

CAPSTEAD MORTGAGE CORP  
Form 10-Q  
May 09, 2014

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

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, 2014

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: 001-08896

CAPSTEAD MORTGAGE CORPORATION  
(Exact name of Registrant as specified in its Charter)

Maryland 75-2027937  
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

8401 North Central Expressway, Suite 800, Dallas, TX 75225  
(Address of principal executive offices) (Zip Code)

(214) 874-2323  
(Registrant's telephone number, including area code)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

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.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Common Stock (\$0.01 par value) 95,767,180 as of May 9, 2014

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CAPSTEAD MORTGAGE CORPORATION  
FORM 10-Q  
FOR THE QUARTER ENDED MARCH 31, 2014

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## ITEM 1. FINANCIAL STATEMENTS

## PART I. ¾ FINANCIAL INFORMATION

## CAPSTEAD MORTGAGE CORPORATION

## CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	March 31, 2014 (unaudited)	December 31, 2013
<b>Assets</b>		
Residential mortgage investments (\$13.22 and \$13.12 billion pledged under repurchase arrangements at March 31, 2014 and December 31, 2013, respectively)	\$ 13,529,211	\$ 13,475,874
Cash collateral receivable from interest rate swap counterparties	35,996	25,502
Interest rate swap agreements at fair value	1,207	5,005
Cash and cash equivalents	486,293	413,356
Receivables and other assets	89,112	96,231
	\$ 14,141,819	\$ 14,015,968
<b>Liabilities</b>		
Repurchase arrangements and similar borrowings	\$ 12,590,255	\$ 12,482,900
Interest rate swap agreements at fair value	15,439	11,304
Unsecured borrowings	100,000	100,000
Common stock dividend payable	33,636	30,872
Accounts payable and accrued expenses	23,900	25,109
	12,763,230	12,650,185
<b>Stockholders' equity</b>		
Preferred stock - \$0.10 par value; 100,000 shares authorized: 7.50% Cumulative Redeemable Preferred Stock, Series E, 6,917 and 6,861 shares issued and outstanding (\$172,922 and \$171,521 aggregate liquidation preference) at March 31, 2014 and December 31, 2013, respectively	167,092	165,756
Common stock - \$0.01 par value; 250,000 shares authorized: 95,767 and 95,807 shares issued and outstanding at March 31, 2014 and December 31, 2013, respectively	958	958
Paid-in capital	1,329,994	1,329,792
Accumulated deficit	(347,357 )	(349,866 )
Accumulated other comprehensive income	227,902	219,143
	1,378,589	1,365,783
	\$ 14,141,819	\$ 14,015,968

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF INCOME(in thousands, except per share amounts)  
(unaudited)

	Quarter Ended	
	March 31	
	2014	2013
Interest income:		
Residential mortgage investments	\$59,445	\$58,468
Other	61	112
	59,506	58,580
Interest expense:		
Repurchase arrangements and similar borrowings	(15,407)	(18,468)
Unsecured borrowings	(2,122 )	(2,187 )
	(17,529)	(20,655)
	41,977	37,925
Other revenue (expense):		
Salaries and benefits	(1,132 )	(1,001 )
Annual incentive compensation	(540 )	(554 )
Long-term incentive compensation	(626 )	(406 )
Other general and administrative expense	(1,203 )	(1,081 )
Miscellaneous other revenue (expense)	(85 )	(30 )
	(3,586 )	(3,072 )
Income before equity in earnings of unconsolidated affiliates	38,391	34,853
Equity in earnings of unconsolidated affiliates	–	65
Net income	\$38,391	\$34,918
Net income available to common stockholders:		
Net income	\$38,391	\$34,918
Less dividends on preferred shares	(3,238 )	(5,270 )
	\$35,153	\$29,648
Net income per common share:		
Basic	\$0.37	\$0.31
Diluted	0.37	0.31
Weighted average common shares outstanding:		
Basic	95,349	95,020
Diluted	95,538	95,450
Cash dividends declared per share:		
Common	\$0.34	\$0.31
Series A Preferred	–	0.40
Series B Preferred	–	0.32
Series E Preferred	0.47	–

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, unaudited)

	Quarter Ended	
	March 31	
	2014	2013
Net income	\$38,391	\$34,918
Other comprehensive income		
Amounts related to available-for-sale securities:		
Change in net unrealized gains	16,693	(7,705 )
Amounts related to cash flow hedges:		
Change in net unrealized losses	(12,656)	2,479
Reclassification adjustment for amounts included in net income	4,722	5,434
	8,759	208
Comprehensive income	\$47,150	\$35,126

See accompanying notes to consolidated financial statements.

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Quarter Ended March 31	
	2014	2013
Operating activities:		
Net income	\$38,391	\$34,918
Noncash items:		
Amortization of investment premiums	22,288	28,399
Depreciation and other amortization	37	47
Amortization of equity-based awards	718	512
Change in measurable hedge ineffectiveness related to interest rate swap agreements designated as cash flow hedges	–	(138 )
Net change in receivables, other assets, accounts payable and accrued expenses	(37 )	(499 )
Net cash provided by operating activities	61,397	63,239
Investing activities:		
Purchases of residential mortgage investments	(669,003 )	(839,897 )
Interest receivable acquired with the purchase of residential mortgage investments	(1,121 )	(1,495 )
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	617,074	819,023
Net cash used in investing activities	(53,050 )	(22,369 )
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	31,981,126	34,947,671
Principal payments on repurchase arrangements and similar borrowings	(31,873,771)	(34,910,386)
(Increase) decrease in cash collateral receivable from interest rate swap counterparties	(10,494 )	9,739
Common share repurchases	–	(7,292 )
Proceeds from issuance of preferred shares	1,336	–
Other capital stock transactions	(512 )	(521 )
Dividends paid	(33,095 )	(34,016 )
Net cash provided by financing activities	64,590	5,195
Net change in cash and cash equivalents	72,937	46,065
Cash and cash equivalents at beginning of period	413,356	425,445
Cash and cash equivalents at end of period	\$486,293	\$471,510

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
MARCH 31, 2014  
(unaudited)

NOTE 1 ¾ BUSINESS

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a "REIT") and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as "Capstead" or the "Company." Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage ("ARM") securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac (together, the "GSEs"), or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by the GSEs or Ginnie Mae, referred to as "Agency Securities," are considered to have limited, if any, credit risk.

NOTE 2 ¾ BASIS OF PRESENTATION

Interim Financial Reporting and Reclassifications

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter ended March 31, 2014 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2014. For further information refer to the audited consolidated financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended December 31, 2013. Certain prior period annual and long-term incentive compensation amounts have been reclassified from Salaries and benefits to separate line items in the Statement of Income to conform to the current year presentation.

NOTE 3 ¾ NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income, after deducting preferred share dividends and adjusting for the impact of unvested stock awards deemed to be participating securities, by the weighted average number of common shares outstanding, calculated excluding unvested stock awards.

Diluted net income per common share is computed by dividing net income available to common stockholders, after adding dividends on the Company's Series A and B convertible preferred shares when such shares were dilutive, by the basic weighted average number of common shares and common share equivalents outstanding, giving effect to equity awards and these convertible preferred shares when such awards and shares were dilutive. Prior to their redemption in June 2013, the Series A and B preferred shares were considered dilutive whenever basic net income per common share exceeded each Series' dividend divided by the conversion rates applicable for that period. Shares of the Company's 7.50% Series E Cumulative Redeemable Preferred Stock first issued in May 2013 are contingently convertible into common shares only upon the occurrence of a change in control and are therefore not presently considered dilutive securities. Unvested stock awards that are deemed participating securities are included in the calculation of diluted net income per common share, if dilutive, under either the two-class method or the treasury stock method, depending upon which method produces the more dilutive result.



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Components of the computation of basic and diluted net income per common share were as follows (dollars in thousands, except per share amounts):

	Quarter Ended March 31	
	2014	2013
Basic net income per common share		
Numerator for basic net income per common share:		
Net income	\$38,391	\$34,918
Preferred share dividends	(3,238 )	(5,270 )
Unvested stock award participation in earnings	(24 )	(32 )
	\$35,129	\$29,616
Denominator for basic net income per common share:		
Weighted average common shares outstanding	95,777	95,560
Average unvested stock awards outstanding	(428 )	(540 )
	95,349	95,020
	\$0.37	\$0.31
Diluted net income per common share		
Numerator for diluted net income per common share:		
Net income available to common stockholders	\$35,129	\$29,616
Dividends on dilutive convertible preferred shares	–	75
	\$35,129	\$29,691
Denominator for diluted net income per common share:		
Basic weighted average common shares outstanding	95,349	95,020
Net effect of dilutive equity awards	189	121
Net effect of dilutive convertible preferred shares	–	309
	95,538	95,450
	\$0.37	\$0.31

Potentially dilutive securities excluded from the computation of net income per share because the effect of inclusion was antidilutive were as follows (in thousands):

	Quarter Ended March 31	
	2014	2013
Antidilutive convertible preferred shares*	–	16,493
Antidilutive equity awards excludable under the treasury stock method	30	35

\*The Series A and Series B preferred shares were redeemed in June 2013.

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## NOTE 4 ¾ RESIDENTIAL MORTGAGE INVESTMENTS

Residential mortgage investments classified by collateral type and interest rate characteristics as of the indicated dates were as follows (dollars in thousands):

	Unpaid Principal Balance	Investment Premiums	Amortized Cost Basis	Carrying Amount <sup>(a)</sup>	Net WAC <sup>(b)</sup>	Average Yield <sup>(b)</sup>	
March 31, 2014							
Agency Securities:							
Fannie Mae/Freddie Mac:							
Fixed-rate	\$2,089	\$ 5	\$2,094	\$2,096	6.65 %	6.55 %	
ARMs	10,726,961	346,807	11,073,768	11,300,859	2.56	1.83	
Ginnie Mae ARMs	2,129,114	73,401	2,202,515	2,217,563	2.62	1.60	
	12,858,164	420,213	13,278,377	13,520,518	2.57	1.79	
Residential mortgage loans:							
Fixed-rate	2,315	2	2,317	2,317	7.01	5.39	
ARMs	4,136	17	4,153	4,153	3.82	3.31	
	6,451	19	6,470	6,470	4.96	4.10	
Collateral for structured financings	2,187	36	2,223	2,223	8.09	7.61	
	\$12,866,802	\$ 420,268	\$13,287,070	\$13,529,211	2.58	1.79	
December 31, 2013							
Agency Securities:							
Fannie Mae/Freddie Mac:							
Fixed-rate	\$2,158	\$ 6	\$2,164	\$2,167	6.67 %	6.47 %	
ARMs	10,675,620	343,452	11,019,072	11,231,057	2.58	1.76	
Ginnie Mae ARMs	2,145,639	74,396	2,220,035	2,233,495	2.64	1.64	
	12,823,417	417,854	13,241,271	13,466,719	2.59	1.74	
Residential mortgage loans:							
Fixed-rate	2,633	3	2,636	2,636	6.99	5.63	
ARMs	4,244	18	4,262	4,262	3.81	3.35	
	6,877	21	6,898	6,898	5.03	4.20	
Collateral for structured financings	2,220	37	2,257	2,257	8.09	7.68	
	\$12,832,514	\$ 417,912	\$13,250,426	\$13,475,874	2.59	1.74	

<sup>(a)</sup> Includes unrealized gains and losses for residential mortgage investments classified as available-for-sale (see NOTE 10).

Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments net of servicing and other fees as of the indicated balance sheet date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans <sup>(b)</sup> underlying these investments. Average yield is presented for the quarter then ended, and is based on the cash component of interest income expressed as a percentage calculated on an annualized basis on average amortized cost basis (the "cash yield") less the effects of amortizing investment premiums. Investment premium amortization is determined using the interest method and incorporates actual and anticipated future mortgage prepayments.

Because of federal government support for the GSEs, Agency Securities are considered to have limited, if any, credit risk. Residential mortgage loans held by Capstead were originated prior to 1995 when the Company operated a mortgage conduit and the related credit risk is borne by the Company. Collateral for structured financings consists of private residential mortgage securities that are backed by loans obtained through this mortgage conduit and are

pledged to secure repayment of related structured financings. Credit risk for these securities is borne by the related bondholders. The maturity of Residential mortgage investments is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, actual maturities will be significantly shorter than the portfolio's weighted average contractual maturity of 288 months.

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Fixed-rate investments consist of residential mortgage loans and Agency Securities backed by residential mortgage loans with fixed rates of interest. Adjustable-rate investments generally are ARM Agency Securities backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities either (i) adjust annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate (“CMT”) or the one-year London interbank offered rate (“LIBOR”), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans.

Capstead classifies its ARM securities based on each security’s average number of months until coupon reset (“months to roll”). Months to roll is an indicator of asset duration which is a measure of market price sensitivity to interest rate movements and a shorter duration generally indicates less interest rate risk. Current-reset ARM securities have months to roll of less than 18 months while longer-to-reset ARM securities have months to roll of 18 months or greater. As of March 31, 2014, the average months to roll for the Company’s \$7.55 billion (amortized cost basis) in current-reset ARM securities was 5.9 months while the average months-to-roll for the Company’s \$5.73 billion (amortized cost basis) in longer-to-reset ARM securities was 38.9 months.

## NOTE 5 ¾ INVESTMENTS IN UNCONSOLIDATED AFFILIATES

To facilitate the issuance of Unsecured borrowings, in 2006 and 2005 Capstead formed and capitalized three Delaware statutory trusts through the issuance to the Company of the trusts’ common securities totaling \$3.1 million (see NOTE 8). In order to simplify the Company’s capital structure, in December 2013 the trusts were dissolved after distributing the related junior subordinated notes (originally issued to the trusts by the Company) to the holders of the trusts’ common and preferred securities. Prior to dissolution, the Company’s equity in the earnings of the trusts consisted solely of the common trust securities’ pro rata share in interest accruing on junior subordinated notes issued to the trusts.

## NOTE 6 ¾ REPURCHASE ARRANGEMENTS AND SIMILAR BORROWINGS

Capstead generally pledges its Residential mortgage investments as collateral under repurchase arrangements with commercial banks and other financial institutions, referred to as counterparties, the terms and conditions of which are negotiated on a transaction-by-transaction basis when each borrowing is initiated or renewed. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date, typically with terms of 30 to 90 days, and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of the repurchase arrangement and receives the related principal and interest payments. The amount borrowed is generally equal to the fair value of the assets pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a “haircut.” Interest rates on these borrowings are fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase arrangement at which time the Company may enter into a new repurchase arrangement at prevailing market rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. None of the Company’s counterparties are obligated to renew or otherwise enter into new repurchase arrangements at the conclusion of existing repurchase arrangements. In response to declines in fair value of pledged securities due to changes in market conditions or the publishing of monthly security pay down factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or fund cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements. These actions are referred to as margin calls. Conversely, in response to increases in fair value of pledged securities, the Company routinely margin calls its lending counterparties in order to

release posted collateral. Repurchase arrangements and similar borrowings (and related pledged collateral, including accrued interest receivable), classified by collateral type and remaining maturities, and related weighted average borrowing rates as of the indicated dates were as follows (dollars in thousands):

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Collateral Type	Collateral Carrying Amount	Accrued Interest Receivable	Borrowings Outstanding	Average Borrowing Rates	
March 31, 2014					
Borrowings with maturities of 30 days or less:					
Agency Securities	\$ 12,082,363	\$ 26,211	\$ 11,506,451	0.31	%
Borrowings with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	550,569	1,400	524,261	0.33	
Agency Securities (greater than 90 days)	585,291	1,303	557,320	0.46	
Similar borrowings:					
Collateral for structured financings*	2,223	–	2,223	8.09	
	\$ 13,220,446	\$ 28,914	\$ 12,590,255	0.32	
Quarter-end borrowing rates adjusted for effects of related derivative financial instruments (“Derivatives”) held as cash flow hedges (see NOTE 7)				0.48	
December 31, 2013					
Borrowings with maturities of 30 days or less:					
Agency Securities	\$ 12,169,534	\$ 28,195	\$ 11,578,211	0.38	%
Borrowings with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	951,966	2,068	902,432	0.38	
Similar borrowings:					
Collateral for structured financings*	2,257	–	2,257	8.09	
	\$ 13,123,757	\$ 30,263	\$ 12,482,900	0.38	
Quarter-end borrowing rates adjusted for effects of related Derivatives held as cash flow hedges				0.49	

\* The maturity of structured financings is directly affected by prepayments on the related mortgage pass-through securities pledged as collateral and these financings are subject to redemption by the residual bondholders.

Average borrowings outstanding differed from respective quarter-end balances during the indicated periods primarily due to changes in portfolio levels and differences in the timing of portfolio acquisitions relative to portfolio runoff as illustrated below (dollars in thousands):

	Quarter Ended			
	March 31, 2014	December 31, 2013	Average Borrowings	Average Rate
Average borrowings and rates adjusted for the effects of related Derivatives held as cash flow hedges for the indicated quarters	\$ 12,465,629	0.49 %	\$ 12,510,701	0.49 %

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## NOTE 7 ¾ USE OF DERIVATIVE FINANCIAL INSTRUMENTS, OFFSETTING DISCLOSURES AND CHANGES IN OTHER COMPREHENSIVE INCOME BY COMPONENT

To help mitigate exposure to higher interest rates, Capstead typically uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms. These Derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate of current and forecasted 30- to 90-day borrowings under repurchase arrangements. This hedge relationship establishes a relatively stable fixed rate on related borrowings because the variable-rate payments received on the swap agreements offset a significant portion of the interest accruing on the related borrowings, leaving the fixed-rate payments to be paid on the swap agreements as the Company's effective borrowing rate, subject to certain adjustments. These adjustments include changes in spreads between variable rates on the swap agreements and actual borrowing rates as well as the effects of measured hedge ineffectiveness. Additionally, changes in fair value of these Derivatives tend to partially offset opposing changes in fair value of the Company's residential mortgage investments that can occur in response to changes in market interest rates.

During the quarter ended March 31, 2014 Capstead entered into new forward-starting swap agreements with notional amounts totaling \$700 million requiring fixed rate interest payments averaging 0.52% for two-year periods that commence on various dates between April 2014 and July 2014. Also during the current quarter, \$200 million notional amount of swaps requiring fixed rate interest payments averaging 0.60% matured, while \$1.70 billion notional amount of previously acquired forward-starting swaps requiring fixed rate interest payments averaging 0.51% moved into current-pay status. At March 31, 2014, the Company's portfolio of financing-related swap positions had the following characteristics (dollars in thousands):

Period of Contract Expiration	Notional Amount	Average Fixed Rate Payment Requirement	
Currently-paying contracts:			
Second quarter 2014	\$400,000	0.51	%
Third quarter 2014	200,000	0.51	
Fourth quarter 2014	500,000	0.58	
First quarter 2015	1,100,000	0.50	
Second quarter 2015	200,000	0.43	
Third quarter 2015	400,000	0.47	
Fourth quarter 2015	1,200,000	0.45	
First quarter 2016	1,700,000	0.51	
(average expiration: 15 months)	5,700,000	0.50	
Forward-starting contracts:			
Second quarter 2016	1,100,000	0.47	
Third quarter 2016	400,000	0.54	
(average expiration: 25 months)	1,500,000	0.49	
(average expiration: 17 months)	\$7,200,000		

In addition to portfolio financing-related swap positions, in 2010 the Company entered into three forward-starting, three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements with notional amounts totaling \$100 million and average fixed rates of 4.09% with 20-year payment terms coinciding with the floating-rate terms of the Company's Unsecured borrowings which begin between October 2015 and September 2016. These Derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate associated with the floating-rate terms of these long-term borrowings (see NOTE 8).





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Interest rate swap agreements are measured at fair value on a recurring basis primarily using Level Two Inputs in accordance with “Fair Value Measurements and Disclosures” (“ASC 820”). In determining fair value estimates for these Derivatives, Capstead utilizes the standard methodology of netting the discounted future fixed cash payments and the discounted future variable cash receipts which are based on expected future interest rates derived from observable market interest rate curves. The Company also incorporates both its own nonperformance risk and its counterparties’ nonperformance risk in determining the fair value of these Derivatives. In considering the effect of nonperformance risk, the Company considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and has concluded that counterparty risk is not significant to the overall valuation of these agreements. The following tables include fair value and other related disclosures regarding all Derivatives held as of and for the indicated periods (in thousands):

		March	December
	Balance Sheet	31,	31,
	Location	2014	2013
Balance sheet-related			
Swap agreements in a gain position (an asset) related to:			
Borrowings under repurchase arrangements	(a)	\$1,207	\$1,094
Unsecured borrowings	(a)	–	3,911
Swap agreements in a loss position (a liability) related to:			
Borrowings under repurchase arrangements	(a)	(11,927)	(11,304 )
Unsecured borrowings	(a)	(3,512 )	–
Related net interest payable	(b)	(7,647 )	(5,493 )
		\$ (21,879)	\$ (11,792 )

The fair value of Derivatives with realized and unrealized gains are aggregated and recorded as an asset on the face of the Balance Sheet separately from the fair value of Derivatives with realized and unrealized losses that are (a) recorded as a liability. The amount of unrealized losses at March 31, 2014 scheduled to be recognized in the Statement of Income over the next twelve months primarily in the form of fixed-rate swap payments in excess of current market rates totaled \$17.6 million.

(b) Included in “Accounts payable and accrued expenses” on the face of the Balance Sheet.

	Location		
	of		
	Gain or		
	(Loss)		
	Recognized	Quarter Ended	
	in	March 31	
	Net		
	Income	2014	2013
Income statement-related			
Components of effect on interest expense:			
Amount of loss reclassified from Accumulated other comprehensive income related to the effective portion of active positions		\$(4,722 )	\$(5,434)
Amount of gain (loss) recognized (ineffective portion)		(58 )	120
Increase in interest expense and decrease in Net income as a result of the use of Derivatives	*	\$(4,780 )	\$(5,314)
Other comprehensive income-related			
Amount of gain (loss) recognized in Other comprehensive income (effective portion)		\$(12,656)	\$2,479

\* Included in "Interest expense: Repurchase arrangements and similar borrowings" on the face of the Statement of Income.

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Capstead's swap agreements and borrowings under repurchase arrangements are subject to master netting arrangements in the event of default on, or termination of, any one contract. See NOTE 6 for more information on the Company's use of repurchase arrangements. The following tables provide disclosures concerning offsetting of financial liabilities and Derivatives as of the indicated dates (in thousands):

Offsetting of Derivative Assets						
	Gross	Net	Gross	Amounts	Not	
	Amounts	Amounts	Amounts	Offset	in the	
	of	of Assets	of Assets	in the	Balance	
	the	Presented	Presented	Cash		
	Recognized	Balance	Balance	Financial	Collateral	Net
	Assets	Sheet	Sheet	Instruments	Received	Amount
As of March 31, 2014:						
Counterparty 2	\$249	–	\$249	\$(249)	\$–	\$–
Counterparty 4	958	–	958	(958)	–	–
	\$1,207	\$–	\$1,207	\$(1,207)	\$–	\$–
As of December 31, 2013:						
Counterparty 1	\$3,911	\$–	\$3,911	\$(3,911)	\$–	\$–
Counterparty 2	634	–	634	(634)	–	–
Counterparty 4	460	–	460	(460)	–	–
	\$5,005	\$–	\$5,005	\$(5,005)	\$–	\$–
Offsetting of Financial Liabilities and Derivative Liabilities						
	Gross	Net	Gross	Amounts	Not	
	Amounts	Amounts	Amounts	Offset	in the	
	of	of Liabilities	of Liabilities	in the	Balance	
	the	Presented	Presented	Cash	Sheet	
	Recognized	the Balance	the Balance	Financial	Collateral	Net
	Liabilities	Sheet	Sheet	Instruments	Pledged	Amount
	(b)		(a)			
As of March 31, 2014:						
Derivatives by counterparty:						
Counterparty 1	\$10,550	\$–	\$10,550	\$–	\$(10,550)	\$–
Counterparty 2	6,854	–	6,854	(249)	(6,550)	55
Counterparty 3	1,115	–	1,115	–	(1,115)	–
Counterparty 4	4,567	–	4,567	(958)	(3,609)	–
	23,086	–	23,086	(1,207)	(21,824)	55
Repurchase arrangements and similar borrowings	12,593,613	–	12,593,613	(12,593,613)	–	–
	\$12,616,699	\$–	\$12,616,699	\$(12,594,820)	\$(21,824)	\$55
As of December 31, 2013:						
Derivatives by counterparty:						
Counterparty 1	\$6,002	\$–	\$6,002	\$(3,911)	\$(2,091)	\$–
Counterparty 2	6,352	–	6,352	(634)	(5,718)	–
Counterparty 3	1,581	–	1,581	–	(1,581)	–
Counterparty 4	2,862	–	2,862	(460)	(2,402)	–
	16,797	–	16,797	(5,005)	(11,792)	–

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Repurchase arrangements and similar borrowings	12,487,604	–	12,487,604	(12,487,604)	–	–
	\$12,504,401	\$ –	\$12,504,401	\$(12,492,609)	\$(11,792)	\$ –

Amounts presented are limited to recognized liabilities and cash collateral received associated with the indicated (a) counterparty sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.

Amounts include accrued interest of \$7.6 million and \$5.5 million on interest rate swap agreements and \$3.4 (b) million and \$4.7 million on repurchase arrangements and similar borrowings, included in “Accounts payable and accrued expenses” on the face of the Balance Sheets as of March 31, 2014 and December 31, 2013, respectively.

Amounts presented are limited to recognized assets and collateral pledged associated with the indicated (c) counterparty sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.

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Changes in Accumulated other comprehensive income by component for the quarter ended March 31, 2014 were as follows (in thousands):

	Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Total
Balance at December 31, 2013	\$(6,305 )	\$ 225,448	\$219,143
Activity for the quarter ended March 31, 2014:			
Other comprehensive income (loss) before reclassifications	(12,656)	16,693	4,037
Amounts reclassified from accumulated other comprehensive income	4,722	—	4,722
Other comprehensive income (loss)	(7,934 )	16,693	8,759
Balance at March 31, 2014	\$(14,239)	\$ 242,141	\$227,902

## NOTE 8 ¾ UNSECURED BORROWINGS

Unsecured borrowings consist of 30-year junior subordinated notes originally issued in 2005 and 2006 to three special-purpose statutory trusts formed to issue \$3.1 million of the trusts' common securities to Capstead and to privately place \$100 million of so-called trust preferred securities with unrelated third party investors. In December 2013 these trusts were dissolved after the subordinated notes were distributed to the holders of the trusts' common and preferred securities. Included in Receivables and other assets are \$2.2 million in remaining issue costs at March 31, 2014 associated with the original issuance of these notes. Note balances and related weighted average interest rates as of March 31, 2014 and December 31, 2013 (calculated including issue cost amortization) were as follows (dollars in thousands):

	Borrowings Outstanding	Average Rate *
Junior subordinated notes:		
Capstead Mortgage Trust I	\$ 35,000	8.31 %
Capstead Mortgage Trust II	40,000	8.46
Capstead Mortgage Trust III	25,000	8.78
	\$ 100,000	8.49

The indicated weighted average rates have been in effect since issuance. After considering cash flow hedges that coincide with the floating rate terms of these borrowings that begin in October and December 2015 for the notes \*associated with Capstead Mortgage Trusts I and II and September 2016 for the notes associated with Capstead Mortgage Trust III, the effective borrowing rate during the final 20 years of these borrowings will average 7.56%, subject to certain adjustments for the effects of measured hedge ineffectiveness, if any.

The notes associated with Capstead Mortgage Trust I mature in October 2035 and are currently redeemable, in whole or in part, without penalty, at the Company's option. The notes associated with Capstead Mortgage Trust II mature in December 2035 and are redeemable, in whole or in part, without penalty, at the Company's option anytime on or after December 15, 2015. The notes associated with Capstead Mortgage Trust III mature in September 2036 and are redeemable, in whole or in part, without penalty, at the Company's option anytime on or after September 15, 2016.

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## NOTE 9 ¾ ISSUANCE OF 7.50% SERIES E PERPETUAL PREFERRED SHARES AND REDEMPTION OF SERIES A AND B PERPETUAL PREFERRED SHARES

In May 2013 Capstead completed a public offering of 6.8 million shares (\$170.0 million face amount) of its 7.50% Series E Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share. The Series E preferred shares are redeemable at the Company's option for \$25.00 per share, plus any accumulated and unpaid dividends, on or after May 13, 2018. Proceeds of the offering after underwriting fees and other costs totaled \$164.3 million and together with \$42.7 million of cash on hand were used to fund the June 2013 redemption of the Company's Series A and B perpetual preferred shares.

In late 2013 the Company began issuing additional Series E preferred shares through an at-the-market continuous offering program. During the quarter ended March 31, 2014, the Company issued 56,000 Series E preferred shares at an average price of \$23.83, net of expenses, for net proceeds of \$1.3 million. Subsequent to quarter-end through May 9, 2014 the Company issued 92,000 Series E preferred shares at an average price of \$23.96 net of expenses, for net proceeds of \$2.2 million. Modest additional amounts of Series E preferred capital may be raised in the future under this program subject to market conditions, compliance with federal securities laws and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

## NOTE 10 ¾ DISCLOSURES REGARDING FAIR VALUES OF FINANCIAL INSTRUMENTS

This note provides fair value disclosures as of the indicated balance sheet dates, all of which are determined using Level 2 Inputs in accordance with ASC 820, for Capstead's financial assets and liabilities, most of which are influenced by changes in, and market expectations for changes in, interest rates and market liquidity conditions, as well as other factors beyond the control of management.

Residential mortgage investments, nearly all of which are mortgage securities classified as available-for-sale, are measured at fair value on a recurring basis. In determining fair value estimates for mortgage securities, the Company considers recent trading activity for similar investments and pricing levels indicated by lenders in connection with designating collateral for repurchase arrangements, provided such pricing levels are considered indicative of actual market clearing transactions. In determining fair value estimates for longer-term borrowings under repurchase arrangements, the Company considers pricing levels indicated by lenders for entering into new transactions using similar pledged collateral with terms equal to the remaining terms of the longer-term borrowings. In determining fair value estimates for unsecured borrowings, the Company considers current pricing for financial instruments with similar characteristics. Excluded from these disclosures are financial instruments for which the Company's cost basis is deemed to approximate fair value due primarily to the short duration of these instruments, which are valued using primarily Level 1 measurements, including Cash and cash equivalents, cash collateral receivable from, or payable to, interest rate swap counterparties, receivables, payables and borrowings under repurchase arrangements with initial terms of 120 days or less. See NOTE 7 for information relative to the valuation of interest rate swap agreements. Fair value disclosures for financial instruments other than debt securities were as follows as of the indicated dates (in thousands):

	March 31, 2014		December 31, 2013	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Residential mortgage loans	\$6,470	\$6,600	\$6,898	\$7,000
Interest rate swap agreements	1,207	1,207	5,005	5,005
Financial liabilities:				
Repurchase arrangements with initial terms of greater than 120 days	557,320	557,500	36,299	36,300
Unsecured borrowings	100,000	100,800	100,000	101,000

Interest rate swap agreements	15,439	15,439	11,304	11,304
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Fair value and related disclosures for debt securities were as follows as of the indicated dates (in thousands):

	Amortized Cost Basis	Gross Gains	Unrealized Losses	Fair Value
March 31, 2014				
Agency Securities classified as available-for-sale:				
Fannie Mae/Freddie Mac	\$11,073,810	\$234,823	\$7,730	\$11,300,903
Ginnie Mae	2,202,515	19,486	4,438	2,217,563
Residential mortgage securities classified as held-to-maturity	4,275	203	–	4,478
December 31, 2013				
Agency Securities classified as available-for-sale:				
Fannie Mae/Freddie Mac	11,019,116	224,456	12,468	11,231,104
Ginnie Mae	2,220,035	18,384	4,924	2,233,495
Residential mortgage securities classified as held-to-maturity	4,376	211	–	4,587

	March 31, 2014		December 31, 2013	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities in an unrealized loss position:				
One year or greater	\$40,113	\$ 404	\$39,030	\$ 380
Less than one year	2,085,181	11,764	2,857,724	17,012
	\$2,125,294	\$ 12,168	\$2,896,754	\$ 17,392

Capstead's investment strategy involves managing a leveraged portfolio of seasoned, short-duration ARM Agency Securities and management expects these securities will be held until payoff absent a major shift in strategy or a severe contraction in the Company's ability to obtain financing to support its portfolio. Declines in fair value caused by increases in interest rates are typically modest for investments in short-duration ARM Agency Securities compared to investments in longer-duration ARM or fixed-rate assets. These declines are generally recoverable in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment.

From a credit risk perspective, federal government support for the GSEs helps ensure that fluctuations in value due to credit risk associated with these securities will be limited. Given that (a) any existing unrealized losses on mortgage securities held by the Company are not attributable to credit risk and declines in fair value of ARM securities due to changes in interest rates are generally recoverable in a relatively short period of time, (b) the Company typically holds its investments to maturity, and (c) it is more likely than not that the Company will not be required to sell any of its investments given the resiliency of the financing market for Agency Securities, none of these investments are considered other-than-temporarily impaired at March 31, 2014.

NOTE 11  $\frac{3}{4}$  COMPENSATION PROGRAMS

The compensation committee of Capstead's board of directors (the "Committee") administers all compensation programs for employees including salaries, annual and long-term incentive compensation, including equity-based awards, as well as other benefit programs.



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Annual Incentive Compensation Programs

To provide employees with appropriate performance-based annual incentive compensation opportunities, each year the Committee approves an incentive formula for the award of annual incentive compensation that is directly linked with the performance of the Company. The formula used through June 2013 and in prior years accomplished this by establishing an incentive pool equal to a percentage participation in Capstead's earnings in excess of a pre-established performance threshold, subject to a maximum amount, or cap. The Committee determined (i) the amount actually awarded, (ii) its allocation among executives and with other employees and (iii) the form of payment (e.g., cash or equity awards). The Committee terminated this absolute return program effective June 30, 2013 and adopted a new annual incentive compensation program for key executives referred to as the "2013 Program." In connection with terminating the old program, incentive pool amounts totaling \$474,000 were distributed subsequent to year-end to all employees.

The 2013 Program determined levels of annual cash incentive compensation based on relative performance metrics measured against the Company's peers in the mortgage REIT industry and the attainment of individual goals and objectives for participating executives. The relative performance metrics used were relative economic return (change in book value plus dividends) and relative operating efficiency (operating expenses divided by Unsecured borrowings and Stockholders' equity), calculated for the full year and prorated for the six month period during which the program was effective in 2013. The 2013 Program defined maximum payout percentages based on a multiple of salary for each program metric thereby limiting the amount payable to each participating executive. Actual amounts awarded to participating executives in March 2014 pursuant to the 2013 Program totaled \$1.9 million and were based on separate calculations for each performance metric as well as the Committee's evaluation of the participating executives' attainment of individual goals and objectives. In addition, \$175,000 in annual incentive compensation was awarded to employees not participating in the 2013 Program.

For 2014 the Committee revised the newly-developed annual incentive program to include an absolute economic return performance metric which measures performance against established return levels. Included in Accounts payable and accrued expenses at March 31, 2014 are 2014 annual incentive compensation-related accruals for all employees totaling \$492,000. Actual amounts expensed during the first quarter of 2014 were lower as a result of a \$175,000 over accrual at December 31, 2013 associated with final settlement of the 2013 annual incentive awards.

Since 2008 the Committee has utilized an additional performance-based cash annual incentive compensation program for key executives that provides for payments equal to per share dividends declared on Capstead's common stock multiplied by a notional amount of non-vesting or "phantom" common shares ("Dividend Equivalent Rights" or "DERs"). DERs are not attached to any stock or option awards and only represent the right to receive the same cash distributions that the Company's common stockholders are entitled to receive during the term of the grants, subject to certain conditions, including continuous service. DERs outstanding at March 31, 2014 totaled 654,000 and included in Accounts payable and accrued expenses are first quarter 2014 DER distribution amounts totaling \$222,000. Recognized in Annual incentive compensation are \$222,000 and \$203,000, respectively, related to the DER program for the quarters ended March 31, 2014 and 2013. All grants expire July 1, 2015.

Long-term Equity-based Incentive Awards

Capstead sponsors equity-based award plans to provide for the issuance of stock awards, restricted stock unit awards, option awards and other long-term equity-based incentive awards to directors and employees. As of March 31, 2014, the Company has issued awards reserving for potential future issuance nearly all available shares under its existing plans. A new plan is being submitted for stockholder approval at this year's annual meeting of stockholders scheduled for May 28, 2014 to allow for the granting of future long-term equity-based incentive awards.

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In December 2013 the Committee adopted a new long-term incentive program, and granted key executives a total of 242,505 performance-based restricted stock units which are convertible into common shares following a three-year performance period ending December 31, 2016 depending upon whether, and to what extent, defined performance levels established for certain relative and absolute return performance metrics are met or exceeded. The relative return metrics measure the Company's performance against its peers in the mortgage REIT industry on the basis of relative economic return and relative total stockholder return (change in stock price plus reinvested dividends). The absolute economic return metric measures performance against established return levels. For conversion purposes, each performance metric is assigned a weighting and the Company's performance relative to each metric is calculated separately. The actual number of common shares, if any, the units can convert into for each of the metrics can range from one-half of a common share per unit if that metric's minimum threshold of performance is met, to two common shares per unit if the related maximum performance threshold is met or exceeded, adjusted for the weighting assigned to the metric. If a metric's minimum performance threshold is not met, no shares are issuable under that metric. Dividends accrue from the date of grant and will be paid in cash when the units convert into common shares based on the number of common shares ultimately issued, if any.

Under a prior absolute return performance-based stock award program, the Committee granted stock awards from 2008 through 2012 to all employees with staggered three-year vesting periods subject to Capstead generating annualized returns on investment capital, (defined for this purpose as Unsecured borrowings and Stockholders' equity, less accumulated OCI and subject to certain other adjustments), equal to the greater of 8.0% or the average 10-year U.S. Treasury rate plus 200 basis points. If the required returns are not generated during a three-year measurement period, vesting will be deferred and a new three-year measurement period will be established to include the subsequent year, up to and including the seventh calendar year after the year of grant. Any remaining unvested awards issued under this program will expire if the required returns are not generated for the final three-year measurement period. Information pertaining to absolute return performance-based stock awards issued to employees pursuant to this program is as follows:

Year of Grant	Grant Date Fair Value Per Share	Total Original Grants	Forfeited	Final	Remaining Shares with Initial Measurement Periods		
				Measurement Period Ends December 31	2014	2015	2016
2008 (a)	\$ 10.18	140,658	5,464	n/	a -	-	-
2009 (b)	14.33	110,917	4,571	n/	a -	-	-
2010 (c)	12.44	128,766	5,759	2017	61,499	-	-
2011	12.72	132,490	5,050	2018	63,722	63,718	-
2012	11.67	145,399	5,697	2019	-	69,853	69,849

- (a) The absolute return metrics for the three-year measurement periods ending December 31, 2012 and 2011 were met resulting in the vesting of 67,595 shares associated with the second 50% of this grant in January 2013 and 67,599 shares associated with the first 50% of this grant in February 2012.

The absolute return metrics for the three-year measurement periods ending December 31, 2013 and 2012 were met (b)resulting in the vesting of 52,915 shares associated with the second 50% of this grant in January 2014 and 53,431 shares associated with the first 50% of this grant in January 2013.

- (c) The absolute return metric for the first three-year measurement period ending December 31, 2013 was met resulting in the vesting of 61,508 shares associated with the first 50% of this grant in January 2014.



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Information pertaining to service-based stock awards issued to directors and employees (subject to certain restrictions, principally continuous service), is as follows:

Year of Grant	Grant Date Fair Value	Total Original Grants	As of March 31, 2014		Remaining Shares Scheduled to Vest During:	
	Per Share	Grants	Vested	Forfeited	2014	2017
2007 (a)	\$12.93	156,000	143,168	12,832	—	—
2008 (b)	12.87	6,000	6,000	—	—	—
2009 (b)	11.39	6,000	6,000	—	—	—
2010 (b)	11.64	12,000	12,000	—	—	—
2011 (b)	13.23	24,000	24,000	—	—	—
2012 (b)	13.59	29,000	29,000	—	—	—
2013 (b)	13.02	28,000	—	—	28,000	—
2013 (c)	12.34	35,703	—	—	—	35,703

(a) The remaining 2007 grant shares vested in January 2014.

(b) Director stock awards have been granted annually upon election or reelection to the board of directors. These awards vest one year after issuance.

(c) In December 2013 the Committee granted service-based stock awards to employees that were not awarded performance-based restricted stock units. These awards vest on January 2, 2017.

Performance-based and service-based stock award activity for quarter ended March 31, 2014 is summarized below:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested stock awards outstanding at December 31, 2013	528,931	12.51
Vestings	(136,587)	13.27
Unvested stock awards outstanding at March 31, 2014	392,344	12.25

During the quarters ended March 31, 2014 and 2013, the Company recognized in Long-term incentive compensation \$375,000 and \$406,000, respectively, related to amortization of the grant date fair value of employee performance-based and service-based stock awards. The amounts amortized for these periods assumed that performance metrics, if applicable, would continue to be met for related initial measurement periods. In addition, the Company recognized in Other general and administrative expense \$92,000 and \$106,000 related to amortization of the grant date fair value of service-based director stock awards during the quarters ended March 31, 2014 and 2013, respectively. Unrecognized compensation expense for unvested stock awards totaled \$2.5 million as of March 31, 2014, to be expensed over a weighted average period of 1.5 years (assumes minimal employee and director attrition and, if applicable, absolute return performance metrics being met for related initial measurement periods).

During the quarter ended March 31, 2014 the Company recognized in Long-term incentive compensation \$251,000 related to the performance-based restricted stock units granted in December 2013. A grant date fair value of \$12.45

was assigned to each unit based on estimated outcomes for each nonmarket-based performance metric and a Monte Carlo simulation for the relative total stockholder return performance metric. Assuming certain targeted performance levels are achieved and there are no forfeitures, \$3.0 million can be expected to be expensed over the related three-year performance period. However, the value associated with the nonmarket-based performance metrics is subject to change over the units' performance period. Actual expense assuming no forfeitures will range from a minimum of \$625,000 (the grant date fair value of the total stockholder return performance metric and assuming no shares are ultimately issued under the terms of these grants because the Company's performance for all performance metrics was less than the related minimum threshold performance levels) to approximately \$5.4 million assuming maximum performance levels are met or exceeded for all performance metrics resulting in the issuance of 485,010 common shares.

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All service-based stock awards receive dividends on a current basis without risk of forfeiture if the related awards do not vest. Performance-based restricted stock units and stock awards granted since 2010 defer the payment of dividends accruing between the grant dates and the end of related performance periods. If the restricted stock units do not convert into any common shares or a stock award does not vest, the related accrued dividends will be forfeited. Included in Common stock dividend payable at March 31, 2014 are estimated dividends payable pertaining to these awards totaling \$1.2 million.

Option awards currently outstanding have ten-year contractual terms from the grant date and were issued with strike prices equal to the quoted market prices of the Company's common shares on the date of grant. The fair value of option awards was estimated on the date of grant using a Black-Scholes option pricing model. The Company estimated option exercises, expected holding periods and forfeitures based on past experience and expectations for option performance and employee or director attrition. Risk-free rates were based on market rates for the expected life of the options. Expected dividends were based on historical experience and expectations for future performance. Expected volatility factors were based on historical experience. No option awards have been granted since 2010 and no option award activity occurred during the quarter ended March 31, 2014. Exercisable option awards outstanding at March 31, 2014 totaled 77,500 shares with a weighted average remaining contractual term of 3.4 years, an average exercise price of \$11.75 and an aggregate intrinsic value of \$92,000.

Other Benefit Programs

Capstead sponsors a qualified defined contribution retirement plan for all employees and a nonqualified deferred compensation plan for certain of its executives. In general the Company matches up to 50% of a participant's voluntary contribution up to a maximum of 6% of a participant's salary and short-term incentive compensation and makes discretionary contributions of up to another 3% of such compensation regardless of participation in the plans. Company contributions are subject to certain vesting requirements. During the quarters ended March 31, 2014 and 2013, the Company recognized in Salaries and benefits \$64,000 and \$63,000 related to contributions to these plans, respectively.

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

FINANCIAL CONDITION

Overview

Capstead operates as a self-managed REIT and earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of short-duration ARM Agency Securities, which are considered to have limited, if any, credit risk and reset to more current interest rates within a relatively short period of time. This strategy of investing in ARM Agency Securities positions the Company to (a) benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates and (b) experience smaller fluctuations in portfolio values compared to portfolios containing a significant amount of longer-duration ARM or fixed-rate mortgage securities. Duration is a common measure of market price sensitivity to interest rate movements and a shorter duration generally indicates less interest rate risk.

Capstead finances its portfolio of ARM Agency Securities with borrowings under repurchase arrangements with commercial banks and other financial institutions supported by its long-term investment capital, which as of March 31, 2014 totaled \$1.48 billion and consisted of \$1.21 billion of common and \$167 million of perpetual preferred stockholders' equity (recorded amount) and \$100 million of unsecured borrowings that mature in 2035 and 2036. Long-term investment capital increased by \$13 million during the quarter ended March 31, 2014 primarily as a result of higher portfolio pricing levels (\$17 million), earnings in excess of dividend payments (\$3 million) and Series E preferred capital raised using an at-the-market continuous offering program (\$1 million), partially offset by lower pricing levels for interest rate swap agreements held for hedging purposes (\$8 million).

The recorded value of Capstead's holdings of ARM Agency Securities increased by \$53 million during the quarter to \$13.53 billion at March 31, 2014, with portfolio acquisitions exceeding portfolio runoff by \$34 million (principal amount) and the remainder primarily attributable to a 13.5 basis point increase in overall portfolio pricing levels. Borrowings under repurchase arrangements increased by \$107 million during the quarter to \$12.59 billion. Portfolio leverage (borrowings under repurchase arrangements divided by long-term investment capital) was unchanged from year-end at 8.52 to one at March 31, 2014. Management believes borrowing at current levels represents an appropriate and prudent use of leverage under current market conditions for a portfolio of seasoned, short-duration ARM Agency Securities.

Capstead reported net income of \$38 million or \$0.37 per diluted common share for the first quarter of 2014 compared to \$37 million or \$0.35 per diluted common share for the fourth quarter of 2013 and \$35 million or \$0.31 per diluted common share for the first quarter of 2013.

Financing spreads on residential mortgage investments averaged 1.30% for the first quarter of 2014, compared to 1.25% for the fourth quarter of 2013 and 1.15% for the first quarter of 2013. Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on residential mortgage investments, net of borrowing rates on repurchase arrangements and similar borrowings, adjusted for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure that includes yields on all interest-earning assets, as well as rates paid on all interest-bearing liabilities, principally unsecured borrowings. See page 28 for a reconciliation of these GAAP and non-GAAP financial measures. Higher financing spreads reflect lower investment premium amortization as a result of lower mortgage prepayment rates offset by the effects of a lower average portfolio outstanding and lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates resetting lower to more current rates as well as lower coupon interest rates on acquisitions. Average borrowing rates were unchanged from the fourth quarter of 2013 while considerably lower than in the first quarter of 2013.





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Operating costs (salaries and benefits, incentive compensation and other general and administrative expense) as a percentage of long-term investment capital averaged 0.96% for the first quarter of 2014, compared to 1.07% for the fourth quarter of 2013 and 0.77% during the first quarter of 2013.

The size and composition of Capstead's investment portfolio depends on investment strategies being implemented by management, as well as overall market conditions, including the availability of attractively priced investments and suitable financing to leverage the Company's investment capital. Market conditions are influenced by, among other things, current levels of, and expectations for future levels of, short-term interest rates, mortgage prepayments and market liquidity.

## Risk Factors and Critical Accounting Policies

Under the captions "Risk Factors" and "Critical Accounting Policies" are discussions of risk factors and critical accounting policies affecting Capstead's financial condition and earnings that are an integral part of this discussion and analysis. Readers are strongly urged to consider the potential impact of these factors and accounting policies on the Company and its financial results.

## Book Value per Common Share

Nearly all of Capstead's residential mortgage investments and all of its interest rate swap agreements are reflected at fair value on the Company's balance sheet and are therefore included in the calculation of book value per common share (total stockholders' equity, less aggregate liquidation preferences for preferred shares, divided by common shares outstanding). The fair value of these investments is impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels, among other factors. The Company's investment strategy attempts to mitigate these risks by focusing on investments in Agency Securities, which are considered to have little, if any, credit risk and are collateralized by ARM loans with interest rates that reset periodically to more current levels. Because of these characteristics, the fair value of Capstead's portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to portfolios containing a significant amount of non-agency and/or fixed-rate mortgage securities. The following table illustrates the progression of the Company's book value per common share for the quarter ended March 31, 2014:

Book value per common share, beginning of quarter	\$12.47	
Earnings in excess of dividend distributions	0.03	0.3%
Change in unrealized gains and losses on mortgage securities classified as available-for-sale	\$0.17	
Change in unrealized gains and losses on interest rate swap agreements designated as cash flow hedges of:		
Borrowings under repurchase arrangements	(0.01)	
Unsecured borrowings	(0.07)	
	0.09	0.7%
Book value per common share, end of quarter	\$12.59	
Increase in book value per common share during the quarter	\$0.12	1.0%

## Issuance of 7.50% Series E Perpetual Preferred Shares

In May 2013 Capstead completed a public offering of 6.8 million shares (\$170 million face amount) of its 7.50% Series E Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share, using the \$164 million in proceeds, net of underwriter fees and other costs, together with \$43 million of cash on hand to fund the June 2013 redemption of the Company's Series A and B perpetual preferred shares. The Series E preferred shares are redeemable at the Company's option for \$25.00 per share, plus any accumulated and unpaid dividends, on or after May 13, 2018.



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In late 2013 the Company began issuing additional Series E preferred shares through an at-the-market continuous offering program. During the quarter ended March 31, 2014, the Company issued 56,000 Series E preferred shares at an average price of \$23.83, net of expenses, and has continued issuing Series E preferred shares subsequent to quarter-end. Modest additional amounts of Series E preferred capital may be raised in the future under this program subject to market conditions, compliance with federal securities laws and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

## Residential Mortgage Investments

Capstead's investment strategy focuses on managing a large portfolio of residential mortgage investments consisting almost exclusively of ARM Agency Securities. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by the GSEs, which are federally chartered corporations, or Ginnie Mae, which is an agency of the federal government. Federal government support for the GSEs has largely alleviated market concerns regarding the ability of the GSEs to fulfill their guarantee obligations. By focusing on investing in seasoned, short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration ARM or fixed-rate assets. These declines are generally recoverable in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment. This investment strategy positions the Company to benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates. The following table illustrates the progression of the Company's portfolio of residential mortgage investments for the quarter ended March 31, 2014 (dollars in thousands):

Residential mortgage investments, beginning of quarter	\$ 13,475,874
Increase in net unrealized gains on securities classified as available-for-sale	16,693
Portfolio acquisitions (principal amount) at average lifetime purchased yields of 2.45%	644,356
Investment premiums on acquisitions*	24,647
Portfolio runoff (principal amount)	(610,071 )
Investment premium amortization	(22,288 )
Residential mortgage investments, end of quarter	\$ 13,529,211

Average residential mortgage investments outstanding during the quarter ended March 31, 2014 \$ 13,493,742

Residential mortgage investments typically are acquired at a premium to the securities' unpaid principal balances.

\* Investment premiums are recognized in earnings as portfolio yield adjustments using the interest method over the estimated lives of the related investments. As such, the level of mortgage prepayments impacts how quickly investment premiums are amortized.

ARM securities are backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying the Company's ARM securities either (i) adjust annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate ("CMT") or the one-year London interbank offered rate ("LIBOR"), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans.

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Capstead classifies its ARM securities based on the average length of time until the loans underlying each security reset to more current rates (“months-to-roll”) (less than 18 months for “current-reset” ARM securities, and 18 months or greater for “longer-to-reset” ARM securities). After consideration of any applicable initial fixed-rate periods, at March 31, 2014 approximately 84%, 10% and 6% of the Company’s ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly, respectively. Approximately 84% of the Company’s current-reset ARM securities have reached an initial coupon reset date, while none of its longer-to-reset ARM securities have reached an initial coupon reset date. Additionally, at March 31, 2014 approximately 15% of the Company’s ARM securities were backed by interest-only loans that have not reached an initial coupon reset date. All percentages are approximate and based on averages of the characteristics of mortgage loans underlying each security and calculated using unpaid principal balances as of the indicated date. The Company’s ARM holdings featured the following characteristics at March 31, 2014 (dollars in thousands):

ARM Type (a)	Amortized Cost Basis (b)	Net WAC (c)	Fully Indexed WAC (c)	Average Net Margins (c)	Average Periodic Caps (c)	Average Lifetime Caps (c)	Months To Roll (a)
<b>Current-reset ARMs:</b>							
Fannie Mae Agency Securities	\$4,657,092	2.33 %	2.14 %	1.70 %	3.32 %	10.04 %	5.3
Freddie Mac Agency Securities	1,657,935	2.42	2.23	1.82	2.21	10.48	6.1
Ginnie Mae Agency Securities	1,229,990	2.50	1.65	1.51	1.04	8.76	8.0
Residential mortgage loans	4,153	3.45	2.25	2.02	1.50	10.94	4.5
	7,549,170	2.38	2.08	1.70	2.71	9.93	5.9
<b>Longer-to-reset ARMs:</b>							
Fannie Mae Agency Securities	2,952,741	2.82	2.29	1.73	4.86	7.83	40.5
Freddie Mac Agency Securities	1,806,000	2.90	2.36	1.81	4.59	7.95	40.7
Ginnie Mae Agency Securities	972,525	2.76	1.66	1.51	1.15	7.87	30.5
	5,731,266	2.83	2.20	1.72	4.14	7.87	38.9
	\$13,280,436	2.57	2.14	1.71	3.33	9.04	20.0
Gross WAC (rate paid by borrowers) (d)		3.18					

(a) Capstead classifies its ARM securities based on the average length of time until the loans underlying each security reset to more current rates (“months-to-roll”) (less than 18 months for “current-reset” ARM securities, and 18 months or greater for “longer-to-reset” ARM securities). Once an ARM loan reaches its initial reset date, it will reset at least once a year to a margin over a corresponding interest rate index, subject to periodic and lifetime limits or caps.

(b) Amortized cost basis represents the Company’s investment (unpaid principal balance plus unamortized investment premiums) before unrealized gains and losses. As of March 31, 2014, the ratio of amortized cost basis to related unpaid principal balance for the Company’s ARM securities was 103.27. This table excludes \$2 million in fixed-rate Agency Securities, \$2 million in fixed-rate residential mortgage loans and \$2 million in private residential mortgage pass-through securities held as collateral for structured financings.

(c) Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments, net of servicing and other fees as of the indicated date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments. Fully indexed WAC represents the weighted average coupon upon one or more resets using interest rate indexes and net margins as of the indicated date. Average net margins represent the weighted average levels over the underlying indexes that the underlying loans can adjust to upon reset, usually subject to initial, periodic and/or lifetime limits, or caps, on the amount of such adjustments during any single interest rate

adjustment period and over the contractual term of the underlying loans. ARM securities issued by the GSEs with initial fixed-rate periods of five years or longer have either 200 or 500 basis point initial caps with 200 basis point periodic caps. Additionally, certain ARM securities held by the Company are subject only to lifetime caps or were not subject to a cap. For presentation purposes, average periodic caps in the table above reflect initial caps until after an ARM security has reached its initial reset date and lifetime caps, less related current net WAC, for ARM securities subject only to lifetime caps. At quarter-end, 71% of current-reset ARMs were subject to periodic caps averaging 1.82%; 16% were subject to initial caps averaging 2.89%; 12% were subject to lifetime caps, less related current net WAC, averaging 7.66%; and 1% were not subject to a cap. All longer-to-reset ARM securities at March 31, 2014 were subject to initial caps.

(d) Gross WAC is the weighted average interest rate of the mortgage loans underlying the indicated investments, which includes servicing and other fees paid by borrowers, as of the indicated balance sheet date.

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Capstead generally pledges its residential mortgage investments as collateral under repurchase arrangements with commercial banks and other financial institutions, referred to as counterparties, the terms and conditions of which are negotiated on a transaction-by-transaction basis when each borrowing is initiated or renewed. None of the Company's counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date, typically with terms of 30 to 90 days, and are accounted for as financings by the Company. The Company maintains the beneficial interest in the specific securities pledged during the term of the repurchase arrangement and receives the related principal and interest payments. The amount borrowed is generally equal to the fair value of the assets pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a "haircut." Haircuts on outstanding borrowings averaged 4.6 percent and ranged from 3.0 to 5.0 percent of the fair value of pledged residential mortgage pass-through securities at March 31, 2014, little changed from the prior year. After considering haircuts and related interest receivable on the collateral, as well as interest payable on these borrowings, the Company had \$656 million of capital at risk with its lending counterparties as of March 31, 2014.

Interest rates charged on repurchase arrangements, referred to as repo borrowing rates, are fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase arrangement at which time the Company may enter into a new repurchase arrangement at prevailing market rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. When the fair value of pledged securities declines due to changes in market conditions or the publishing of monthly security pay down factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or fund cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. Conversely, if collateral fair values increase, lenders are required to release collateral back to the Company pursuant to Company-issued margin calls.

The Company's borrowings under repurchase arrangements and similar borrowings at March 31, 2014 consisted of \$12.59 billion of primarily 30-day borrowings with 22 counterparties at average rates of 0.32%, before the effects of interest rate swap agreements held as cash flow hedges and 0.48% including the effects of these derivatives.

To help mitigate exposure to higher short-term interest rates, Capstead typically uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms. Variable payments received by the Company under these swap agreements offset a significant portion of the interest accruing on a like amount of the Company's 30- to 90-day borrowings. As a result, the Company's effective borrowing rate for these borrowings consists of fixed-rate payments made on the swap agreements adjusted for differences between variable rate payments received on the swap agreements and related actual repo borrowing rates, as well as the effects of measured hedge ineffectiveness.

At March 31, 2014, the Company held portfolio financing-related swap agreements totaling \$7.20 billion notional amount with average contract expirations of 17 months. These swap positions consisted of (a) \$5.70 billion notional amount in currently-paying swap agreements requiring the payment of fixed rates of interest averaging 0.50% for average remaining interest-payment terms of 15 months and (b) \$1.50 billion notional amount in forward-starting swap agreements that will begin requiring fixed rate interest payments averaging 0.49% for two-year periods that commence on various dates between April 2014 and July 2014, with average contract expirations of 25 months. During the quarter ended March 31, 2014 Capstead entered into new forward-starting swap agreements with notional amounts totaling \$700 million requiring fixed rate interest payments averaging 0.52% for two-year periods that commence on various dates between April 2014 and July 2014. Also during the current quarter, \$200 million notional amount of swaps requiring fixed rate interest payments averaging 0.60% matured, while \$1.70 billion notional amount of previously acquired forward-starting swaps requiring fixed rate interest payments averaging 0.51% moved into current-pay status. After consideration of all portfolio financing-related swap positions entered into as of quarter-end, the Company's residential mortgage investments and related borrowings had estimated durations at March 31, 2014 of

11½ and 9½ months, respectively, for a net duration gap of approximately two months – see pages 33 and 34 under the caption “Interest Rate Risk” for further information about the Company’s sensitivity to changes in market interest rates. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated repurchase arrangements if available at attractive terms.

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Components of quarterly financing spreads on residential mortgage investments, a non-GAAP financial measure, and mortgage prepayment rates, expressed as an annualized constant prepayment rate, or “CPR,” were as follows for the indicated periods:

	2014	2013				2012		
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2
Yields on residential mortgage investments: <sup>(a)</sup>								
Cash yields	2.46 %	2.48 %	2.50 %	2.52 %	2.57 %	2.60 %	2.65 %	2.71 %
Investment premium amortization	(0.67 )	(0.74 )	(1.14 )	(0.99 )	(0.84 )	(0.84 )	(0.79 )	(0.67 )
Adjusted yields	1.79	1.74	1.36	1.53	1.73	1.76	1.86	2.04
Related borrowing rates: <sup>(b)</sup>								
Repo borrowing rates	0.34	0.38	0.37	0.39	0.41	0.45	0.41	0.37
Fixed swap rates	0.50	0.52	0.59	0.65	0.71	0.75	0.78	0.80
Adjusted borrowing rates	0.49	0.49	0.49	0.53	0.58	0.63	0.56	0.54
Financing spreads on residential mortgage investments	1.30	1.25	0.87	1.00	1.15	1.13	1.30	1.50
CPR	15.16	17.14	25.49	23.12	20.05	19.99	19.14	16.31

(a) Cash yields are based on the cash component of interest income. Investment premium amortization is determined using the interest method which incorporates actual and anticipated future mortgage prepayments. Both are expressed as a percentage calculated on an annualized basis on average amortized cost basis for the indicated periods.

(b) Repo borrowing rates represent average rates on repurchase agreements and similar borrowings, before consideration of related currently-paying interest rate swap agreements.

Fixed swap rates represent the average fixed-rate payments made on currently-paying interest rate swap agreements held for portfolio hedging purposes and exclude differences between LIBOR-based variable-rate payments received on these swaps and repo borrowing rates, as well as the effects of any hedge ineffectiveness. These differences averaged 18 basis points on average currently-paying swap notional amounts outstanding during the first quarter of 2014.

Adjusted borrowing rates reflect repo borrowing rates, fixed swap rates and the above-mentioned differences. All rates presented are expressed as a percentage calculated on an annualized basis for the indicated periods.

First quarter 2014 cash yields declined by two basis points from fourth quarter 2013 cash yields reflecting lower coupon interest rates on mortgage loans underlying the Company’s holdings of ARM securities resulting from changes in portfolio composition due to acquisitions and portfolio runoff as well as ARM loan coupon resets. Declines in coupon interest rates because of ARM coupon resets have moderated as an increasing number of these loans approach fully-indexed levels.

Investment premium amortization is primarily driven by changes in mortgage prepayment rates and investment premium levels. As older, lower-basis securities held by the Company prepay, the cost basis of the portfolio (expressed as a ratio of amortized cost basis to unpaid principal balance) has increased over time largely because of higher prices paid in recent periods for acquisitions. During the current quarter the increase was limited to one basis point to 103.27 compared to 17 basis points over the course of 2013. A higher cost basis in the portfolio contributes over time to larger yield adjustments for investment premium amortization.



Mortgage prepayments began moderating the latter part of 2013 as refinancing opportunities began receding after mortgage interest rates rose earlier in the year. A further decline in mortgage prepayment levels during the first quarter of 2014 to two-year lows resulted in a corresponding decline in the yield adjustment necessary for investment premium amortization. This decline was in large part due to higher prevailing mortgage interest rates, as well as seasonal factors. Mortgage prepayment rates will likely be modestly higher during the remainder of 2014 reflecting seasonal factors and an improving housing market. Repo borrowing rates averaged four basis points lower during the first quarter of 2014 compared to the fourth quarter of 2013 reflecting the current breadth and health of the financing market for Agency Securities. Adjusted for portfolio financing-related and currently-paying interest rate swap agreements, borrowing rates averaged 0.49% during the first quarter of 2014, unchanged from the fourth quarter of 2013 as the benefits of lower repo borrowing rates were offset by a greater percentage of portfolio-financing related interest rate swap agreements moving into current-pay status. See NOTE 7 to the consolidated financial statements for further information regarding the Company's currently-paying and forward-starting swap agreements.

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## Reconciliation of Financing Spreads on Residential Mortgage Investments to Total Financing Spreads

Financing spreads on residential mortgage investments differs from total financing spreads, an all-inclusive GAAP measure, that is based on all interest-earning assets and all interest-paying liabilities. The Company believes that presenting financing spreads on residential mortgage investments provides useful information for evaluating portfolio performance. The following table reconciles this measure for the indicated periods:

	2014		2013			2012				
	Q1	Q4	Q3	Q2	Q1	Q4	Q3	Q2		
Financing spreads on residential mortgage investments	1.30 %	1.25 %	0.87 %	1.00 %	1.15 %	1.13 %	1.30 %	1.50 %		
Impact of yields on other interest-earning assets*	(0.04)	(0.03)	(0.02)	(0.05)	(0.05)	(0.07)	(0.05)	(0.06)		
Impact of borrowing rates on unsecured borrowings and interest-paying liabilities*	(0.07)	(0.07)	(0.06)	(0.06)	(0.06)	(0.06)	(0.06)	(0.07)		
Total financing spreads	1.19	1.15	0.79	0.89	1.04	1.00	1.19	1.37		

Other interest-earning assets consist of overnight investments and cash collateral receivable from interest rate swap \*counterparties. Other interest-paying liabilities consist of long-term unsecured borrowings (at an average borrowing rate of 8.49%) that the Company considers a component of its long-term investment capital and cash collateral payable to interest rate swap counterparties.

## Utilization of Long-term Investment Capital and Potential Liquidity

Capstead's investment strategy is to manage a conservatively leveraged portfolio of ARM Agency Securities that can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. Borrowings under repurchase arrangements generally can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Consequently, potential liquidity inherent in the Company's unencumbered residential mortgage investments is as important as the actual level of cash and cash equivalents carried on the balance sheet. Potential liquidity is affected by, among other things, current portfolio leverage levels; changes in market value of assets pledged and interest rate swap agreements held for hedging purposes as determined by lending and swap counterparties; principal prepayments; collateral requirements of lenders and swap counterparties; and general conditions in the commercial banking and mortgage finance industries. Future levels of portfolio leverage will be dependent upon many factors, including the size and composition of the Company's investment portfolio (see "Liquidity and Capital Resources").

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Capstead's utilization of its long-term investment capital and its estimated potential liquidity were as follows as of March 31, 2014 in comparison with December 31, 2013 (in thousands):

	Investments (a)	Related Borrowings	Capital Employed	Potential Liquidity (b)	Portfolio Leverage
Balances as of March 31, 2014:					
Residential mortgage investment portfolio	\$13,529,211	\$12,590,255	\$938,956	\$300,912	
Cash collateral receivable from swap counterparties, net (c)			21,764	—	
Other assets, net of other liabilities			517,869	486,293	
			\$1,478,589	\$787,205	8.52:1
Balances as of December 31, 2013	\$13,475,874	\$12,482,900	\$1,465,783	\$770,639	8.52:1

(a) Investments are stated at balance sheet carrying amounts, which generally reflect estimated fair value as of the indicated dates.

Potential liquidity is based on maximum amounts of borrowings available under existing uncommitted repurchase (b) arrangements considering management's estimate of the fair value of related collateral as of the indicated dates adjusted for other sources of liquidity such as cash and cash equivalents.

(c) Cash collateral receivable from swap counterparties is presented net of cash collateral payable to swap counterparties, if applicable, and the fair value of interest rate swap positions as of the indicated date.

In order to prudently and efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund borrowing and interest rate swap margin calls under stressed market conditions, including margin calls resulting from monthly principal payments (remitted to the Company 20 to 45 days after any given month-end), as well as reasonably possible declines in the market value of pledged assets and swap positions. Should market conditions deteriorate, management may reduce portfolio leverage and therefore increase liquidity by raising new equity capital, selling mortgage securities and/or curtailing the replacement of portfolio runoff. Additionally, the Company routinely does business with a large number of lending counterparties, which bolsters financial flexibility to address challenging market conditions and limits exposure to any individual counterparty.

At March 31, 2014 portfolio leverage was unchanged from year-end at 8.52 to one while the portfolio, long-term investment capital and potential liquidity increased modestly during this period. Management believes current portfolio leverage levels represent an appropriate and prudent use of leverage under current market conditions for a portfolio consisting of seasoned, short-duration ARM Agency Securities.

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## RESULTS OF OPERATIONS

	Quarter Ended March 31	
	2014	2013
Income statement data: (in thousands, except per share data)		
Interest income on residential mortgage investments (before investment premium amortization)	\$81,733	\$86,867
Investment premium amortization	(22,288)	(28,399)
Related interest expense	(15,407)	(18,468)
	44,038	40,000
Other interest income (expense) *	(2,061 )	(2,010 )
	41,977	37,990
Other revenue (expense):		
Salaries and benefits	(1,132 )	(1,001 )
Annual incentive compensation	(540 )	(554 )
Long-term incentive compensation	(626 )	(406 )
Other general and administrative expense	(1,203 )	(1,081 )
Miscellaneous other revenue (expense)	(85 )	(30 )
	(3,586 )	(3,072 )
Net income	\$38,391	\$34,918
Net income per diluted common share	\$0.37	\$0.31
Average diluted shares outstanding	95,538	95,450
Key operating statistics: (dollars in millions)		
Average yields:		
Residential mortgage investments:		
Cash yields	2.46 %	2.57 %
Investment premium amortization	(0.67 )	(0.84 )
Adjusted yields	1.79	1.73
Other interest-earning assets	0.06	0.11
Total average yields	1.75	1.68
Average borrowing rates:		
Repurchase arrangements and similar borrowings:		
Repo borrowing rates	0.34	0.41
Fixed swap rates	0.50	0.71
Adjusted borrowing rates	0.49	0.58
Unsecured borrowings	8.49	8.49
Total average borrowing rates	0.56	0.64
Total average financing spreads	1.19	1.04
Average financing spreads on residential mortgage investments	1.30	1.15
Average net yield on total interest-earning assets	1.23	1.09
Average CPR	15.16	20.05
Average balance information:		
Residential mortgage investments (cost basis)	\$13,254	\$13,543
Other interest-earning assets	383	428
Repurchase arrangements and similar borrowings	12,466	12,769
Currently-paying swap agreements (notional amounts)	5,686	4,293
Unsecured borrowings (included in long-term investment capital)	100	103
Long-term investment capital ("LTIC")	1,485	1,605
Portfolio leverage	8.39:1	7.96:1

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Operating costs as a percentage of average LTIC	0.96	%	0.77	%
Return on average LTIC	11.07		9.36	
Return on average common equity capital	11.70		9.14	

\* Consists principally of interest on unsecured borrowings and is presented net of earnings of related statutory trusts.  
These affiliates were dissolved in December 2013.

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Capstead reported net income of \$38 million or \$0.37 per diluted common share for the first quarter of 2014 compared to \$35 million or \$0.31 per diluted common share for the first quarter of 2013.

Financing spreads on residential mortgage investments averaged 1.30% for the first quarter of 2014, compared to 1.15% for the first quarter of 2013. Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on residential mortgage investments, net of repo borrowing rates after adjusting for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure that includes yields on all interest-earning assets, as well as rates paid on all interest-bearing liabilities, principally unsecured borrowings. See page 28 for a reconciliation of these GAAP and non-GAAP financial measures. Higher financing spreads reflect lower investment premium amortization as a result of a 24% decline in mortgage prepayment rates offset by the effects of a modestly lower average portfolio outstanding and lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates resetting lower to more current rates as well as lower coupon interest rates on acquisitions. Average borrowing rates were considerably lower than in the first quarter of 2013 reflecting the benefits of lower market rates for repo financing and older, higher-rate interest rate swap agreements used for hedging purposes being replaced with lower-rate swap agreements since the beginning of last year.

Yields on residential mortgage securities averaged 1.79% during the quarter ended March 31, 2014, compared to 1.73% for the same period in 2013. Cash yields averaged 2.46% during the quarter ended March 31, 2014; which was 11 basis points lower than cash yields reported for the same period in 2013. Investment premium amortization totaled \$22 million for the quarter ended March 31, 2014, representing a yield adjustment of 67 basis points, compared to amortization of \$28 million or 84 basis points for the same period in 2013. Of the 17 basis point decrease in investment premium amortization, approximately 19 basis points was attributable to lower levels of portfolio runoff due to lower levels of mortgage prepayments, while the offsetting two basis points was primarily attributable to increases in the cost basis of the portfolio. See page 27 for further discussion of the effects of the current market environment on mortgage prepayment levels.

After adjusting for interest rate hedging transactions, borrowing rates averaged 0.49% during the quarter ended March 31, 2014, a decrease of nine basis points from the same period in 2013. Repo borrowing rates averaged 0.34% during the first quarter of 2014, seven basis points lower than rates reported for the same period in 2013, reflecting increasingly healthy repo financing market conditions, including less competition for borrowings as a result of significant declines in portfolio holdings experienced by the Company's mortgage REIT peers in 2013. Rates on \$5.69 billion of the Company's average borrowings during the quarter ended March 31, 2014 were largely fixed through the use of interest rate swap agreements. The corresponding amount was \$4.29 billion for the same period in 2013. Fixed-rate payment requirements on the Company's currently-paying swap positions (excluding adjustments for spreads between variable rates on the swap agreements and repo borrowing rates and the effects of measured hedge ineffectiveness) averaged 0.50% for the first quarter of 2014, which was 21 basis points lower than rates reported for the same period in 2013, reflecting the expiration of older, higher-rate swap agreements over the last 15 months which were replaced with lower-rate swap agreements. Some of the benefits of lower repo borrowing rates and lower fixed-rate payment requirements were offset by a greater percentage of portfolio-financing related interest rate swap agreements moving into current-pay status.

Operating costs (salaries and benefits, incentive compensation and other general and administrative expense) as a percentage of long-term investment capital averaged 0.96% for the first quarter of 2014, which was 19 basis points higher than reported for the same period in 2013. The increase is attributable to higher costs in addition to the effects of lower average long-term investment capital on the ratio. See NOTE 11 to the accompanying consolidated financial statements for additional information regarding the Company's compensation programs.

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## LIQUIDITY AND CAPITAL RESOURCES

Capstead's primary sources of funds are borrowings under repurchase arrangements and monthly principal and interest payments on its investments. Other sources of funds may include proceeds from debt and equity offerings and asset sales. The Company generally uses its liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage its long-term investment capital. Because the level of these borrowings can generally be adjusted on a daily basis, the Company's potential liquidity inherent in its unencumbered residential mortgage investments is as important as the level of cash and cash equivalents carried on the balance sheet. The table included under "Utilization of Long-term Investment Capital and Potential Liquidity" on page 29 illustrates management's estimate of additional funds potentially available to the Company as of March 31, 2014 and the accompanying discussion provides insight into the Company's perspective on the appropriate level of portfolio leverage to employ under current market conditions. The Company currently believes that it has sufficient liquidity and capital resources available for the acquisition of additional investments, common share repurchases when considered appropriate, repayments on borrowings and the payment of cash dividends as required for the Company's continued qualification as a REIT. It is the Company's policy to remain strongly capitalized and conservatively leveraged.

Capstead generally pledges its residential mortgage investments as collateral under repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties, when each borrowing is initiated or renewed. None of the Company's counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. As of March 31, 2014, the Company had uncommitted repurchase facilities with a variety of lending counterparties to finance its portfolio, subject to certain conditions, and had borrowings outstanding with 22 of these counterparties. Amounts available to be borrowed under these arrangements are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders' determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the commercial banking and mortgage finance industries. Borrowings under repurchase arrangements totaled \$12.59 billion at March 31, 2014, primarily with original maturities of 30 days. Borrowings under repurchase arrangements began the year at \$12.48 billion and averaged \$12.47 billion during the first quarter of 2014. Average borrowings during the quarter can differ from quarter-end balances for a number of reasons including portfolio growth or contraction as well as differences in the timing of portfolio acquisitions relative to portfolio runoff.

To help mitigate exposure to higher interest rates, Capstead typically uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms that are designated as cash flow hedges of a like amount of borrowings under repurchase arrangements. At March 31, 2014, portfolio financing-related swap agreements totaling \$7.20 billion notional amount with average contract expirations of 17 months, consisting of (a) \$5.70 billion notional amount in currently-paying swap agreements requiring the payment of fixed rates of interest averaging 0.50% for average remaining interest-payment terms of 15 months and (b) \$1.50 billion notional amount in forward-starting swap agreements that will begin requiring fixed rate interest payments averaging 0.49% for two-year periods that commence on various dates between April 2014 and July 2014, with average contract expirations of 25 months. Relative to the floating rate terms of the Company's \$100 million in unsecured borrowings that begin at various dates between October 2015 and September 2016, the Company entered into forward-starting swap agreements to effectively lock in fixed rates of interest averaging 7.56% for the final 20 years of these borrowings that mature in 2035 and 2036. The Company intends to continue to utilize suitable derivative financial instruments such as interest rate swap agreements to manage interest rate risk.

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In late 2012 Capstead implemented a \$100 million common share repurchase program and suspended its common share continuous offering program until further notice. Purchases made pursuant to the common share repurchase program can be made in the open market or through privately negotiated transactions from time to time as permitted by securities laws and other legal requirements. The timing, manner, price and amount of any repurchases are determined by the Company in its discretion and are subject to economic and market conditions, applicable legal requirements and other factors. Pursuant to this authorization, in late 2012 repurchases totaled 3.0 million common shares at an average cost of \$11.80 per share for \$35 million. An additional 638,000 shares were repurchased in early January 2013 at an average cost of \$11.43 per share for \$7 million, leaving \$58 million of the authorization available for future repurchases. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company's discretion without prior notice. Upon suspension of the repurchase program, issuances of common shares under the continuous offering program or by other means may resume subject to market conditions, compliance with federal securities laws and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

In May 2013 Capstead completed a public offering of 6.8 million shares (\$170 million face amount) of its 7.50% Series E Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share, using the \$164 million in proceeds, net of underwriter fees and other costs, together with \$43 million of cash on hand to fund the June 2013 redemption of the Company's Series A and B perpetual preferred shares. The Series E shares are redeemable at the Company's option for \$25.00 per share, plus any accumulated and unpaid dividends, on or after May 13, 2018. In late 2013 the Company began issuing additional Series E preferred shares through an at-the-market continuous offering program. During the quarter ended March 31, 2014, the Company issued 56,000 Series E preferred shares at an average price of \$23.83, net of expenses, and has continued issuing Series E preferred shares subsequent to quarter-end. Modest additional amounts of Series E preferred capital may be raised in the future under this program subject to market conditions, compliance with federal securities laws and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

## Interest Rate Risk

Because Capstead's residential mortgage investments consist almost entirely of Agency Securities, which are considered to have limited, if any, credit risk, interest rate risk is the primary market risk faced by the Company. Interest rate risk is highly sensitive to a number of factors, including economic conditions, government fiscal policy, central bank monetary policy and banking regulation. By focusing on investing in relatively short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration, fixed-rate assets. These declines can be recovered in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment. This strategy positions the Company to benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates.

To further mitigate Capstead's exposure to higher short-term interest rates, the Company uses currently-paying and forward-starting interest rate swap agreements that typically require interest payments for two-year terms in order to lengthen the effective duration of its borrowings to more closely match the duration of its investments. After consideration of all swap positions entered into as of quarter-end to hedge changes in short-term interest rates, the Company's residential mortgage investments and related borrowings under repurchase arrangements had estimated durations at March 31, 2014 of 11½ and 9½ months, respectively, for a net duration gap of approximately two months. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated repurchase arrangements if available at attractive terms.



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Capstead performs sensitivity analyses using a model to estimate the effects that specific interest rate changes can reasonably be expected to have on net interest margins and portfolio values. All investments, related borrowings and derivative financial instruments held are included in these analyses. For net interest margin modeling purposes, the model incorporates management's assumptions for mortgage prepayment levels for a given interest rate change using market-based estimates of prepayment speeds for the purpose of amortizing investment premiums and reinvesting portfolio runoff. These assumptions are developed through a combination of historical analysis and expectations for future pricing behavior under normal market conditions unaffected by changes in market liquidity. For portfolio valuation modeling purposes, a static portfolio is assumed. This modeling is the primary tool used by management to assess the direction and magnitude of changes in net interest margins and portfolio values resulting solely from changes in interest rates. Key modeling assumptions include mortgage prepayment speeds, adequate levels of market liquidity, current market conditions, and portfolio leverage levels. Given the present low level of interest rates, a floor of 0.00% is assumed. However, it is assumed that borrowing rates cannot decline beyond a certain level. These assumptions are inherently uncertain and, as a result, modeling cannot precisely estimate the impact of higher or lower interest rates. Actual results will differ from simulated results due to the timing, magnitude and frequency of interest rate changes, other changes in market conditions, changes in management strategies and other factors.

The table below reflects the estimated impact of instantaneous parallel shifts in the yield curve on net interest margins and the fair value of Capstead's portfolio of residential mortgage investments and related derivatives at March 31, 2014 and December 31, 2013, subject to the modeling parameters described above.

	Federal Funds Rate	10-year U.S. Treasury Rate	Down 0.50%	Up 0.50%	Up 1.00%
Projected 12-month percentage change in net interest margins: *					
March 31, 2014	<0.25 %	2.72 %	(18.0)%	0.8 %	(2.0 )%
December 31, 2013	<0.25 %	3.03 %	(15.9 )	(1.5 )	(6.6 )
Projected percentage change in portfolio and related derivative values: *					
March 31, 2014	<0.25 %	2.72 %	0.1 %	(0.2 )%	(0.4 )%
December 31, 2013	<0.25 %	3.03 %	-	(0.2 )	(0.3 )

Sensitivity of net interest margins as well as portfolio and related derivative values to changes in interest rates is determined relative to the actual rates at the applicable date. Note that the projected 12-month net interest margin \*change is predicated on acquisitions of similar assets sufficient to replace runoff. There can be no assurance that suitable investments will be available for purchase at attractive prices, if investments made will behave in the same fashion as assets currently held or if management will choose to replace runoff with such assets.

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RISK FACTORS

An investment in securities issued by Capstead involves various risks. An investor should carefully consider the following risk factors in conjunction with the other information contained in this document before purchasing the Company's securities. The risks discussed herein can adversely affect the Company's business, liquidity, operating results, financial condition and future prospects, causing the market price of the Company's securities to decline, which could cause an investor to lose all or part of his/her investment. The risk factors described below are not the only risks that may affect the Company. Additional risks and uncertainties not presently known to the Company also may adversely affect its business, liquidity, operating results, prospects and financial condition.

Risks Related to Capstead's Business

Monetary policy actions by the Federal Reserve could adversely affect Capstead's liquidity, financial condition and earnings. Over the last six years the Federal Reserve has employed a number of new policy initiatives, most notably the purchase of U.S. Treasury securities and Agency Securities. This expansion of the Federal Reserve's balance sheet is often referred to as quantitative easing or QE. The policy goals of the QE initiatives have been to support the GSEs and the housing markets, and otherwise improve economic and labor market conditions by exerting downward pressure on longer term interest rates, including mortgage interest rates.

Under the current QE initiative that began in September 2012 (referred to as QE3), the Federal Reserve had been purchasing \$45 billion a month in long-term Treasury securities and \$40 billion a month in fixed-rate Agency Securities, as well as replacing run off of existing holdings of fixed-rate Agency Securities. In May 2013 the markets began interpreting comments by members of the Federal Reserve's Federal Open Market Committee to mean that purchases under QE3 would begin to be reduced sometime in 2013. The Federal Reserve then articulated that the so-called "tapering" of purchases could begin in September 2013. Citing mixed economic reports and the potential for further fiscal discord in Washington, the Federal Reserve did not begin tapering in September; however in December 2013 it announced that beginning in January 2014 it was reducing purchases of Treasuries and Agency Securities by \$5 billion each. At each successive meeting thus far in 2014 further tapering of \$5 billion each was announced such that for May 2014 the Federal Reserve plans on purchasing \$25 billion in Treasury Securities and \$20 billion in Agency Securities, while continuing to replace portfolio runoff. The Federal Reserve has indicated that the pace of tapering can be expected to continue, contingent upon its outlook for the labor market and inflation as well as its assessment of the efficacy and costs of such purchases.

In general, QE elevated pricing for Agency Securities resulting in declining yields on new purchases and lower mortgage interest rates, resulting in higher mortgage prepayment rates. The Company's net interest margins, and therefore earnings, have been adversely affected over time as its existing portfolio is replaced with higher cost, lower-yielding securities. See discussion below regarding the negative effects of higher mortgage prepayment levels.

Because of expectations for near-term tapering of QE3, in May and June 2013 the markets experienced an abrupt transition to higher long-term interest rates, which had a substantial negative effect on pricing for longer-duration ARM and fixed-rate Agency Securities in particular, and to a lesser extent, on the Company's portfolio of seasoned, short-duration ARM Agency Securities. This initially had a negative effect on the Company's liquidity and book value per common share, even as mortgage prepayment rates eventually receded as opportunities for mortgagors to refinance into lower-rate mortgages dissipated. The actual pace of tapering could result in additional negative effects. In addition, should the Federal Reserve decide to eventually reduce its holdings of fixed-rate Agency Securities through asset sales, the pricing for all Agency Securities could decline, which could adversely affect the Company's liquidity, earnings and book value per common share, as more fully described below.

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Potential changes in the relationship between the federal government and the GSEs could adversely affect Capstead's liquidity, financial condition and earnings. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest on these securities are guaranteed by the GSEs, or by Ginnie Mae, an agency of the federal government. Only the guarantee by Ginnie Mae is explicitly backed by the full faith and credit of the federal government. The high actual or perceived credit quality of Agency Securities allows the Company to finance its portfolio using repurchase arrangements with favorable interest rate terms and margin requirements that otherwise would not be available. As a result of deteriorating housing market conditions that began in 2007, the GSEs incurred substantial losses due to high levels of mortgagor defaults and in 2008 the Federal Housing Finance Agency placed the GSEs into conservatorship, allowing it to operate the GSEs without forcing them to liquidate. Additionally, the federal government, through the U.S. Treasury and the Federal Reserve, undertook other actions to provide financial support to these entities and the housing market including the acquisition of large holdings of Agency Securities. These and other steps taken by the federal government were designed to support market stability and mortgage availability at favorable rates in part by providing additional confidence to investors in Agency Securities.

It is anticipated that over the next several years U.S. policy makers will reach a consensus on what the long-term role of the federal government in general, and the GSEs in particular, will have in the housing markets. In this regard there have been numerous proposals put forth by members of both Houses of Congress, the Treasury Department and regulators regarding GSE reform. The actual or perceived credit quality of Agency Securities could be adversely affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between the GSEs and the federal government. A significantly reduced role by the federal government or other changes in the guarantees provided by Ginnie Mae, the GSEs or their successors could adversely affect the credit profile and pricing of existing holdings and/or future issuances of Agency Securities and whether the Company's strategy of holding a leveraged portfolio of Agency Securities remains viable, which could adversely affect earnings and book value per common share.

Failure of the federal government to periodically increase the U.S. Treasury's borrowing capacity while reducing future federal budget deficits could adversely impact Capstead's liquidity, financial condition and earnings. The increasing amount of outstanding federal debt relative to the size of the U.S. economy, particularly in light of projected growth in federal government spending and resulting federal budget deficits, have increased the possibility of further credit rating agency actions to downgrade the federal government's credit rating. This could eventually lead to a decline in the market's perception of the creditworthiness of the federal government. Because market participants rely on the federal government's continued support of the GSEs, the perception of credit risk associated with Agency Securities and, therefore, the pricing of existing holdings of Agency Securities could be adversely affected. In addition, these circumstances could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability and/or terms and conditions of borrowings under repurchase arrangements which could adversely impact the Company's liquidity, earnings and book value per common share, as more fully described below.

Legislative and regulatory actions could adversely affect the availability and/or terms and conditions of borrowings under repurchase arrangements and consequently, the Company's liquidity, financial condition and earnings. In July 2010 the U.S. Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") in order to restrict certain business practices of systemically significant participants in the financial markets, which include many of the Company's lending counterparties. Additionally, changes in regulatory capital requirements and other leverage constraints are being implemented worldwide. It remains unclear how significant of an impact Dodd Frank and changes in regulatory capital requirements will have on the financial markets in general and on the Company's strategy of holding an appropriately hedged, leveraged portfolio of Agency Securities. However, it is possible that the availability and/or terms and conditions of borrowings under repurchase arrangements and related derivative financial instruments held for hedging purposes could be adversely affected which could adversely affect the Company's liquidity, earnings and book value per common share, as more fully described below.



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Government-supported mortgagor relief programs could adversely affect Capstead's liquidity, financial condition and earnings. U.S. policy makers have established programs designed to provide qualified homeowners with assistance in avoiding foreclosure or in qualifying for the refinancing of their existing mortgages, which typically entails the pay off of existing mortgages with any losses absorbed by the GSEs. One of these programs, the Home Affordable Refinance Program ("HARP"), has been revised with the intent of increasing its availability to homeowners who are current on their mortgage payments but whose homes have lost significant value making it difficult to qualify for a new mortgage. A significant expansion of these mortgagor relief programs, as well as any future legislative or regulatory actions, could significantly increase mortgage prepayments which could reduce the expected life of the Company's residential mortgage investments; therefore, actual yields the Company realizes on these investments could be lower due to faster amortization of investment premiums which could adversely affect earnings. A significant expansion of these programs also could adversely affect book value per common share because of the elimination of any unrealized gains on that portion of the portfolio that prepays. Additionally, heightened prepayment exposure due to the real or perceived potential for government intervention could adversely affect pricing for Agency Securities in general and, as a result, liquidity and book value per common share could be adversely affected due to declines in the fair value of the Company's remaining portfolio.

An increase in prepayments may adversely affect Capstead's liquidity, financial condition and earnings. When short- and long-term interest rates are at nearly the same levels (i.e., a "flat yield curve" environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of the Company's portfolio of residential mortgage investments; therefore, actual yields the Company realizes can be lower due to faster amortization of investment premiums, which could adversely affect earnings. High levels of mortgage prepayments can also lead to larger than anticipated demands on the Company's liquidity from its lending counterparties, as more fully described below. Additionally, periods of high prepayments can adversely affect pricing for Agency Securities in general and, as a result, book value per common share can be adversely affected due to declines in the fair value of the Company's remaining portfolio and the elimination of any unrealized gains on that portion of the portfolio that prepays.

Changes in interest rates, whether increases or decreases, may adversely affect Capstead's liquidity, financial condition and earnings. Capstead's earnings depend primarily on the difference between the interest received on its residential mortgage investments and the interest paid on its related borrowings, net of the effect of derivatives held for hedging purposes. The Company typically finances its investments at 30- to 90-day interest rates. Coupon interest rates on only a portion of the ARM loans underlying the Company's securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan. Consequently, interest rates on related borrowings not effectively fixed through the use of interest rate swap agreements can rise to levels that may exceed yields on these securities in a rising short-term interest rate environment. This can contribute to lower, or in more extreme circumstances, negative financing spreads and, therefore, adversely affect earnings. Because rising interest rates tend to put downward pressure on financial asset prices, Capstead may be presented with substantial margin calls during such periods adversely affecting the Company's liquidity. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

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During periods of relatively low short-term interest rates, declines in the indices used to determine coupon interest rate resets for ARM loans may adversely affect yields on the Company's ARM securities as the underlying ARM loans reset at lower rates. If declines in these indices exceed declines in the Company's borrowing rates, earnings would be adversely affected.

Periods of illiquidity in the mortgage markets may reduce amounts available to be borrowed under Capstead's repurchase arrangements due to declines in the perceived value of related collateral, which could adversely impact the Company's liquidity, financial condition and earnings. Capstead generally finances its residential mortgage investments by pledging them as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis. The amount borrowed under a repurchase arrangement is limited to a percentage of the estimated market value of the pledged collateral and is specified at the inception of the transaction. The portion of the pledged collateral held by the lender that is not advanced under the repurchase arrangement is referred to as margin collateral and the resulting margin percentage is required to be maintained throughout the term of the borrowing. If the perceived market value of the pledged collateral as determined by the Company's lenders declines, the Company may be subject to margin calls wherein the lender requires the Company to pledge additional collateral to reestablish the agreed-upon margin percentage. Because market illiquidity tends to put downward pressure on asset prices, Capstead may be presented with substantial margin calls during such periods. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

Periods of illiquidity in the mortgage markets may reduce the number of counterparties willing to lend to the Company and/or the amounts individual counterparties are willing to lend via repurchase arrangements, which could adversely affect the Company's liquidity, financial condition and earnings. Capstead enters into repurchase arrangements with numerous commercial banks and other financial institutions, both foreign and domestic, routinely with maturities of 30 to 90 days. The Company's ability to achieve its investment objectives depends on its ability to re-establish or roll maturing borrowings on a continuous basis and none of the Company's counterparties are obligated to enter into new repurchase transactions at the conclusion of existing transactions. If a counterparty chooses not to roll a maturing borrowing, the Company must pay off the borrowing, generally with cash available from another repurchase arrangement entered into with another counterparty. If the Company determines that it does not have sufficient borrowing capacity with its remaining counterparties, it could be forced to reduce its portfolio leverage by selling assets under potentially adverse market conditions, resulting in losses. This risk is increased if Capstead relies significantly on any single counterparty for a significant portion of its repurchase arrangements. An industry-wide reduction in the availability of borrowings under repurchase arrangements could adversely affect pricing levels for Agency Securities leading to further declines in the Company's liquidity and book value per common share. Under these conditions, the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of residential mortgage investments will lead to declines in book value per common share.

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If Capstead is unable to negotiate favorable terms and conditions on future repurchase arrangements with one or more of the Company's lending counterparties, the Company's liquidity, financial condition and earnings could be adversely impacted. The terms and conditions of each repurchase arrangement are negotiated on a transaction-by-transaction basis, and these borrowings generally are re-established, or rolled, at maturity. Key terms and conditions of each transaction include interest rates, maturity dates, asset pricing procedures and margin requirements. The Company cannot assure investors that it will be able to continue to negotiate favorable terms and conditions on its future repurchase arrangements. For instance, during periods of market illiquidity or due to perceived credit deterioration of the collateral pledged or the Company itself, a lender may require that less favorable asset pricing procedures be employed, margin requirements be increased and/or may choose to limit or completely curtail lending to the Company. Under these conditions, the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

Capstead's use of repurchase arrangements to finance its investments may expose the Company to losses if a lending counterparty seeks bankruptcy protection, or otherwise defaults on its obligation to deliver pledged collateral back to the Company. Repurchase arrangements involve the sale and transfer of pledged collateral to the lending counterparty and a simultaneous agreement to repurchase the transferred assets at a future date. This may make it difficult for the Company to recover its pledged assets if a lender files for bankruptcy or otherwise fails to deliver pledged collateral back to the Company and subject the Company to losses to the extent of any margin amounts (pledged assets in excess of amounts borrowed) held by the lending counterparty.

Capstead's use of repurchase arrangements to finance its investments may give the Company's lending counterparties greater rights if the Company seeks bankruptcy protection, exposing the Company to losses. Borrowings made under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. If the Company files for bankruptcy, its lending counterparties could avoid the automatic stay provisions of the U.S. Bankruptcy Code and liquidate pledged collateral without delay, which could result in losses to the extent of any margin amounts held by the lending counterparties.

Capstead may sell assets for various reasons, including a change in the Company's investment focus, which could increase earnings volatility. Capstead may periodically sell assets to enhance its liquidity during periods of market illiquidity or rising interest rates or the Company may change its investment focus requiring it to sell some portion of its existing investments. Gains or losses resulting from any such asset sales, or from terminating any related longer-dated repurchase arrangements or interest rate swap agreements, could increase the Company's earnings volatility.

Capstead may invest in derivative financial instruments such as interest rate swap agreements to mitigate or hedge the Company's interest rate risk, which may adversely affect the Company's liquidity, financial condition or earnings. The Company may invest in such instruments from time to time with the goal of achieving more stable borrowing costs over an extended period. However, these activities may not have the desired beneficial impact on the Company's liquidity, financial condition or earnings. For instance, the pricing of residential mortgage investments and the pricing of related derivatives may deteriorate at the same time leading to margin calls by counterparties to both the borrowings supporting these investments and the derivatives, adversely impacting the Company's liquidity and financial condition. In addition, counterparties could fail to honor their commitments under the terms of the derivatives or have their credit quality downgraded impairing the value of the derivatives. In the event of any defaults by counterparties, the Company may have difficulty recovering its cash collateral receivable from its counterparties and may not receive payments provided for under the terms of the derivatives and as a result, the Company may incur losses. No such hedging activity can completely insulate the Company from the risks associated with changes in interest rates and prepayment rates.

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Derivative financial instruments held may fail to qualify for hedge accounting introducing potential volatility to Capstead's earnings. The Company typically qualifies derivative financial instruments held as cash flow hedges for accounting purposes in order to record the effective portion of the change in fair value of derivatives as a component of stockholders' equity rather than in earnings. If the hedging relationship for any derivative held ceases to qualify for hedge accounting treatment for any reason, including failing to meet documentation and ongoing hedge effectiveness requirements, the Company would be required to record in earnings the total change in fair value of any such derivative. In addition the Company could elect to no longer avail itself of cash flow hedge accounting for its derivative positions. Such changes could introduce a potentially significant amount of volatility to earnings reported by the Company.

The lack of availability of suitable investments at attractive pricing may adversely affect Capstead's earnings. The pricing of investments is determined by a number of factors including interest rate levels and expectations, market liquidity conditions, and competition among investors for these investments, many of whom have greater financial resources and lower return requirements than Capstead. Additionally, in recent years the federal government, primarily through the Federal Reserve, has been an active buyer of Agency Securities which has had the effect of supporting, if not increasing, pricing for these securities. To the extent the proceeds from prepayments on Capstead's mortgage investments are not reinvested or cannot be reinvested at rates of return at least equal to the rates previously earned on those investments, the Company's earnings may be adversely affected. Similarly, if proceeds from capital raising activities are not deployed or cannot be deployed at rates of return being earned on existing capital, earnings may be adversely affected. Capstead cannot assure investors that the Company will be able to acquire suitable investments at attractive pricing and in a timely manner to replace portfolio runoff as it occurs or to deploy new capital as it is raised. Neither can the Company assure investors that it will maintain the current composition of its investments, consisting primarily of ARM Agency Securities.

Capstead is dependent on its executives and employees and the loss of one or more of its executive officers could harm the Company's business and its prospects. As a self-managed REIT with 13 full-time employees and one part-time employee, Capstead is dependent on the efforts of its key officers and employees, most of whom have significant experience in the mortgage industry. Although the Company's named executive officers and some of its other employees are parties to severance agreements, the Company's key officers and employees are not subject to employment agreements with non-compete clauses, nor has Capstead acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on the Company's operations.

Risks Related to Capstead's Status as a REIT and Other Tax Matters

If Capstead does not qualify as a REIT, the Company will be subject to tax as a regular corporation and face substantial tax liability. Capstead has elected to be taxed as a REIT for federal income tax purposes and intends to continue to so qualify. Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could jeopardize the Company's REIT status. Furthermore, new tax legislation, administrative guidance or court decisions, in each instance potentially with retroactive effect, could make it more difficult or impossible for the Company to qualify as a REIT.

If Capstead fails to qualify as a REIT in any tax year, then:

The Company would be taxed as a regular domestic corporation, which, among other things, means that the Company would be unable to deduct dividends paid to its stockholders in computing taxable income and would be subject to federal income tax on its taxable income at regular corporate rates;



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Any resulting tax liability could be substantial and would reduce the cash available for distribution to stockholders, and the Company would not be required to make income distributions; and

Unless Capstead were entitled to relief under applicable statutory provisions, the Company would be disqualified from treatment as a REIT for the subsequent four taxable years and, as a result, the Company's cash available for distribution to stockholders would be reduced during these years.

Even if Capstead remains qualified as a REIT, the Company may face other tax liabilities that reduce its earnings. Even if Capstead remains qualified for taxation as a REIT, the Company may be subject to certain federal, state and local taxes on its income and assets. For example, the Company:

- will be required to pay tax on any undistributed REIT taxable income,
- may be subject to the "alternative minimum tax" on any tax preference items, and
- may operate taxable REIT subsidiaries subject to tax on any taxable income earned.

Complying with REIT requirements may limit Capstead's ability to hedge effectively. The REIT provisions of the Code may limit Capstead's ability to hedge mortgage securities and related borrowings by requiring it to limit its income in each year from unqualified hedges together with any other income not generated from qualified real estate assets, to no more than 25% of gross income. In addition, the Company must limit its aggregate income from nonqualified hedging transactions, from providing certain services, and from other non-qualifying sources to not more than 5% of annual gross income. As a result, the Company may have to limit its use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than the Company would otherwise incur. If the Company were to violate the 25% or 5% limitations, it may have to pay a penalty tax equal to the amount of gross income in excess of those limitations, multiplied by a fraction intended to reflect the profitability of these transactions or activities. If the Company fails to satisfy the REIT gross income tests it could lose its REIT status for federal income tax purposes unless the failure was due to reasonable cause and not due to willful neglect.

Complying with REIT requirements may cause Capstead to forego otherwise attractive opportunities. To qualify as a REIT for federal income tax purposes, Capstead must continually satisfy tests concerning, among other things, the sources of its income, the nature and diversification of its assets, the amounts that it distributes to its stockholders, and the ownership of its stock. The Company may be required to make distributions to stockholders at disadvantageous times or when it does not have funds readily available for distribution. As a result, compliance with the REIT requirements may hinder the Company's ability to operate solely on the basis of maximizing profits.

Complying with REIT requirements may force Capstead to liquidate otherwise attractive investments. To qualify as a REIT, Capstead must also ensure that at the end of each calendar quarter at least 75% of the value of its assets consists of cash, cash items, United States government securities and qualified REIT real estate assets. The remainder of the Company's investments in securities (other than government securities and qualified real estate assets) 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, in general, no more than 5% of the value of the Company's assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 25% of the value of its total securities can be represented by securities of one or more taxable REIT subsidiaries. If the Company fails to comply with these requirements at the end of any calendar quarter, it must correct such failure within 30 days after the end of the calendar quarter to avoid losing its REIT status and suffering adverse tax consequences. As a result, the Company may be required to liquidate otherwise attractive investments.

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Complying with REIT requirements may force Capstead to borrow to make distributions to stockholders. As a REIT, Capstead must distribute at least 90% of its annual taxable income (subject to certain adjustments) to its stockholders. To the extent that the Company satisfies the distribution requirement, but distributes less than 100% of its taxable income, the Company will be subject to federal corporate income tax on its undistributed taxable income. In addition, the Company will be subject to a 4% nondeductible excise tax if the actual amount that it pays out to its stockholders in a calendar year is less than a minimum amount specified under the federal tax laws. From time to time, the Company may generate taxable income greater than its net income for financial reporting purposes or its taxable income may be greater than the Company's cash flow available for distribution to stockholders. If the Company does not have other funds available in these situations, it could be required to borrow funds, sell investments at disadvantageous prices or find another alternative source of funds to make distributions sufficient to enable it to pay out enough of its taxable income to satisfy the distribution requirement and to avoid corporate income tax or the 4% excise tax in a particular year. These alternatives could increase the Company's costs and reduce its long-term investment capital.

Capstead may be subject to adverse legislative or regulatory tax changes that could reduce the market price of the Company's securities. Federal income tax laws governing REITs or the administrative interpretations of those laws may change at any time. Any such changes in laws or interpretations thereof may apply retroactively and could adversely affect Capstead or its stockholders. Capstead cannot predict any impact on the value of its securities from adverse legislative or regulatory tax changes.

An investment in Capstead's securities has various federal, state and local income tax risks that could affect the value of an investor's investment. The Company strongly urges investors to consult their own tax advisor concerning the effects of federal, state and local income tax law on an investment in the Company's securities, because of the complex nature of the tax rules applicable to REITs and their stockholders.

## Risk Factors Related to Capstead's Corporate Structure

There are no assurances of Capstead's ability to pay dividends in the future. Capstead intends to continue paying quarterly dividends and to make distributions to its stockholders in amounts such that all or substantially all of the Company's taxable income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable the Company to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. However, the Company's ability to pay dividends may be adversely affected by the risk factors described in this filing. All distributions will be made at the discretion of the Company's board of directors and will depend upon the Company's earnings, its financial condition, maintenance of its REIT status and such other factors as the board may deem relevant from time to time. There are no assurances of the Company's ability to pay dividends in the future.

Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect Capstead's results of operations. The Investment Company Act of 1940 (the "40 Act") exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Capstead believes that it conducts its business in a manner that allows the Company to avoid registration as an investment company under the 40 Act. For over 30 years, the staff of the SEC has interpreted the provisions of the 40 Act to require, among other things, a REIT to maintain at least 55% of its assets directly in qualifying real estate interests and at least 80% of its assets in real estate-related assets in order to be exempt from regulation as an investment company. Critical to Capstead's exemption from regulation as an investment company is the long-standing SEC staff interpretation that so called whole loan mortgage securities, in which an investor holds all issued certificates with respect to an underlying pool of mortgage loans, constitutes a qualifying real estate interest for purposes of the staff's 55% qualifying real estate interest requirement.

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Conversely, so called partial pool mortgage securities presently do not qualify for purposes of meeting the 55% requirement, although they are considered by the staff to be real estate-related assets for purposes of meeting the staff's 80% real estate-related asset requirement.

In August 2011, the SEC staff issued a request for information (Concept Release No. IC-29778) from industry participants and investors regarding, among other things, its past interpretations of the 40 Act real estate exemption, including the interpretations described above, raising concerns that the SEC may issue a proposal for rulemaking that could overturn some of the staff's past interpretations regarding the real estate exemption. If the SEC or its staff adopts contrary interpretations of the 40 Act and the Company and other similar REITs become subject to regulation as investment companies, the industry's use of leverage would be substantially reduced. Absent a restructuring of the Company's business operations to avoid such regulation, this could require the sale of most of the Company's portfolio of Agency Securities under potentially adverse market conditions resulting in losses and significantly reduce future net interest margins and earnings.

Pursuant to Capstead's charter, its board of directors has the ability to limit ownership of the Company's capital stock, to the extent necessary to preserve its REIT qualification. For the purpose of preserving Capstead's REIT qualification, the Company's charter gives the board the ability to repurchase outstanding shares of capital stock from existing stockholders if the directors determine in good faith that the concentration of ownership by such individuals, directly or indirectly, would cause the Company to fail to qualify or be disqualified as a REIT. Constructive ownership rules 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 outstanding stock by an individual or entity could cause that individual or entity to own constructively a greater concentration of the Company's outstanding stock than is acceptable for REIT purposes, thereby giving the board the ability to repurchase any excess shares.

Because provisions contained in Maryland law and Capstead's charter may have an anti-takeover effect, investors may be prevented from receiving a "control premium" for their shares. Provisions contained in Capstead's charter and Maryland general corporation law can delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a "control premium" for their shares. For example, these provisions may defer or prevent tender offers for the Company's common stock or purchases of large blocks of the Company's common stock, thereby limiting the opportunities for its stockholders to receive a premium over then-prevailing market prices. These provisions include the following:

**Repurchase rights:** Repurchase rights granted to Capstead's board in its charter limit related investors, including, among other things, any voting group, from owning common stock if the concentration owned would jeopardize the Company's REIT status.

**Classification of preferred stock:** Capstead's charter authorizes the board to issue preferred stock and establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval and could have the effect of delaying or preventing someone from taking control of the Company.

**Statutory provisions:** Capstead is subject to provisions of Maryland statutory law that restrict business combinations with interested stockholders and restrict voting rights of certain shares acquired in control share acquisitions. The board has not taken any action to exempt the Company from these provisions.

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Maryland statutory law provides that an act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director. Hence, directors of Maryland corporations may not be required to act in takeover situations under the same standards as apply in Delaware and certain other corporate jurisdictions

There are risks associated with ownership of Capstead's Series E Preferred Stock. Risks associated with ownership of the Company's Series E preferred shares include:

**Redemption rights:** The Series E preferred shares are redeemable by the Company, in whole or in part, at any time on or after May 13, 2018, or pursuant to a Special Optional Redemption Right upon the occurrence of a Change of Control, as both terms are defined in the Series E Articles Supplementary, at a cash redemption price of \$25.00 plus all accrued and unpaid dividends to, but not including, the date of redemption, which may be less than the prevailing market price for the Series E preferred shares.

**Limited conversion rights:** Holders of the Series E preferred shares may convert into common shares only upon the occurrence of a Change of Control, and only if the Company does not exercise its Special Optional Redemption Right. Even if this were to occur, it may not be economically advantageous to convert based on then existing conversion ratios and trading levels of the Company's common shares.

**Subordination:** The Series E preferred shares are subordinate to all of the Company's existing and future debt. None of the provisions relating to the Series E preferred shares limit the Company's ability to incur future debt. Future debt may include restrictions on the Company's ability to pay dividends on, redeem, or pay the liquidation preference on, the Series E preferred shares.

**Dilution through issuance of additional preferred shares:** The Company's charter currently authorizes the issuance of up to 100 million shares of preferred stock in one or more series. The issuance of additional preferred stock on parity with or senior to the Series E preferred shares would dilute the interests of Series E preferred stockholders, and could affect the Company's ability to pay dividends on, redeem, or pay the liquidation preference on, the Series E preferred shares. None of the provisions relating to Series E preferred shares limit the Company's ability to issue additional preferred stock on parity with Series E preferred shares.

**Limited voting rights:** Voting rights as a holder of Series E preferred shares are limited. The Company's common stock is currently the only class of stock carrying full voting rights. Voting rights for holders of Series E preferred shares exist primarily with respect to (i) adverse changes in the terms of the Series E preferred shares, (ii) the creation of additional classes or series of preferred stock that are senior to the Series E preferred shares, and (iii) the non-payment of six quarterly dividends (whether or not consecutive) are in arrears.

Capstead may change its policies without stockholder approval. Capstead's board and management determine all of its policies, including its investment, financing and distribution policies and may amend or revise these policies at any time without a vote of the Company's stockholders. Policy changes could adversely affect the Company's financial condition, results of operations, the market price of its common and preferred stock or the Company's ability to pay dividends or distribution.

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## CRITICAL ACCOUNTING POLICIES

Management's discussion and analysis of financial condition and results of operations is based upon Capstead's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that can affect the reported amounts of assets, liabilities (including contingencies), revenues and expenses, as well as related disclosures. These estimates are based on available internal and market information and appropriate valuation methodologies believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the expected useful lives and carrying values of assets and liabilities which can materially affect the determination of net income and book value per common share. Actual results may differ from these estimates under different assumptions or conditions.

Management believes the following are critical accounting policies in the preparation of Capstead's consolidated financial statements that involve the use of estimates requiring considerable judgment:

Amortization of investment premiums on residential mortgage investments – Investment premiums on residential mortgage investments are recognized in earnings as adjustments to interest income by the interest method over the estimated lives of the related assets. The single largest determinant in amortizing investment premiums is actual portfolio runoff (scheduled and unscheduled principal paydowns) for a given accounting period. This is because the investment premium associated with actual runoff is effectively written off (amortized) when the runoff occurs pursuant to the interest method. Amortization is also affected by estimates and judgments related to future levels of mortgage prepayments used in determining additional amortization that may be necessary to achieve the required effective yield over the estimated life of the related investment. Mortgage prepayment expectations can change based on how current and projected changes in interest rates impact the economic attractiveness of mortgage refinance opportunities, if available, and other factors such as lending industry underwriting practices and capacity constraints, regulatory changes, borrower credit profiles and the health of the economy and housing markets. Management estimates mortgage prepayments based these factors and past experiences with specific investments within the portfolio. Should actual prepayment rates differ materially from these estimates, investment premiums would be expensed at a different pace.

Fair value and impairment accounting for residential mortgage investments – Nearly all of Capstead's residential mortgage investments are held in the form of mortgage securities that are classified as available-for-sale and recorded at fair value on the balance sheet with unrealized gains and losses recorded in Stockholders' equity as a component of Accumulated other comprehensive income. As such, these unrealized gains and losses enter into the calculation of book value per common share, a key financial metric used by investors in evaluating the Company. Fair values fluctuate with current and projected changes in interest rates, prepayment expectations and other factors such as market liquidity conditions. Considerable judgment is required to interpret market data and develop estimated fair values, particularly in circumstances of deteriorating credit quality and market liquidity. See NOTE 9 to the consolidated financial statements (included under Item 1 of this report) for discussion of how Capstead values its residential mortgage investments. Generally, gains or losses are recognized in earnings only if sold; however, if a decline in fair value of a mortgage security below its amortized cost occurs that is determined to be other-than-temporary, the difference between amortized cost and fair value would be recognized in earnings as a component of Other revenue (expense) if the decline was credit-related or it was determined to be more likely than not that the Company will incur a loss via an asset sale. Other-than-temporary impairment of a mortgage security due to other factors would be recognized in Accumulated other comprehensive income.

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Accounting for derivative financial instruments – Capstead uses derivatives for risk management purposes. Derivatives are recorded as assets or liabilities and carried at fair value and consequently, changes in value of these instruments enter into the calculation of book value per common share. Fair values fluctuate with current and projected changes in interest rates and other factors such as the Company’s and its counterparties’ nonperformance risk. Judgment is required to develop estimated fair values.

The accounting for changes in fair value of each derivative held depends on whether it has been designated as an accounting hedge, as well as the type of hedging relationship identified. To qualify as a cash flow hedge for accounting purposes, at the inception of the hedge relationship the Company must anticipate and document that the hedge relationship will be highly effective and must monitor ongoing effectiveness on at least a quarterly basis. As long as the hedge relationship remains effective, the effective portion of changes in fair value of the derivative is recorded in Accumulated other comprehensive income and the ineffective portion is recorded in earnings as a component of Interest expense. The effective portion of changes in fair value is reclassified from Accumulated comprehensive income to earnings over the term of the derivative primarily in the form of derivative cash flows that are either in excess of or lower than market rates. Changes in fair value of derivatives not held as accounting hedges, or for which the hedge relationship is deemed to no longer be highly effective and as a result hedge accounting is terminated, are recorded in earnings as a component of Other revenue (expense).

The Company currently uses interest rate swap agreements in hedge relationships accounted for as cash flow hedges in order to hedge variability in borrowing rates due to changes in the underlying benchmark interest rate related to a designated portion of its current and anticipated future 30- and 90-day borrowings and the 20-year floating-rate periods of the Company’s long-term unsecured borrowings. Variable-rate payments to be received on the swap agreements and any measured hedge ineffectiveness are recorded in interest expense as an offset to interest owed on the hedged borrowings that reset to market rates generally on a monthly basis while fixed rate swap payments to be made are also recorded in interest expense resulting in an effectively fixed borrowing rate on these borrowings, subject to certain adjustments. See NOTE 7 to the consolidated financial statements (included under Item 1 of this report) and “Financial Condition–Residential Mortgage Investments” for additional information regarding the Company’s current use of derivatives and its related risk management policies.

STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS

This document contains “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain the words “believe,” “anticipate,” “expect,” “estimate,” “intend,” “will be,” “will likely continue,” “will likely result,” or words or phrases of similar meaning. Forward-looking statements are based largely on the expectations of management and are subject to a number of risks and uncertainties including, but not limited to, the following:

- changes in general economic conditions;
- fluctuations in interest rates and levels of mortgage prepayments;
- the effectiveness of risk management strategies;
- the impact of differing levels of leverage employed;

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- liquidity of secondary markets and credit markets;
- the availability of financing at reasonable levels and terms to support investing on a leveraged basis;
- the availability of new investment capital;
- the availability of suitable qualifying investments from both an investment return and regulatory perspective;
- changes in legislation or regulation affecting the GSEs, Ginnie Mae and similar federal government agencies and related guarantees;
- other changes in legislation or regulation affecting the mortgage and banking industries;
- changes in market conditions as a result of Federal Reserve monetary policy or federal government fiscal challenges;
- deterioration in credit quality and ratings of existing or future issuances of GSE or Ginnie Mae securities;
- changes in legislation or regulation affecting exemptions for mortgage REITs from regulation under the Investment Company Act of 1940; and
- increases in costs and other general competitive factors.

In addition to the above considerations, actual results and liquidity are affected by other risks and uncertainties which could cause actual results to be significantly different from those expressed or implied by any forward-looking statements included herein. It is not possible to identify all of the risks, uncertainties and other factors that may affect future results. In light of these risks and uncertainties, the forward-looking events and circumstances discussed herein may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. Forward-looking statements speak only as of the date the statement is made and the Company undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, readers of this document are cautioned not to place undue reliance on any forward-looking statements included herein.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISKS**

The information required by this Item is incorporated by reference to the information included in Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations."

**ITEM 4. CONTROLS AND PROCEDURES**

As of March 31, 2014, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of March 31, 2014. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to March 31, 2014.

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PART II. ¾ OTHER INFORMATION

ITEM 6. EXHIBITS

Exhibit

Number DESCRIPTION

3.1	Charter, including Articles of Incorporation, Articles Supplementary for each series of preferred shares (except the 7.50% Series E Cumulative Redeemable Preferred Stock) and all other amendments to such Articles of Incorporation. <sup>(1)</sup>
3.2	Articles Supplementary classifying and designating the Registrant's 7.50% Series E Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share, par value \$0.10 per share. <sup>(2)</sup>
3.3	Amended and Restated Bylaws. <sup>(3)</sup>
4.1	Specimen of Common Stock Certificate. <sup>(4)</sup>
4.2	Specimen of stock certificate evidencing the 7.50% Series E Cumulative Redeemable Preferred Stock of the Registrant, liquidation preference \$25.00 per share, par value \$0.10 per share. <sup>(2)</sup>
4.3	Junior Subordinated Indenture dated September 26, 2005. <sup>(5)</sup>
4.4	Indenture dated December 15, 2005. <sup>(5)</sup>
4.5	Indenture dated September 11, 2006. <sup>(5)</sup>
10.01	Amended and Restated Deferred Compensation Plan. <sup>(5)</sup>
10.02	Amended and Restated 2004 Flexible Long-Term Incentive Plan. <sup>(6)</sup>
10.03	Second Amended and Restated Incentive Bonus Plan. <sup>(7)</sup>
10.04	Form of nonqualified stock option and stock award agreements for non-employee directors. <sup>(5)</sup>
10.05	Form of nonqualified stock option and stock award agreements for employees with service conditions. <sup>(5)</sup>
10.06	Form of stock award agreements for employees with performance conditions. <sup>(8)</sup>
10.07	Form of stock award agreements for employees with performance conditions and deferral of dividends. <sup>(9)</sup>
10.08	2013 Annual Incentive Plan (short-term). <sup>(10)</sup>
10.09	2014 Annual Incentive Compensation Program (short-term). <sup>(3)</sup>
10.10	2014 Long-Term Award Criteria, as corrected. <sup>(3)</sup>
10.11	Form of Performance Unit Agreement, as corrected. <sup>(3)</sup>
10.12	Sales Agreement, dated November 12, 2013, by and between the Company and the Sales Manager. <sup>(11)</sup>
<u>12</u>	Computation of ratio of net income to fixed charges and ratio of net income to combined fixed charges and preferred stock dividends.*
<u>31.1</u>	Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*
<u>31.2</u>	Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*
<u>32</u>	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**
101.INS	XBRL Instance Document***
101.SCH	XBRL Taxonomy Extension Schema***
101.CAL	XBRL Taxonomy Extension Calculation Linkbase***
101.DEF	XBRL Additional Taxonomy Extension Definition Linkbase***
101.LAB	XBRL Taxonomy Extension Label Linkbase***
101.PRE	XBRL Taxonomy Extension Presentation Linkbase***

(1) Incorporated by reference to the Registrant's Annual Report on Form 10-K/A for the year ended December 31, 2012.

(2) Incorporated by reference to the Registrant's Registration of Certain Classes of Securities on Form 8-A dated May 13, 2013.

(3) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed on February 3, 2014, for the event dated January 29, 2014.



(4) Incorporated by reference to the Registrant's Registration Statement on Form S-3 (No. 333-63358) dated June 19, 2001.

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- (5) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2011.
- (6) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2013.
- (7) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed on May 5, 2011, for the event dated May 4, 2011.
- (8) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008.
- (9) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2010.
- (10) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed on October 23, 2013 for the event dated October 21, 2013.
- (11) Incorporated by reference to the Registrant's Current Report on Form 8-K, filed on November 13, 2013, for the event dated November 12, 2013.

\* Filed herewith

\*\* Furnished herewith

\*\*\* Submitted electronically herewith

SIGNATURES

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

CAPSTEAD MORTGAGE CORPORATION  
Registrant

Date: May 9, 2014 By: /s/ ANDREW F. JACOBS  
Andrew F. Jacobs  
President and Chief Executive Officer

Date: May 9, 2014 By: /s/ PHILLIP A. REINSCH  
Phillip A. Reinsch  
Executive Vice President and Chief Financial Officer