DYNEX CAPITAL INC
Form 10-K
March 16, 2009

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

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2008

or

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

For the transition period from _______________ to _______________

Commission file number 1-9819

DYNEX CAPITAL, INC.
(Exact name of registrant as specified in its charter)

Virginia (State or other jurisdiction of incorporation or organization)	52-1549373 (I.R.S. Employer Identification No.)
4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia (Address of principal executive offices)	23060 (Zip Code)

(804) 217-5800
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.01 par value	New York Stock Exchange
Series D 9.50% Cumulative Convertible Preferred Stock, $.01 par value	New York Stock Exchange

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.
Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.
Yes o No þ

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 þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	o	Accelerated filer	þ
Non-accelerated filer	o (Do not check if a smaller reporting company)	Smaller reporting company	o

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

As of June 30, 2008, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $86,604,355 based on the closing sales price on the New York Stock Exchange of $8.80.

Common stock outstanding as of February 28, 2009 was 12,169,762 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Definitive Proxy Statement for the registrant's 2009 annual meeting of shareholders, expected to be filed pursuant to Regulation 14A within 120 days from December 31, 2008, are incorporated by reference into Part III.

DYNEX CAPITAL, INC.
2008 FORM 10-K ANNUAL REPORT

TABLE OF CONTENTS

i

CAUTIONARY STATEMENT – This annual report on Form 10-K may contain "forward-looking" statements within the meaning of Section 27A of the Securities Act of 1933, as amended (or "1933 Act"), and Section 21E of the Securities Exchange Act of 1934, as amended. We caution that any such forward-looking statements made by us are not guarantees of future performance and that actual results may differ materially from those in such forward-looking statements. Some of the factors that could cause actual results to differ materially from estimates contained in our forward-looking statements are set forth in this annual report on Form 10-K for the year ended December 31, 2008. See Item 1A, "Risk Factors" and "Forward-Looking Statements" set forth in Item 7, "Managements Discussion and Analysis of Financial Condition and Results of Operations" of this annual report on Form 10-K.

In this annual report on Form 10-K, we refer to Dynex Capital, Inc. and its subsidiaries as "we," "us," or "our," unless we specifically state otherwise or the context indicates otherwise. The following defines certain of the commonly used terms in this annual report on Form 10-K: MBS refers to residential mortgage-backed securities; CMBS refers to commercial mortgage-backed securities; Agency MBS refers to our MBS that are issued or guaranteed by a federally chartered corporation, such as Fannie Mae or Freddie Mac, or an agency of the U.S. government, such as Ginnie Mae; Hybrid ARMs refers to ARMs that have interest rates that are fixed for a specified period of time and, thereafter, generally adjust annually to an increment over a specified interest rate index; ARMs refers to adjustable-rate mortgage loans which typically have interest rates that adjust annually to an increment over a specified interest rate index, which includes Hybrid ARMs; and ARM-MBS refers to MBS that are secured by ARMs. Hybrid ARMs are identified by their initial fixed-rate and adjustable-rate periods. The date that a Hybrid ARM shifts from a fixed-rate payment schedule to an adjustable-rate payment schedule is known as the reset date.

PART I

ITEM 1. BUSINESS

Our Business

We are a specialty finance company organized as a real estate investment trust, or REIT, which invests in mortgage loans and securities on a leveraged basis. We were incorporated in Virginia on December 18, 1987 and commenced operations in February 1988. We invest in residential mortgage-backed securities, or MBS, issued or guaranteed by a federally chartered corporation, such as Federal National Mortgage Corporation, or Fannie Mae, or Federal Home Loan Mortgage Corporation, or Freddie Mac, or an agency of the U.S. government, such as Government National Mortgage Association, or Ginnie Mae. MBS issued or guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae are commonly referred to as "Agency MBS". We initiated our Agency MBS strategy during the first quarter of 2008.

We are also invested in securitized residential and commercial mortgage loans, non-agency mortgage-backed securities, or non-Agency MBS, and, through a joint venture, commercial mortgage-backed securities ("CMBS"). Substantially all of these loans and securities, including those owned by the joint venture, consist of, or are secured by, first lien mortgages which were originated by us from 1992 to 1998. We are no longer originating loans.

We have generally financed our investments through a combination of repurchase agreements, securitization financing, and equity capital. We employ leverage in order to increase the overall yield on our invested capital. Our primary source of income is net interest income, which is the excess of the interest income earned on our investments over the cost of financing these investments. We may occasionally sell investments prior to their maturity.

As a REIT, we are required to distribute to shareholders as dividends at least 90% of our taxable income, which is our income as calculated for tax, after consideration of any tax net operating loss, or NOL, carryforwards. We had an NOL carryforward of approximately $150 million at December 31, 2007. We have not completed our tax return for the year ended December 31, 2008, but we do not believe there will be a material change in the balance of our NOL. These NOLs were principally generated during 1999 and 2000 and do not begin to meaningfully expire until 2019. Provided that we do not experience an ownership shift as defined under Section 382 of the Internal Revenue Code, or Code, we may utilize the NOLs to offset portions of our distribution requirements for our REIT taxable income with certain limitations. If we do incur an ownership shift under Section 382 of the Code then the use of the NOLs to offset REIT distribution requirements may be limited. We also have a taxable REIT subsidiary which has an NOL carryforward of approximately $4 million at December 31, 2008. For further discussion, see "Federal Income Tax Considerations."

Investment Strategy

With respect to our investment in Agency MBS, we invest in Hybrid Agency ARMs and Agency ARMs (both defined below) and, to a lesser extent, fixed-rate Agency MBS. At December 31, 2008, we had approximately $218.1 million in Hybrid Agency ARMs and approximately $93.4 million in Agency ARMs. Our Agency MBS portfolio collateralized approximately $274.2 million in repurchase agreement borrowings as of December 31, 2008 used to finance their purchase as discussed further below.

Hybrid ARMs are MBS securities collateralized by hybrid adjustable mortgage loans, which have a fixed rate of interest for a specified period (typically three to ten years) and which then adjust their interest rate at least annually to an increment over a specified interest rate index. Hybrid Agency ARMs are Hybrid ARMs that are issued or guaranteed by a federally chartered corporation or an agency of the U.S. government. Agency ARMs are MBS securities collateralized by adjustable rate mortgage loans which have interest rates that generally will adjust at least annually to an increment over a specified interest rate index. Agency ARMs may be collateralized by Hybrid Agency ARMs that are past their fixed rate periods.

Interest paid on Agency MBS is based on the interest paid by the underlying mortgage loans. Interest rates on the adjustable rate loans collateralizing the Hybrid Agency ARMs or Agency ARMs are based on specific index rates, such as the one-year constant maturity treasury, or CMT rate, the London Interbank Offered Rate, or LIBOR, the Federal Reserve U.S. 12-month cumulative average one-year CMT, or MTA, or the 11th District Cost of Funds Index, or COFI. These loans will typically have interim and lifetime caps on interest rate adjustments, or interest rate caps, limiting the amount that the rates on these loans may reset in any given period.

We also have investments in securitized commercial mortgage and single-family residential loans previously originated by us from 1992 to 1998. At December 31, 2008, we had $172.0 million in securitized commercial mortgage loans and $71.9 million in securitized single-family mortgage loans. These mortgage loans represent first lien interests in commercial and single-family properties, are highly seasoned, and are pledged as collateral to support securitization financing. The commercial mortgage loans carried an average fixed rate of 8.3% at December 31, 2008. The single-family mortgage loans are predominantly variable rate based primarily on a spread to six month LIBOR. At December 31, 2008, the weighted average coupon on the single-family mortgage loans was 6.85%. As discussed below, we have the option to redeem the associated securitization financing under certain conditions and we have exercised this right in the past when economically beneficial to us. As of December 31, 2008, approximately $18.3 million in securitization financing was redeemable by us.

We also have other investments in non-Agency MBS, equity securities, and an investment in a joint-venture which owns CMBS which were issued by us in 1997 and 1998. The total of these investments was $15.5 million at December 31, 2008. The joint venture owns the right to redeem at par in whole or in part $193.7 million in commercial mortgage backed securities issued in 1998 beginning in February 2009. Approximately $124.3 million of these securities were rated 'AAA' by at least one of the nationally recognized ratings agency as of December 31, 2008. The current economic and market conditions make it unfeasible to redeem these bonds, and any future decision on whether to redeem these bonds will be based on the economic and market conditions at that time. The termination date for our investment in the joint venture is April 15, 2009, unless otherwise extended by the parties. We are currently working with our joint venture partner to determine what actions to take with regard to the joint venture. If the joint venture is terminated, we may purchase certain assets from the joint venture in connection with its termination.

Our new investment activity for 2008 was principally in Agency MBS. We expect to continue to invest in Agency MBS for the foreseeable future. We may also invest in non-Agency MBS or CMBS depending on the nature and risks of the investment, its expected return and future economic and market conditions. Where economically beneficial to us, we may also invest additional capital in our securitized mortgage loan pools by redeeming the associated securitization financing in whole or in part.

Financing Strategy

Agency MBS

We generally finance our acquisition of Agency MBS by borrowing against a substantial portion of the market value of these assets utilizing repurchase agreements. Repurchase agreements are financings under which we pledge our Agency MBS as collateral to secure loans made by repurchase agreement counterparties (i.e., lenders). The amount borrowed under a repurchase agreement is limited to a specified percentage of the estimated market value of the pledged collateral generally between 90% and 95%. The difference between the market value of the pledged collateral and the amount of the repurchase agreement is referred to as our margin, and which is intended to provide the lender some protection against fluctuations of value in the collateral and/or the failure by us to repay the borrowing. Under our repurchase agreements, a lender may require that we pledge additional assets, by initiating a margin call, if the fair value of our existing pledged collateral declines below a required margin amount during the term of the borrowing. The required margin amount varies depending on the specific terms of a particular repurchase agreement. Our pledged collateral fluctuates in value primarily due to principal payments and changes in market interest rates, prevailing market yields, actual or anticipated prepayment speeds and other market conditions. Lenders may also initiate margin calls during periods of market stress. If we fail to meet any margin call, our lenders have the right to terminate the repurchase agreement and sell the collateral pledged. We generally expect to maintain an effective debt to equity capital ratio of between five and nine times our equity capital invested in Agency MBS, although the ratio may vary from time to time depending upon market conditions and other factors.

Repurchase agreement borrowings generally will have a term of between one and three months and carry a rate of interest based on a spread to an index, such as LIBOR. Repurchase agreement financing is provided principally by major financial institutions and major broker-dealers. A significant source of liquidity for the repurchase agreement market is money market funds which provide collateral based lending to the financial institutions and broker-dealer community which in turn is provided to the repurchase agreement market. In order to reduce our exposure to counterparty-related risk, we generally seek to diversify our exposure by entering into repurchase agreements with multiple lenders. At December 31, 2008, we had a maximum net exposure (the difference between the amount loaned to us, including interest payable, and the value of the securities pledged by us as collateral, including accrued interest receivable on such securities) to any single repurchase agreement lender of $5.5 million.

Interest rates on Agency MBS assets will not reset as frequently as the interest rates on repurchase agreement borrowings. As a result, we are exposed to reductions in our net interest income earned during a period of rising rates. In an effort to protect our net interest income during a period of rising interest rates, we would attempt to extend the interest rate reset dates on our repurchase agreement borrowings. In addition, in a period of rising rates we may experience a decline in the carrying value of our Agency MBS, which would impact our shareholders’ equity and common book value per share. In an effort to protect our book value per common share as well as our net interest income during a period of rising rates, we may utilize derivative financial instruments such as interest rate swap agreements. An interest rate swap agreement would allow us to fix the borrowing cost on a portion of our repurchase agreement financing for a specified period of time. We currently have no interest rate swaps outstanding.

We may also use interest rate cap agreements. An interest rate cap agreement is a contract whereby we, as the purchaser, pay a fee in exchange for the right to receive payments equal to the principal (i.e., notional amount) times the difference between a specified interest rate and a future interest rate during a defined “active” period of time. Interest rate cap agreements should mitigate declines in our net interest income in a rapidly rising interest rate environment.

In the future, we may use other sources of funding in addition to repurchase agreements to finance our Agency MBS portfolio, including but not limited to, other types of collateralized borrowings, loan agreements, lines of credit, commercial paper or the issuance of equity or debt securities.

Securitized Mortgage Loans

We have financed our securitized mortgage loans with securitization financing issued by us to third parties. Securitization financing is collateralized by pools of the mortgage loans, and principal and interest payments received on the loans is used to make principal and interest payments on the securitization financing. Securitization financing is non-recourse to us and is paid only by amounts received on the loans. As of December 31, 2008, approximately $150 million of securitization financing carried a fixed-rate of interest and approximately $28 million carried a variable-rate of interest which resets monthly based on a spread to LIBOR. Generally we will have the right to redeem the financing at its current outstanding balance after a certain date or once the financing reaches a certain percentage of its original issued balance. At December 31, 2008, we had the right to redeem $18.3 million in securitization financing bonds collateralized by commercial mortgage loans. The current weighted average interest rate on this financing is 6.76%, and payment for the most senior class, which had a principal balance of $17.3 million at December 31, 2008, is guaranteed by Fannie Mae for which we pay an annual fee of 0.32%. We may use repurchase agreements to finance the redemption of securitization financing.

Competition

The financial services industry is a highly competitive market in which we compete with a number of institutions with greater financial resources. In purchasing portfolio investments, we compete with other mortgage REITs, investment banking firms, savings and loan associations, commercial banks, mortgage bankers, insurance companies, federal agencies and other entities, many of which have greater financial resources and a lower cost of capital than we do. Increased competition in the market and our competitors greater financial resources have adversely affected us and may continue to do so. Competition may also continue to keep pressure on spreads resulting in us being unable to reinvest our capital on an acceptable risk-adjusted basis.

Moreover, the U.S. Treasury announced a program to purchase Fannie Mae-guaranteed and Freddie Mac-guaranteed securities in the open market pursuant to a congressional authority that expires December 31, 2009. The size and timing of the purchases are in the discretion of the U.S. Treasury Secretary and will be based on developments in the capital markets and housing markets. In addition, on November 25, 2008, the Federal Reserve announced that it will initiate a program to purchase $500.0 billion in MBS backed by Fannie Me, Freddie Mac and Ginnie Mae. The purchases began in early January 2009. One of the effects of these programs has been, and may continue to be, to increase the price of Agency MBS and thereby decrease our net interest margin with respect to any Agency MBS we buy in the future.

AVAILABLE INFORMATION

Our website can be found at www.dynexcapital.com. Our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K, and amendments to those reports, filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”) are made available, as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission (“SEC”), free of charge through our website.

We have adopted a Code of Business Conduct and Ethics (“Code of Conduct”) that applies to all of our employees, officers and directors. Our Code of Conduct is also available, free of charge, on our website, along with our Audit Committee Charter, our Nominating and Corporate Governance Committee Charter, and our Compensation Committee Charter. We will post on our website amendments to the Code of Conduct or waivers from its provisions, if any, which are applicable to any of our directors or executive officers in accordance with SEC or NYSE requirements.

FEDERAL INCOME TAX CONSIDERATIONS

We believe that we have complied with the requirements for qualification as a REIT under the Internal Revenue Code (the “Code”). The REIT rules generally require that a REIT invest primarily in real estate-related assets, that our activities be passive rather than active and that we distribute annually to our shareholders substantially all of our taxable income, after certain deductions, including deductions for NOL carryforwards. We could be subject to income tax if we failed to satisfy those requirements or if we acquired certain types of income-producing real property. We use the calendar year for both tax and financial reporting purposes. There may be differences between taxable income and income computed in accordance with generally accepted accounting principles in the United States of America (“GAAP”). These differences primarily arise from timing differences in the recognition of revenue and expense for tax and GAAP purposes. We currently have net operating loss (“NOL”) carryforwards of approximately $150 million, which expire between 2019 and 2025. We also had excess inclusion income of approximately $0.5 million for 2008 from our ownership of certain residual interests in real estate mortgage investment conduits (“REMIC”). Excess inclusion income from REMICs cannot be offset by NOL carryforwards, so in order to meet REIT distribution requirements, we must distribute all of our REMIC excess inclusion income.

Failure to satisfy certain Code requirements could cause us to lose our status as a REIT. If we failed to qualify as a REIT for any taxable year, we may be subject to federal income tax (including any applicable alternative minimum tax) at regular corporate rates and would not receive deductions for dividends paid to shareholders. We could, however, utilize our NOL carryforwards to offset any taxable income. In addition, given the size of our NOL carryforwards, we could pursue a business plan in the future in which we would voluntarily forego our REIT status. If we lost or otherwise surrendered our status as a REIT, we could not elect REIT status again for five years. Several of our investments in securitized mortgage loans have ownership restrictions limiting their ownership to REITs. Therefore, if we chose to forego our REIT status, we would have to sell these investments or otherwise provide for REIT ownership of these investments.

We also have a taxable REIT subsidiary ("TRS"), which has a NOL carryforward of approximately $4 million. The TRS has limited operations, and, accordingly, we have established a full valuation allowance for the related deferred tax asset.

Qualification as a REIT

Qualification as a REIT requires that we satisfy a variety of tests relating to our income, assets, distributions and ownership. The significant tests are summarized below.

Sources of Income. To continue qualifying as a REIT, we must satisfy two distinct tests with respect to the sources of our income: the "75% income test" and the "95% income test." The 75% income test requires that we derive at least 75% of our gross income (excluding gross income from prohibited transactions) from certain real estate-related sources. In order to satisfy the 95% income test, 95% of our gross income for the taxable year must consist of either income that qualifies under the 75% income test or certain other types of passive income.

If we fail to meet either the 75% income test or the 95% income test, or both, in a taxable year, we might nonetheless continue to qualify as a REIT, if our failure was due to reasonable cause and not willful neglect and the nature and amounts of our items of gross income were properly disclosed to the Internal Revenue Service. However, in such a case we would be required to pay a tax equal to 100% of any excess non-qualifying income.

Nature and Diversification of Assets. At the end of each calendar quarter, we must meet multiple asset tests. Under the "75% asset test", at least 75% of the value of our total assets must represent cash or cash items (including receivables), government securities or real estate assets. Under the "10% asset test," we may not own more than 10% of the outstanding voting power or value of securities of any single non-governmental issuer, provided such securities do not qualify under the 75% asset test or relate to taxable REIT subsidiaries. Under the "5% asset test," ownership of any stocks or securities that do not qualify under the 75% asset test must be limited, in respect of any single non-governmental issuer, to an amount not greater than 5% of the value of our total assets (excluding ownership of any taxable REIT subsidiaries.

If we inadvertently fail to satisfy one or more of the asset tests at the end of a calendar quarter, such failure would not cause us to lose our REIT status, provided that (i) we satisfied all of the asset tests at the close of the preceding calendar quarter and (ii) the discrepancy between the values of our assets and the standards imposed by the asset tests either did not exist immediately after the acquisition of any particular asset or was not wholly or partially caused by such an acquisition. If the condition described in clause (ii) of the preceding sentence was not satisfied, we still could avoid disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which it arose.

Ownership. In order to maintain our REIT status, we must not be deemed to be closely held and must have more than 100 shareholders. The closely held prohibition requires that not more than 50% of the value of our outstanding shares be owned by five or fewer persons at anytime during the last half of our taxable year. The more than 100 shareholders rule requires that we have at least 100 shareholders for 335 days of a twelve-month taxable year. In the event that we failed to satisfy the ownership requirements we would be subject to fines and be required to take curative action to meet the ownership requirements in order to maintain our REIT status.

EMPLOYEES

As of December 31, 2008, we had 13 employees, 12 of whom were located in our corporate offices in Glen Allen, Virginia. Our Chief Executive Officer, who serves as our Chairman and was appointed CEO on February 5, 2008, works from an office located in Sausalito, California. We believe our relationship with our employees is good. None of our employees are covered by any collective bargaining agreements, and we are not aware of any union organizing activity relating to our employees.

ITEM 1A. RISK FACTORS

Our business is subject to various risks, including those described below. Our business, operating results and financial condition could be materially and adversely affected by any of these risks. Please note that additional risks not presently known to us or that we currently deem immaterial could also impair our business, our operations and our results.

We rely on Fannie Mae and Freddie Mac as guarantors on MBS in which we invest. The federal conservatorship of Fannie Mae and Freddie Mac and related efforts may prove unsuccessful in stabilizing Fannie Mae and Freddie Mac, which may impact their ability to perform under the guaranty.

The payments we receive on the Agency MBS in which we invest depend upon payments on the mortgages underlying the MBS which are guaranteed by Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac are U.S. Government-sponsored entities, but their guarantees are not explicitly backed by the full faith and credit of the United States. Fannie Mae and Freddie Mac have recently reported substantial losses and a need for substantial amounts of additional capital. Such losses are due to these entities' business model being tied extensively to the U.S. housing market which is in a severe contraction. In response to the deteriorating financial condition of Fannie Mae and Freddie Mac from the U.S. housing market contraction, Congress and the U.S. Treasury have undertaken a series of actions to stabilize these entities. The Federal Housing Finance Agency, or FHFA, was established in July 2008 pursuant to the Regulatory Reform Act in an effort to enhance regulatory oversight over Fannie Mae and Freddie Mac. FHFA placed Fannie Mae and Freddie Mac into federal conservatorship in September 2008. As the conservator of Fannie Mae and Freddie Mac, the FHFA controls and directs the operations of Fannie Mae and Freddie Mac and may (1) take over the assets of and operate Fannie Mae and Freddie Mac with all the powers of the stockholders, the directors, and the officers of Fannie Mae and Freddie Mac and conduct all business of Fannie Mae and Freddie Mac; (2) collect all obligations and money due to Fannie Mae and Freddie Mac; (3) perform all functions of Fannie Mae and Freddie Mac which are consistent with the conservator's appointment; (4) preserve and conserve the assets and property of Fannie Mae and Freddie Mac; and (5) contract for assistance in fulfilling any function, activity, action or duty of the conservator.

In order to provide additional capital and to support the debt obligations issued by Fannie Mae and Freddie Mac, the U.S. Treasury and FHFA have entered into preferred stock purchase agreements between the U.S. Treasury and Fannie Mae and Freddie Mac, pursuant to which the U.S. Treasury will ensure that each of Fannie Mae and Freddie Mac maintains a positive net worth. Under this initiative, the U.S. Treasury has purchased or has committed to purchase $200 billion of preferred stock of both Fannie Mae and Freddie Mac. The U.S. Treasury also has established a new secured lending credit facility which will be available to Fannie Mae and Freddie Mac which is intended to serve as a liquidity backstop and which will be available until December 2009. Finally, the U.S. Treasury has initiated a temporary program to purchase securities issued or guaranteed by Fannie Mae and Freddie Mac, including Agency MBS.

Although the federal government has committed capital to Fannie Mae and Freddie Mac, there is no explicit guaranty of the obligations of these entities by the federal government and there can be no assurance that these credit facilities and other capital infusions will be adequate for their needs. If the financial support is inadequate, these companies could continue to suffer losses and could fail to honor their guarantees of payment on Agency MBS in which we invest.

The attempts to stabilize the U. S. housing and mortgage market may make the U.S. Treasury a direct competitor for mortgage assets and may prove unsuccessful.

In December 2008, the U.S. Treasury announced plans to begin purchasing Agency MBS. Thus far, the U.S. Treasury has not purchased Hybrid Agency ARMs or Agency ARMs. The announcement by the Treasury of its intention to purchase Agency MBS and the public statements made by representatives of the federal government are an attempt, we believe, to support lower mortgage rates. These actions have caused Agency MBS to increase in price, in some cases substantially, reducing the yield on these investments. The objective of these actions is to stabilize the U.S. housing market, which is undergoing a severe contraction, which has significantly destabilized institutions with significant capital investment in the U.S. housing and mortgage markets. The Treasury has not yet announced any intention to purchase Hybrid Agency ARMs or Agency ARMs; however, the announcement of the purchase program has created additional demand for all Agency MBS. The size and timing of the federal government's Agency MBS security purchase program is subject to the discretion of the Treasury, which has indicated that the scale of the program will be based on developments in the capital markets and housing markets. The Treasury's purchase of Hybrid Agency ARMs or Agency ARMs may adversely affect the pricing and availability of these securities, which would potentially impact our profitability.

The Treasury actions may be unsuccessful in stabilizing the housing and mortgage market, which could lead to higher volatility in Agency MBS and mortgage related assets in general. In addition, at some point the federal government may withdraw its support for the mortgage market which may cause Agency MBS prices to decline, perhaps severely. Since we pledge our Agency MBS as security for repurchase agreement financing which is based on the market value of such pledged assets, we may experience margin calls if prices decline as a result of continued instability in the housing and mortgage markets and/or the withdrawal of support from these markets by the federal government. This may force us to sell assets at a loss or at an otherwise inopportune time in order to meet margin calls or repay lenders.

The federal conservatorship of Fannie Mae and Freddie Mac may lead to structural changes in Agency RMBS and Fannie Mae and Freddie Mac which may adversely affect our business.

Currently Fannie Mae and Freddie Mac receive monthly payments based on the outstanding balance of the Agency MBS from the payments received on the underlying mortgage loans. Given the conservatorship of these entities, the payment structure on Agency MBS could change in the future, or the roles of Fannie Mae and Freddie Mac could be significantly reduced and the nature of their guarantees could be eliminated or considerably limited relative to historical amounts. Any changes to the nature of the guarantees provided by Fannie Mae and Freddie Mac could redefine what constitutes an Agency MBS and could have broad market implications.

Changes in guarantee payments or changes in the current credit support provided by the U.S. Treasury to Fannie Mae and Freddie Mac, and any additional credit support it may provide in the future, could, among other things, have the effect of lowering the interest income we expect to receive from Agency MBS that we acquire, thereby reducing the spread between the interest we earn on our portfolio of Agency MBS and our cost of financing that portfolio. A reduction in the supply of Agency MBS could also negatively affect the pricing of Agency securities we seek to acquire by reducing the spread between the interest we earn on our investments and our cost of financing those investments.

In addition, the U.S. Treasury could also stop providing credit support to Fannie Mae and Freddie Mac at some point in the future. The U.S. Treasury's authority to purchase Agency securities and to provide financial support to Fannie Mae and Freddie Mac under the Housing and Economic Recovery Act of 2008 expires on December 31, 2009. Following expiration of the current authorization, Fannie Mae and/or Freddie Mac could be dissolved and the federal government could stop providing liquidity or support of any kind to the mortgage market. If Fannie Mae or

Freddie Mac were dissolved, or if their current structures of providing liquidity to the secondary mortgage market were to change radically, it is possible that we would not be able to acquire Agency MBS in the future, which would eliminate a major component of our business model. In addition, Agency MBS which we own may experience volatile changes in market value.

As indicated above, recent legislation has changed the relationship between Fannie Mae and Freddie Mac and the federal government and requires Fannie Mae and Freddie Mac to reduce the amount of mortgage loans they own or for which they provide guarantees on Agency securities. Future legislation could further change the relationship between Fannie Mae and Freddie Mac and the federal government, and could also nationalize or eliminate such entities entirely. Any law affecting these government-sponsored enterprises may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by Fannie Mae or Freddie Mac. As a result, such laws could increase the risk of loss on investments in Fannie Mae and/or Freddie Mac Agency securities. It also is possible that such laws could adversely impact the market for such securities and spreads at which they trade. All of the foregoing could materially adversely affect our business, operations and financial condition.

There can be no assurance that the actions taken by the U.S. and foreign governments, central banks and other governmental and regulatory bodies for the purpose of seeking to stabilize the financial markets will achieve the intended effect or benefit our business, and further government or market developments could adversely affect us.

The previously discussed support being provided to Fannie Mae and Freddie Mac is part of a larger effort by the federal government to stabilize the U.S. and global financial markets. Other central banks and governmental and regulatory bodies around the world are also seeking to stabilize the financial markets. The U.S. federal government has taken a series of specific steps in an attempt to stabilize the financial markets, including direct purchases of assets, infusions of capital in financial institutions, including the purchase of obligations of troubled institutions, and the provision of liquidity and other backstops for institutions which support their operations by subsidizing their access to the world credit markets. In addition, the U.S. Treasury continues to examine the relative benefits of other measures, including purchasing illiquid mortgage-related assets and the creation of a “bad bank” which would purchase the illiquid assets of U.S. financial institutions and other actions.

These actions are intended to reduce the cost of, and increase the availability of, credit for the purchase of assets, which in turn should support the U.S. markets and foster improved conditions in financial markets more generally. In addition, these actions are intended to stabilize financial institutions which provide credit to U.S. and global financial markets.

There can be no assurance that the actions take by the U.S. and foreign governments, central banks, and/or other regulatory bodies will have a beneficial impact on the financial markets. To the extent the markets do not respond favorably to these actions or if they do not function as intended, there may be broad adverse market implications. Such actions could impact the prices of our investments, particularly Agency MBS, and may result in reduced credit availability from our lenders. In addition, U.S. and foreign governments, central banks and other governmental and regulatory bodies have taken or are considering taking other actions to address the financial crisis. We cannot predict whether or when such actions may occur or what affect, if any, such actions could have on our business, results of operations and financial condition.

Our business strategy involves the use of leverage, including short-term repurchase agreements. Changes to the availability and terms of this leverage may adversely affect the return on our investments, result in losses when conditions are unfavorable, and may reduce cash available for distribution to our shareholders.

We finance certain of our investments in part with repurchase agreement financing in order to enhance the overall returns on our invested capital. Repurchase agreement transactions are structured as the sale of securities to a lender in return for cash from the lender and are recourse to the collateral and to us. The lender is required at the end of the term of the transaction to resell the same security back to us. In each repurchase agreement transaction, we will sell the security to the lender at a price less than its fair value, and we agree to repurchase the security from the lender at the end of the term for the original sale price plus interest. Structurally the repurchase agreement transaction requires us to maintain a certain level of collateral relative to the amount of the related borrowings (e.g., the initial sale of the security at an amount below its fair value).

Though we attempt to carefully manage the amount of borrowing relative to the collateral and our committed capital, changes in the availability and cost of repurchase agreement borrowings could negatively impact our results. Such changes may occur as a result of (i) the increased market volatility/reduction in overall liquidity available to finance our investments, (ii) decreases in the market value of the investment, (iii) increases in interest rate volatility, or (iv) financial stress at one or more of our lenders. Our return on our assets and cash available for distribution to our shareholders may be reduced to the extent that changes in market conditions prevent us from leveraging our investments efficiently or cause the cost of our financing to increase relative to the income that can be derived from the leveraged assets. Such an event occurred in the fourth quarter of 2008 as the cost of our financing increased during the quarter as a result of rising global interest rates, particularly LIBOR. We believe that the increase in LIBOR during the fourth quarter resulted largely from the bankruptcy filing of Lehman Brothers and the subsequent impact on the global interbank credit markets.

In addition to interest rate volatility and rising financing costs, if the collateral pledged to support the repurchase agreement borrowing should fall below the level required by the lender, the lender could initiate a margin call. This would require that we either pledge additional collateral acceptable to the lender (typically cash or a highly liquid security such as Agency MBS) or repay a portion of the debt in order to meet the margin requirement. Should we be unable to meet a margin call, we may have to liquidate the collateral or other assets quickly. Because a margin call and quick sale could result in a lower than otherwise expected and attainable sale price, we may incur a loss on the sale of the collateral.

Adverse developments involving major financial institutions or one of our lenders could result in a rapid reduction in our ability to borrow and adversely affect our business and profitability.

Recent turmoil in the financial markets relating to major financial institutions has raised concerns that a material adverse development involving one or more major financial institutions could result in our lenders redu