannot predict the effect, if any, of future sales of shares of our common stock, or the availability of shares for future sales, on the market price of our common stock. Sales of substantial amounts of these shares of common stock, or the perception that these sales could occur, may harm prevailing market prices for our common stock. As of March 31, 2004, there are:

36,841,146 shares of outstanding common stock;

outstanding options to purchase 55,000 shares of our common stock at a weighted-average exercise price of \$14.82 per share; and

an additional 943,505 shares of our common stock available for future awards under our stock incentive plans.

A total of 943,505 shares of our common stock, or 1% of our current total authorized shares, are reserved for future awards and grants under our stock incentive plans. In January 2004, we filed a registration statement on Form S-8 under the Securities Act covering the 1.0 million shares of our common stock issued or reserved for issuance under our stock incentive plans and/or subject to outstanding options under our stock incentive plans. Shares of our common stock issued upon exercise of options under the Form S-8 will be available for sale in the public market, subject to Rule 144 volume limitations applicable to affiliates and subject to the contractual restrictions described above. We recently issued 13,110,000 shares of common stock in our initial public offering. All of those shares are eligible for immediate resale by their holders. Additionally, we recently filed a registration statement covering the resale of up to 11,500,000 shares of our common stock by the selling stockholders named in the prospectus which is a part of such resale registration statement. All of the shares sold from time to time pursuant to our resale registration statement will be eligible for immediate resale by their holders. If any or all of the above holders sell a large number of securities in the public market, the sale could reduce the market price of our common stock and could impede our ability to raise future capital through a sale of additional equity securities.

**Changes in yields may harm the market price of our common stock.**

Our earnings are derived primarily from the expected positive spread between the yield on our assets and the cost of our borrowings. This spread will not necessarily be larger in high interest rate environments than in low interest rate environments and may also be negative. In addition, during periods of high interest rates, our net income, and therefore the amount of any distributions on our common stock, might be less attractive compared to alternative investments of equal or lower risk.

Each of these factors could harm the market price of our common stock.

**Terrorist attacks and other acts of violence or war may affect any market for our common stock, the industry in which we operate, our operations and our profitability.**

Terrorist attacks may harm our results of operations and your investment. We cannot assure you that there will not be further terrorist attacks against the United States or U.S. businesses. These attacks or armed conflicts may impact the property underlying our mortgage-backed securities directly or indirectly, by undermining economic conditions in the United States. Losses resulting from terrorist events are generally uninsurable.



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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our primary component of market risk is interest rate risk, as described below. While we do not seek to avoid risk completely, we do seek to assume risk that can be quantified from historical experience, to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

**Interest Rate Risk**

We are subject to interest rate risk in connection with our investments in fixed-rate, adjustable-rate and hybrid adjustable-rate mortgage-backed securities and our related debt obligations, which are generally repurchase agreements of limited duration that are periodically refinanced at current market rates, and our derivative contracts.

*Effect on Net Interest Income*

We fund our investments in some long-term, fixed-rate and hybrid adjustable-rate mortgage-backed securities with short-term borrowings under repurchase agreements. During periods of rising interest rates, the borrowing costs associated with those fixed-rate and hybrid-adjustable rate mortgage-backed securities tend to increase while the income earned on such fixed-rate and hybrid adjustable-rate mortgage-backed securities (during the fixed-rate component of such securities) may remain substantially unchanged. This results in a narrowing of the net interest spread between the related assets and borrowings and may even result in losses.

As a means to mitigate the negative impact of a rising interest rate environment, we have entered into derivative transactions, specifically Eurodollar futures contracts. Hedging techniques are based, in part, on assumed levels of prepayments of our fixed-rate and hybrid adjustable-rate mortgage-backed securities. If prepayments are slower or faster than assumed, the life of the mortgage-backed securities will be longer or shorter which would reduce the effectiveness of any hedging strategies we may utilize and may result in losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns. Our hedging activity will also be limited by the asset and sources-of-income requirements applicable to us as a REIT.

*Extension Risk*

We invest in fixed-rate and hybrid adjustable-rate mortgage-backed securities. Hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan-typically three, five, seven or 10 years-and thereafter their interest rates reset periodically on the same basis as adjustable-rate mortgage-backed securities. As of March 31, 2004, 94.6% of our investment portfolio was comprised of hybrid adjustable-rate mortgage-backed securities. We compute the projected weighted-average life of our fixed-rate and hybrid adjustable-rate mortgage-backed securities based on the market's assumptions regarding the rate at which the borrowers will prepay the underlying mortgages. In general, when a fixed-rate or hybrid adjustable-rate mortgage-backed security is acquired with borrowings, we may, but are not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes our borrowing costs for a period close to the anticipated average life of the fixed-rate portion of the related mortgage-backed security. This strategy is designed to protect us from rising interest rates because the borrowing costs are fixed for the duration of the fixed-rate portion of the related mortgage-backed security. However, if prepayment rates decrease in a rising interest rate environment, the life of the fixed-rate portion of the related mortgage-backed security could extend beyond the term of the swap agreement or other hedging instrument. This situation could negatively impact us as borrowing costs would no longer be fixed after the end of the hedging instrument while the income earned on the fixed-rate or hybrid adjustable-rate mortgage-backed security would remain fixed. This situation may also cause the market value of our fixed-rate and hybrid adjustable-rate mortgage-backed securities to decline with little or no offsetting gain from the related hedging

transactions. In extreme situations, we may be forced to sell assets and incur losses to maintain adequate liquidity.

**Table of Contents***Adjustable-Rate and Hybrid Adjustable-Rate Mortgage-Backed Security Interest Rate Cap Risk*

We also invest in adjustable-rate and hybrid adjustable-rate mortgage-backed securities which are based on mortgages that are typically subject to periodic and lifetime interest rate caps and floors, which limit the amount by which an adjustable-rate or hybrid adjustable-rate mortgage-backed security's interest yield may change during any given period. However, our borrowing costs pursuant to our repurchase agreements will not be subject to similar restrictions. Therefore, in a period of increasing interest rates, interest rate costs on our borrowings could increase without limitation by caps, while the interest-rate yields on our adjustable-rate and hybrid adjustable-rate mortgage-backed securities would effectively be limited by caps. This problem will be magnified to the extent we acquire adjustable-rate and hybrid adjustable-rate mortgage-backed securities that are not based on mortgages which are fully-indexed. In addition, the underlying mortgages may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. This could result in our receipt of less cash income on our adjustable-rate and hybrid adjustable-rate mortgage-backed securities than we need in order to pay the interest cost on our related borrowings. These factors could lower our net interest income or cause a net loss during periods of rising interest rates, which would negatively impact our financial condition, cash flows and results of operations.

*Interest Rate Mismatch Risk*

We intend to fund a substantial portion of our acquisitions of adjustable-rate and hybrid adjustable-rate mortgage-backed securities with borrowings that have interest rates based on indices and repricing terms similar to, but of somewhat shorter maturities than, the interest rate indices and repricing terms of the mortgage-backed securities. Thus, we anticipate that in most cases the interest rate indices and repricing terms of our mortgage assets and our funding sources will not be identical, thereby creating an interest rate mismatch between assets and liabilities. Therefore, our cost of funds would likely rise or fall more quickly than would our earnings rate on assets. During periods of changing interest rates, such interest rate mismatches could negatively impact our financial condition, cash flows and results of operations. To mitigate interest rate mismatches, we may utilize hedging strategies discussed above.

Our analysis of risks is based on management's experience, estimates, models and assumptions. These analyses rely on models which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of investment decisions by our management may produce results that differ significantly from the estimates and assumptions used in our models and the projected results shown in this report.

*Prepayment Risk*

Prepayments are the full or partial repayment of principal prior to the original term to maturity of a mortgage loan and typically occur due to refinancing of mortgage loans. Prepayment rates for existing mortgage-backed securities generally increase when prevailing interest rates fall below the market rate existing when the underlying mortgages were originated. In addition, prepayment rates on adjustable-rate and hybrid adjustable-rate mortgage-backed securities generally increase when the difference between long-term and short-term interest rates declines or becomes negative. Prepayments of mortgage-backed securities could harm our results of operations in several ways. Some adjustable-rate mortgages underlying our adjustable-rate mortgage-backed securities may bear initial "teaser" interest rates that are lower than their "fully-indexed" rates, which refers to the applicable index rates plus a margin. In the event that such an adjustable-rate mortgage is prepaid prior to or soon after the time of adjustment to a fully-indexed rate, the holder of the related mortgage-backed security would have held such security while it was less profitable and lost the opportunity to receive interest at the fully-indexed rate over the expected life of the adjustable-rate mortgage-backed security. Although we currently do not own any adjustable-rate mortgage-backed securities with "teaser" rates, we may obtain some in the future which would expose us to this prepayment risk. Additionally, we

currently own mortgage-backed securities that were purchased at a premium. The prepayment of such mortgage-backed securities at a rate faster than anticipated would result in a write-off of any remaining capitalized premium amount and a consequent reduction of our net interest income by such amount. Finally, in the event that we are unable to acquire new mortgage-backed securities to replace the prepaid mortgage-backed securities, our financial condition, cash flow and results of operations could be negatively impacted.

**Table of Contents***Effect on Fair Value*

Another component of interest rate risk is the effect changes in interest rates will have on the market value of our assets. We face the risk that the market value of our assets will increase or decrease at different rates than that of our liabilities, including our hedging instruments.

We primarily assess our interest rate risk by estimating the duration of our assets and the duration of our liabilities. Duration essentially measures the market price volatility of financial instruments as interest rates change. We generally calculate duration using various financial models and empirical data. Different models and methodologies can produce different duration numbers for the same securities.

The following sensitivity analysis table shows the estimated impact on the fair value of our interest rate-sensitive investments and repurchase agreement liabilities, at March 31, 2004, assuming rates instantaneously fall 100 basis points, rise 100 basis points and rise 200 basis points:

	<b>Interest Rates Fall 100 Basis Points</b>	<b>Unchanged</b>	<b>Interest Rates Rise 100 Basis Points</b>	<b>Interest Rates Rise 200 Basis Points</b>
(in millions)				
<b>Adjustable-Rate Mortgage-Backed Securities</b>				
Fair value	\$ 166.4	\$ 166.3	\$ 165.8	\$ 165.4
Change in fair value	\$ 0.1		\$ (0.5)	\$ (0.9)
Change as a percent of fair value	0.1%		(0.3)%	(0.5)%
<b>Hybrid Adjustable-Rate Mortgage-Backed Securities</b>				
Fair value	\$3,892.8	\$3,850.0	\$3,784.2	\$3,712.3
Change in fair value	\$ 42.8		\$ (65.8)	\$ (137.7)
Change as a percent of fair value	1.1%		(1.7)%	(3.6)%
<b>Balloon Mortgage-Backed Securities</b>				
Fair value	\$ 56.3	\$ 55.1	\$ 52.6	\$ 53.2
Change in fair value	\$ 1.2		\$ (1.5)	\$ (1.9)
Change as a percent of fair value	2.2%		(2.7)%	(3.4)%
<b>Total Mortgage-Backed Securities</b>				
Fair value	\$4,115.5	\$4,071.4	\$4,003.6	\$3,930.9
Change in fair value	\$ 44.1		\$ (67.8)	\$ (140.5)
Change as a percent of fair value	1.1%		(1.7)%	(3.5)%
<b>Repurchase Agreements (1)</b>				
Fair value	\$2,695.8	\$2,695.8	\$2,695.8	\$2,695.8
Change in fair value				
Change as a percent of fair value				
<b>Hedge Instruments</b>				
Fair value	\$ (27.4)	\$ (3.4)	\$ 20.6	\$ 44.6
Change in fair value	\$ (24.0)		\$ 24.0	\$ 48.0

Change as a percent of fair value	n/m	n/m	n/m
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(1) The fair value of the repurchase agreements would not change materially due to the short-term nature of these instruments.

n/m = not meaningful

It is important to note that the impact of changing interest rates on fair value can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the fair value of our assets could increase significantly when interest rates change beyond 100 basis points. In addition, other factors impact the fair value of our interest rate-sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, in the event of changes in actual interest rates, the change in the fair value of our assets would likely differ from that shown above, and such difference might be material and adverse to our stockholders.

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### *Risk Management*

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

monitoring and adjusting, if necessary, the reset index and interest rate related to our mortgage-backed securities and our borrowings;

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

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

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

## **ITEM 4. CONTROLS AND PROCEDURES**

As of March 31, 2004, our principal executive officer and our principal financial officer have performed an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, or Exchange Act,) and concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission, or SEC, rules and forms. These officers have also concluded that there were no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting.

## **PART II**

### **OTHER INFORMATION**

#### **ITEM 1. LEGAL PROCEEDINGS**

At March 31, 2004, there were no pending legal proceedings to which we were party or of which any of our properties were subject.

#### **ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF SECURITIES**

##### **Use of Proceeds from Registered Securities**

In December 2003, we completed an initial public offering of 13,110,000 shares common stock, \$0.001 par value at an offering price of \$13.00 per share, including the exercise by the underwriter of its over-allotment option to purchase 1,710,000 shares of common stock. Our registration statement was declared effective by the SEC on December 18, 2003 (Registration No. 333-107984). We received aggregate gross offering proceeds of \$170.4 million

from these transactions and paid aggregate underwriting commissions of \$11.9 million. Aggregate other offering costs paid totaled \$1.5 million. Net offering proceeds after deducting underwriting commissions and other offering costs was \$157.0 million. At March 31, 2004, all of the net offering proceeds had been used to purchase mortgage-backed securities.



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ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

**(a) Exhibits**

The exhibits listed on the Exhibit Index (following the Signatures section of this report) are included, or incorporated by reference, in this Quarterly Report on Form 10-Q.

**(b) Reports on Form 8-K**

On January 26, 2004, we filed a Current Report on Form 8-K under Item 7, and furnished information to the SEC on such report under Item 12, to announce the issuance of our press release regarding our financial results for the fourth quarter of 2003 and for the period from April 26, 2003 through December 31, 2003. The information provided on such report shall not be deemed filed for the purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liabilities of that Section.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LUMINENT MORTGAGE CAPITAL, INC.  
(Registrant)

By: /s/ GAIL P. SENECA

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Gail P. Seneca  
Chief Executive Officer  
(Principal Executive Officer)

Date: May 7, 2004

By: /s/ CHRISTOPHER J. ZYDA

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Christopher J. Zyda  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

Date: May 7, 2004

**Table of Contents****EXHIBIT INDEX**

Pursuant to Item 601(a)(2) of Regulation S-K, this exhibit index immediately precedes the exhibits.

The following exhibits are included, or incorporated by reference, in this Quarterly Report on Form 10-Q and are numbered in accordance with Item 601 of Regulation S-K.

<b>Exhibit Number</b>	<b>Description</b>
3.1	Articles of Amendment and Restatement (1)
3.2	Articles Supplementary (2)
3.3	Amended and Restated Bylaws (1)
3.4	Second Amended and Restated Bylaws (1)
4.1	Form of Common Stock Certificate (1)
4.2	Registration Rights Agreement, dated as of June 11, 2003, by and between the Registrant and Friedman, Billings, Ramsey & Co., Inc. (for itself and for the benefit of the holders from time to time of registrable securities issued in the Registrant's June 2003 private offering) (1)
10.1	Management Agreement, dated as of June 11, 2003, by and between the Registrant and Seneca Capital Management LLC ( Seneca ) (1)
10.2	Cost-Sharing Agreement, dated as of June 11, 2003, by and between the Registrant and Seneca (1)
10.3	2003 Stock Incentive Plan (1)
10.4	Form of Incentive Stock Option under the 2003 Stock Incentive Plan (1)
10.5	Form of Non Qualified Stock Option under the 2003 Stock Incentive Plan (1)
10.6	2003 Outside Advisors Stock Incentive Plan of the Registrant (1)
10.7	Form of Non Qualified Stock Option under the 2003 Outside Advisors Stock Incentive Plan (1)
10.8	Form of Indemnity Agreement (1)
10.9	Employment Agreement dated as of August 4, 2003 by and between the Registrant and Christopher J. Zyda (1)
10.10	Form of Restricted Stock Award Agreement for Christopher J. Zyda (1)
10.11	Form of Restricted Stock Award Agreement for Seneca (3)

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- 31.1\* Rule 13a-14(a)/15d-14(a) Certification of Gail P. Seneca, Chief Executive Officer of the Registrant
  - 31.2\* Rule 13a-14(a)/15d-14(a) Certification of Christopher J. Zyda, Chief Financial Officer of the Registrant
  - 32.1\* Section 1350 Certification of Gail P. Seneca, Chief Executive Officer of the Registrant
  - 32.2\* Section 1350 Certification of Christopher J. Zyda, Chief Financial Officer of the Registrant
- (1) Incorporated by reference from our Registration Statement on Form S-11 (Registration No. 333-107984) which became effective under the Securities Act of 1933, as amended, on December 18, 2003.
  - (2) Incorporated by reference from our Current Report on Form 8-K filed on December 23, 2003.
  - (3) Incorporated by reference from our Registration Statement on Form S-11 (Registration No. 333-107981) which became effective under the Securities Act of 1933, as amended, on February 13, 2004.

\* Filed herewith.

Denotes a management contract or compensatory plan.