CAPSTEAD MORTGAGE CORP
Form 10-K
February 25, 2013
Table of Contents

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ü **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended: December 31, 2012

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	**75225-4404**
(Address of principal executive offices)	(Zip Code)

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

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

Title of Each Class	Name of Exchange on Which Registered
Common Stock ($0.01 par value)	New York Stock Exchange
$1.60 Cumulative Preferred Stock, Series A ($0.10 par value)	New York Stock Exchange
$1.26 Cumulative Convertible Preferred Stock, Series B ($0.10 par value)	New York Stock Exchange

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES ü NO __

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES __ NO ü

Indicate by check mark whether the Registrant (1) has filed all documents and reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. YES ü 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 during the preceding 12 months (or for such shorter period that Registrant was required to submit and post such files).

YES ü NO __

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

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

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

At June 29, 2012 the aggregate market value of the common stock held by nonaffiliates was $1,335,075,485.

Number of shares of Common Stock outstanding at February 25, 2013: 95,533,208

DOCUMENTS INCORPORATED BY REFERENCE:

Portions of the Registrant s definitive Proxy Statement, to be issued in connection with the 2013 Annual Meeting of Stockholders of the Registrant, are incorporated by reference into Part III.

Table of Contents

CAPSTEAD MORTGAGE CORPORATION

2012 FORM 10-K ANNUAL REPORT

TABLE OF CONTENTS

Table of Contents

PART I

ITEM 1. 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 was incorporated in the state of Maryland in 1985 and is listed on the New York Stock Exchange under the symbol CMO.

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.

Capstead s investment strategy involves managing 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. This strategy differentiates the Company from its peers because ARM Agency Securities reset to more current interest rates within a relatively short period of time allowing for (a) the recovery of financing spreads diminished during periods of rising interest rates and (b) smaller fluctuations in portfolio values from changes in interest rates compared to portfolios that contain a significant amount of fixed-rate Agency Securities. From a credit-risk perspective, the credit quality of Agency Securities helps ensure that fluctuations in value due to credit risk should be limited and financing at reasonable rates and terms is more likely to remain available under stressed market conditions.

For further discussion of the Company s business and financial condition, see Item 7 of this report, Management s Discussion and Analysis of Financial Condition and Results of Operations, which is incorporated herein by reference.

Competition

As a residential mortgage REIT that focuses on investing in ARM Agency Securities, Capstead competes for the acquisition of suitable investments with other mortgage REITs, commercial banks, savings banks, insurance companies, and institutional investors such as private equity funds, mutual funds, pension funds and sovereign wealth funds. Many of these entities have lower yield requirements as well as greater financial resources and access to capital than the Company. In addition, the federal government, through the Federal Reserve, U.S. Treasury, the GSEs and the Federal Home Loan Banks, has substantial holdings of primarily fixed-rate Agency Securities and the Federal Reserve is currently acquiring additional fixed-rate Agency Securities. Increased competition for the acquisition of Agency Securities can result in higher pricing levels for such assets and lead to lower mortgage interest rates. Although higher pricing levels generally correspond to a higher book value per common share for the Company, higher pricing levels also generally result in lower portfolio yields, which could adversely affect future profitability. Lower mortgage interest rates can result in higher levels of mortgage prepayments, generally resulting in lower portfolio yields because of increases in investment premium amortization which can adversely affect current profitability.

Further, the policy goals of the federal government may differ from the economic goals of other investors in Agency Securities. For instance, the Federal Reserve, the U.S. Treasury or the GSEs may determine it is appropriate to reduce their holdings of Agency Securities at some future date, which could result in lower pricing levels. Although this may result in an opportunity to acquire assets at more attractive yields, the Company s book value per common share could be negatively affected.

Table of Contents

Regulation and Related Matters

Operating as a REIT that primarily invests in Agency Securities subjects Capstead to various federal regulatory requirements. For further discussion, see Item 7 of this report, Management s Discussion and Analysis of Financial Condition and Results of Operations, on pages 26 through 30 under the captions Risk Factors Related to Capstead s Status as a REIT and Other Tax Matters and Risk Factors Related to Capstead s Corporate Structure, which is incorporated herein by reference.

Employees

As of December 31, 2012, Capstead had 12 full-time employees and three part-time employees.

Website Access to Company Reports and Other Company Information

Capstead makes available on its website at www.capstead.com, free of charge, its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, investor presentations and press releases, including amendments to such documents as soon as reasonably practicable after such materials are electronically filed or furnished to the SEC or otherwise publicly released.

Investors may also read and copy any materials filed with the SEC at the SEC s Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC also maintains an Internet site (www.sec.gov) through which investors may view reports, proxy and information statements, and other information filed with the SEC.

The Company also makes available on its website charters for the committees of its board of directors, its Board of Directors Guidelines, its Code of Business Conduct and Ethics, its Financial Code of Professional Conduct and other information, including amendments to such documents and waivers, if any, to the codes. Such information will also be furnished, free of charge, upon written request to Capstead Mortgage Corporation, Attention: Stockholder Relations, 8401 North Central Expressway, Suite 800, Dallas, Texas 75225-4404.

Cautionary 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, 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;
- 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 exemptions for mortgage REITs from regulation under the Investment Company Act of 1940;

changes in legislation or regulation affecting the GSEs, Ginnie Mae and similar federal government agencies and related guarantees;

deterioration in credit quality and ratings of existing or future issuances of Agency Securities; 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 1A. RISK FACTORS

Under the captions Risk Factors and Critical Accounting Policies on pages 21 through 30 and 30 through 31, respectively, of Item 7 are discussions of risk factors and critical accounting policies affecting Capstead s financial condition and results of operations that are an integral part of this report. Readers are strongly urged to consider the potential impact of these factors and accounting policies on the Company while reading this document.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Capstead s headquarters are located in Dallas, Texas in office space leased by the Company.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. MINING SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The New York Stock Exchange trading symbol for Capstead s common shares is CMO. As of December 31, 2012, the Company had 1,283 common stockholders of record and depository companies held common shares for 47,190 beneficial owners. Under the caption Equity Capital Issuances and Common Share Repurchases on page 7 of Item 7 are disclosures relative to a $100 million common share repurchase authorization announced October 30, 2012, which are incorporated herein by reference.

Table of Contents

The high and low sales prices and dividends declared on the common shares were as follows:

	Year Ended December 31, 2012			*Year Ended December 31, 2011*		
	Sales Prices		*Dividends*	*Sales Prices*		*Dividends*
	High	*Low*	*Declared*	*High*	*Low*	*Declared*
First quarter	$ 13.62	$ 12.29	$ 0.43	$ 13.48	$ 12.49	$ 0.41
Second quarter	14.29	12.84	0.40	13.95	12.65	0.48
Third quarter	14.59	13.49	0.36	13.69	11.24	0.44
Fourth quarter	13.60	10.81	0.30	13.11	10.00	0.43

Set forth below is a graph comparing the yearly percentage change in the cumulative total return on Capstead common shares, with the cumulative total return of the Russell 2000 Index and the NAREIT Mortgage REIT Index for the five years ended December 31, 2012 assuming the investment of $100 on December 31, 2007 and the reinvestment of dividends. The stock price and dividend performance reflected in the graph is not necessarily indicative of future performance.

	Period Ending					
	12/31/07	*12/31/08*	*12/31/09*	*12/31/10*	*12/31/11*	*12/31/12*
Capstead Mortgage Corporation	$ 100.00	$ 97.32	$ 146.21	$ 152.96	$ 173.47	$ 179.13
Russell 2000 Index	100.00	66.21	84.20	106.82	102.36	119.09
NAREIT Mortgage REIT Index	100.00	68.69	85.61	104.95	102.42	122.79

See Item 11 of this report for information regarding equity compensation plans which is incorporated herein by reference. Capstead did not issue any unregistered securities during the past three fiscal years.

Table of Contents

ITEM 6. SELECTED FINANCIAL DATA

This table summarizes selected financial information (in thousands, except per share data). For additional information, refer to the audited consolidated financial statements and notes thereto included under Item 8 and Management s Discussion and Analysis of Financial Condition and Results of Operations, included under Item 7 of this report.

	As of or for the year ended December 31				
	2012	***2011***	***2010***	***2009***	***2008***
Selected statement of income data:					
Interest income:					
Residential mortgage investments	$ 255,931	$ 243,077	$ 198,488	$ 313,676	$ 394,729
Other	698	301	1,290	919	5,760
	256,629	243,378	199,778	314,595	400,489
Interest expense:					
Repurchase arrangements and similar borrowings	(69,101)	(57,328)	(47,502)	(120,083)	(249,706)
Unsecured and other borrowings	(8,747)	(8,752)	(8,749)	(8,747)	(8,747)
	(77,848)	(66,080)	(56,251)	(128,830)	(258,453)
	178,781	177,298	143,527	185,765	142,036
Other revenue (expense) [(a)]	(15,414)	(17,353)	(16,890)	(56,761)	(16,372)
Equity in earnings of unconsolidated affiliates	259	259	259	259	259
Net income	$ 163,626	$ 160,204	$ 126,896	$ 129,263	$ 125,923
Net income available to common stockholders, after payment of preferred share dividends	$ 142,605	$ 139,835	$ 106,663	$ 109,024	$ 105,672
Diluted net income per common share	$ 1.50	$ 1.75	$ 1.52	$ 1.66	$ 1.93
Cash dividends per common share	1.49	1.76	1.51	2.24	2.02
Average diluted common shares outstanding	95,012	79,696	69,901	65,449	54,468
Selected balance sheet data:					
Residential mortgage investments	$ 13,860,158	$ 12,264,906	$ 8,515,691	$ 8,081,050	$ 7,456,086
Total assets	14,469,263	12,844,622	8,999,362	8,628,903	7,729,362
Repurchase arrangements and similar borrowings	12,784,238	11,352,444	7,792,743	7,435,256	6,751,500
Long-term investment capital:					
Unsecured borrowings *(net of related investments in statutory trusts)*	99,978	99,978	99,978	99,978	99,978
Preferred stockholders equity	188,992	184,514	179,323	$ 179,333	179,460
Common stockholders equity	1,308,133	1,108,193	848,102	834,608	580,990
Book value per common share *(unaudited)*	13.58	12.52	12.02	11.99	9.14
Key operating data:					
Portfolio acquisitions *(principal amount)*	$ 4,206,459	$ 5,673,803	$ 3,299,600	$ 1,969,113	$ 2,800,579
Portfolio runoff *(principal amount)*	2,784,687	2,127,812	2,932,978	1,513,967	1,511,362
Common equity capital raised	142,036	231,673	10,423	81,441	280,716
Common share repurchases	35,062				
Year-end portfolio leverage [(b)]	8.00:1	8.15:1	6.91:1	6.67:1	7.85:1
Average financing spreads on residential mortgage investments [(c)]	1.38%	1.68%	1.93%	2.42%	1.67%
Average total financing spreads [(c)]	1.26	1.56	1.74	2.23	1.59
	17.18	16.10	29.11	16.56	16.00

Average mortgage prepayment rate, *(expressed as a constant prepayment rate, or CPR)*					
Return on average long-term investment capital	10.98	13.14	12.08	13.34	16.52
Return on average common equity capital	11.15	13.94	12.68	14.90	21.03

(a) In 2009 Capstead recorded impairment charges totaling $40 million substantially reducing its exposure to investments in commercial real estate loans.

(b) Portfolio leverage is calculated by dividing repurchase arrangements and similar borrowings by average long-term investment capital.

(c) Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on Capstead s 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 Item 7 pages 11and 12 for reconciliations of these measures.

Table of Contents

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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 ARM Agency Securities, which are considered to have limited, if any, credit risk.

Capstead finances its investments with borrowings under repurchase arrangements with commercial banks and other financial institutions supported by its long-term investment capital, which as of December 31, 2012 totaled $1.60 billion and consisted of $1.31 billion of common and $189 million of perpetual preferred stockholders equity (recorded amounts) and $100 million of long-term unsecured borrowings (net of related investments in statutory trusts). Long-term investment capital increased by $204 million or 15% during 2012 primarily as a result of higher portfolio pricing levels and raising $142 million in new common equity capital, before the repurchase of $35 million in common shares late in the year. Holdings of ARM Agency Securities increased $1.60 billion or 13% during 2012, to $13.86 billion at December 31, 2012, while repurchase arrangements and similar borrowings increased $1.43 billion or 13% to $12.78 billion. Portfolio leverage (repurchase arrangements and similar borrowings divided by long-term investment capital) decreased to 8.00 to one by December 31, 2012 from 8.15 to one at December 31, 2011. Management believes borrowing at current levels represents an appropriate and prudent use of leverage for a portfolio of Agency Securities under current market conditions, particularly a portfolio consisting almost entirely of short-duration ARM Agency Securities (duration is a common measure of market price sensitivity to interest rate movements). Provided capital can continue to be deployed at attractive levels and financing conditions remain favorable, management currently anticipates maintaining portfolio leverage near December 31, 2012 levels.

Capstead reported net income of $164 million or $1.50 per diluted common share for the year ended December 31, 2012, compared to $160 million or $1.75 per diluted common share in 2011. Net income per diluted common share declined 14% year over year, even as net income increased 2%, reflecting a 19% increase in average common shares outstanding resulting from raising $374 million in new common equity capital during the past two years. Financing spreads on residential mortgage investments averaged 138 basis points during 2012, an 18% decline from 168 basis points reported for 2011. Lower financing spreads during 2012 reflect (a) lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates underlying the portfolio resetting lower to more current rates as well as lower coupon interest rates on acquisitions, and (b) higher investment premium amortization primarily because of higher levels of mortgage prepayments as well as higher prices paid for portfolio acquisitions in recent years. The effect on financing spreads of lower portfolio yields in 2012 was not offset by lower borrowing rates as the benefits of replacing expiring higher cost interest rate swap agreements with additional two-year term swap agreements at more favorable rates were offset by increases in unhedged borrowing rates. Operating costs as a percentage of average long-term investment capital declined 30 basis points to 0.97% during 2012 reflecting both increases in long-term investment capital and lower performance-based compensation costs.

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.

Table of Contents

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.

Equity Capital Issuances and Common Share Repurchases

During the first three quarters of 2012 Capstead raised $142 million in new common equity capital by issuing 10.5 million common shares at an average price of $13.52 per share, after underwriting discounts and offering expenses, through the Company s at-the-market continuous offering program. Additionally, through April 2012 the Company raised $4 million in new preferred equity capital under this program.

On October 30, 2012 the Company announced a $100 million common share repurchase program and suspended its 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, share price, applicable legal requirements and other factors. Pursuant to this authorization, repurchases (nearly all of which were made in November) totaled 3.0 million common shares at an average cost of $11.80 per share for $35 million by year-end. An additional 638,000 shares were repurchased in early January 2013 at an average cost of $11.43 per share for $7 million. At February 25, 2013, $58 million of the repurchase authorization remains available. 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 compliance with federal securities laws, market conditions and blackout periods associated with the dissemination of earnings and dividend announcements and other important Company-specific news.

Book Value per Common Share

The following table illustrates the progression of Capstead s book value per common share for the three years ended December 31, 2012:

	2012	*2011*	*2010*
Book value per common share, beginning of year	$ 12.52	$ 12.02	$ 11.99
Capital transactions:			
Accretion from capital raises	0.12	0.22	0.01
Accretion from stock repurchases	0.02		
Dividend distributions (in excess of) less than earnings	(0.01)	(0.06)	0.01
Increase in fair value of mortgage securities classified as available-for-sale	0.95	0.61	0.01
(Decrease) increase in fair value of interest rate swap agreements designated as cash flow hedges of:			
Repurchase arrangements and similar borrowings	(0.04)	0.01	(0.13)
Unsecured borrowings	0.02	(0.28)	0.13
Book value per common share, end of year	$ 13.58	$ 12.52	$ 12.02
Increase in book value per common share during the indicated year	$ 1.06	$ 0.50	$ 0.03

All but $14 million of Capstead s $13.86 billion of residential mortgage investments and all of its interest rate swap agreements are reflected at fair value on the Company s balance sheet and included in the calculation of book value per common share (total stockholders equity, less perpetual preferred share liquidation preferences, divided by common shares outstanding). The fair value of these investments is

Table of Contents

impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels. 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.

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 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 allowing for the potential recovery of financing spreads diminished during periods of rising interest rates. The following table illustrates the progression of the Company s portfolio of residential mortgage investments for the three years ended December 31, 2012 (in thousands):

	2012	*2011*	*2010*
Residential mortgage investments, beginning of year	$ 12,264,906	$ 8,515,691	$ 8,081,050
Increase in unrealized gains on mortgage securities classified as available-for-sale	91,750	54,325	1,057
Portfolio acquisitions (principal amount) at average lifetime purchased yields of 2.17%, 2.75% and 2.42%, respectively	4,206,459	5,673,803	3,299,600
Securities effectively sold in connection with the bankruptcy of a lending counterparty		(8,262)	
Investment premiums on acquisitions	178,407	225,238	114,543
Portfolio runoff (principal amount)	(2,784,687)	(2,127,812)	(2,922,978)
Investment premium amortization	(96,677)	(68,077)	(57,581)
Residential mortgage investments, end of year	$ 13,860,158	$ 12,264,906	$ 8,515,691

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.

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 December 31, 2012 approximately 81%, 11% and 8% of the

Table of Contents

Company s ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly. Approximately 96% 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 December 31, 2012 approximately 18% 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 December 31, 2012 (dollars in thousands):

ARM Type	*Amortized Cost Basis* (a)	*Net WAC* (b)	*Fully Indexed WAC* (b)	*Average Net Margins* (b)	*Average Periodic Caps* (b)	*Average Lifetime Caps* (b)	*Months To Roll*
Current-reset ARMs:							
Fannie Mae Agency Securities	$ 5,227,486	2.45%	2.29%	1.70%	3.16%	10.16%	5.2
Freddie Mac Agency Securities	1,850,722	2.67	2.42	1.84	2.03	10.67	6.2
Ginnie Mae Agency Securities	739,485	2.48	1.70	1.51	1.02	9.31	6.2
Residential mortgage loans	5,051	3.51	2.38	2.04	1.49	10.97	4.5
	7,822,744	2.51	2.27	1.71	2.70	10.20	5.5
Longer-to-reset ARMs:							
Fannie Mae Agency Securities	2,953,509	2.97	2.61	1.76	4.91	7.99	43.7
Freddie Mac Agency Securities	1,872,883	2.97	2.67	1.84	4.92	7.99	47.4
Ginnie Mae Agency Securities	875,512	3.01	1.68	1.51	1.02	8.04	30.1
	5,701,904	2.98	2.48	1.75	4.32	8.00	42.8
	$ 13,524,648	2.70	2.36	1.73	3.38	9.27	21.1
Gross WAC (rate paid by borrowers) (c)		3.33					

(a) *Amortized cost basis represents Capstead s investment (unpaid principal balance plus $405 million of unamortized investment premiums, and excluding $326 million of unrealized gains and losses). At December 31, 2012, the ratio of amortized cost basis to related unpaid principal balance for the Company s ARM securities was 103.09. This table excludes $3 million in fixed-rate Agency Securities, $3 million in fixed-rate residential mortgage loans and $3 million in private residential mortgage pass-through securities held as collateral for structured financings.*

(b) *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 underlying mortgage loans. 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 portfolio 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 typically have 500 basis point initial caps with 200 basis point periodic caps. Additionally, certain ARM securities are subject only to lifetime caps or are not subject to a cap. For presentation purposes, average periodic caps reflect initial caps until after an ARM security has reached its initial reset date and lifetime caps, less the current net WAC, for ARM securities subject only to lifetime caps. At year-end, 81% of current-reset ARMs were subject to periodic caps averaging 1.85%; 4% were subject to initial caps averaging 2.01%; 14% were subject to lifetime caps, less the current net WAC, averaging 7.58%; and 1% were not subject to a cap. All longer-to-reset ARM securities at December 31, 2012 were subject to initial caps.*

(c) *Gross WAC is the weighted average interest rate of the mortgage loans underlying the Company s ARM holdings, including servicing and other fees paid by borrowers, as of the indicated balance sheet date.*

ARM Agency Securities typically are acquired at a premium to the securities unpaid principal balances and high levels of mortgage prepayments can put downward pressure on yields and financing spreads because the level of mortgage prepayments impacts how quickly investment premiums are written off against earnings as portfolio yield adjustments. During the year ended December 31, 2012 mortgage prepayments, expressed as a constant prepayment rate, or CPR, averaged 17.2% on an annualized basis compared to a CPR of 16.1% in 2011. Higher mortgage prepayment levels, particularly during the second half of 2012, primarily reflects lower prevailing mortgage interest rates available to consumers. While the current low interest rate environment can be expected to persist for some time, certain characteristics of the Company s portfolio moderate the risk of experiencing prepayment levels sharply higher than the levels experienced the second half of 2012. A key differentiating factor of Capstead s investment strategy relative to the strategies implemented by peers in the mortgage REIT sector is the Company s focus on investing solely in short-duration ARM securities. Approximately 93% of the mortgages underlying the Company s current-reset ARM securities were originated prior to 2008 and carry coupon interest rates at or below prevailing fixed mortgage rates diminishing the economic advantage, if any, of refinancing. Additionally, refinancing for many of these homeowners continues to be hampered by low housing prices and credit problems. Newer originations, primarily held in the Company s longer-to-reset portfolio, remain more susceptible to refinancing because it is easier for many of these borrowers to qualify for new mortgages and it may be more attractive to do so from a rate perspective in the current low mortgage interest rate environment. On an overall basis, management expects mortgage prepayment levels to remain manageable in 2013 absent additional government intervention to lower mortgage interest rates beyond the Federal Reserve s current bond buying program. This should help contain investment premium amortization costs, which increased by $29 million in 2012 to $97 million.

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. Haircut requirements for pledged Agency Securities have remained relatively stable since early in 2009 and as of December 31, 2012, haircuts on outstanding borrowings averaged 4.5 percent and ranged from 3.0 to 5.0 percent of the fair value of the pledged securities. After considering haircuts and related interest receivable on the collateral, as well as interest payable on these borrowings, the Company had $695 million of capital at risk with its lending counterparties as of December 31, 2012.

Interest rates charged on repurchase arrangements and similar 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. 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 establish 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 December 31, 2012 consisted of $12.78 billion of primarily 30-day borrowings with 23 counterparties at average rates of 0.47%, before the effects of interest rate swap agreements held as cash flow hedges (see below) and 0.65% including the effects of these derivative financial instruments.

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 largely offset interest accruing on a like amount of the Company s 30- to 90-day 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 the effects of measured hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and related actual borrowing rates. Under the terms of currently-paying interest rate swap agreements held at December 31, 2012, the Company is required to pay fixed rates of interest averaging 0.75% on notional amounts totaling $4.20 billion with average remaining interest payment terms of nine months.

Table of Contents

Additionally, as of year-end the Company had entered into forward-starting swap agreements with notional amounts totaling $2.40 billion that will begin requiring interest payments at fixed rates averaging 0.47% for two-year periods that commence on various dates between January 2013 and December 2013, with an average expiration of 29 months. After consideration of all swap positions entered into as of year-end to hedge short-term borrowing rates, the Company s residential mortgage investments and related borrowings under repurchase arrangements had estimated durations at December 31, 2012 of 10 months and 8 $^{1}/_{4}$ months, respectively, for a net duration gap of approximately 1 $^{3}/_{4}$ months see pages 19 and 20 under the caption Interest Rate Risk for further information. 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.

The following table