DYNEX CAPITAL INC
Form 10-K
February 27, 2019

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-K

x **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 2018
or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
Commission File Number: 1-9819
DYNEX CAPITAL, INC.
(Exact name of registrant as specified in its charter)

Virginia	**52-1549373**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia	**23060-9245**
(Address of principal executive offices)	(Zip Code)

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

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

Title of each class	Name of each exchange on which registered
Common Stock, $.01 par value	New York Stock Exchange
8.50% Series A Cumulative Redeemable Preferred Stock, par value $0.01 per share	New York Stock Exchange
7.625% Series B Cumulative Redeemable Preferred Stock, par value $0.01 per share	New York Stock Exchange

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

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

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

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 x No o

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files).
Yes x No o

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	o	Accelerated filer	x
Non-accelerated filer	o	Smaller reporting company	o
		Emerging growth company	o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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

As of June 30, 2018, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $356,954,131 based on the closing sales price on the New York Stock Exchange of $6.53.

On February 25, 2019, the registrant had 70,818,525 shares outstanding of common stock, $0.01 par value, which is the registrant’s only class of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Definitive Proxy Statement for the registrant’s 2019 Annual Meeting of Shareholders, expected to be filed pursuant to Regulation 14A within 120 days from December 31, 2018, are incorporated by reference into Part III.

DYNEX CAPITAL, INC.
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CAUTIONARY STATEMENT – This Annual Report on Form 10-K contains "forward-looking" statements within the meaning of Section 27A of the Securities Act of 1933, as amended (or "1933 Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (or "Exchange Act"). We caution that any such forward-looking statements made by us are not guarantees of future performance, and actual results may differ materially from those expressed or implied in such forward-looking statements. Some of the factors that could cause actual results to differ materially from estimates expressed or implied in our forward-looking statements are set forth in this Annual Report on Form 10-K for the year ended December 31, 2018. See Item 1A. "Risk Factors" as well as "Forward-Looking Statements" set forth in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Annual Report on Form 10-K.

In this Annual Report on Form 10-K, we refer to Dynex Capital, Inc. and its subsidiaries as "the Company," "we," "us," or "our," unless we specifically state otherwise or the context indicates otherwise.

PART I.

ITEM 1. BUSINESS

COMPANY OVERVIEW

We are an internally managed mortgage real estate investment trust, or mortgage REIT, which primarily invests in residential and commercial mortgage-backed securities ("MBS") on a leveraged basis. We finance our investments principally with borrowings under repurchase agreements. Our objective is to provide attractive risk-adjusted returns to our shareholders over the long term that are reflective of a leveraged, high quality fixed income portfolio with a focus on capital preservation. We seek to provide returns to our shareholders primarily through the payment of regular dividends and also potentially through capital appreciation of our investments.

Our common stock is traded on the New York Stock Exchange ("NYSE") under the symbol "DX". We have two series of preferred stock outstanding, our 8.50% Series A Cumulative Redeemable Preferred Stock (the "Series A Preferred Stock") which is traded on the NYSE under the symbol "DXPRA", and our 7.625% Series B Cumulative Redeemable Preferred Stock (the "Series B Preferred Stock") which is traded on the NYSE under the symbol "DXPRB".

Our investments consist principally of Agency and non-Agency MBS including residential MBS ("RMBS"), commercial MBS ("CMBS") and CMBS interest-only ("IO") securities. Agency MBS have a guaranty of principal payment by an agency of the U.S. government or a U.S. government-sponsored entity ("GSE") such as Fannie Mae and Freddie Mac. Non-Agency MBS are issued by non-governmental enterprises and do not have a guaranty of principal payment. CMBS IO securities in which we invest may be issued by a GSE or a non-governmental enterprise. We may also invest in debt securities issued by the United States Department of the Treasury ("the Treasury" and such securities, "U.S. Treasuries").

Investment Strategy

Our investment strategy and the allocation of our capital to a particular sector or investment is driven by a "top-down" framework that focuses on the expected risk-adjusted outcome of any investment. Key points of this framework include the following:

- understanding macroeconomic conditions including the current state of the U.S. and global economies;

- understanding the regulatory environment, competition for assets, and the terms and availability of financing;
- sector analysis including understanding absolute returns, relative returns and risk-adjusted returns;
- security and financing analysis including sensitivity analysis on credit, interest rate volatility, and market value risk; and
- managing performance and inherent portfolio risks, including but not limited to interest rate, credit, prepayment, and liquidity risks.

In allocating our capital and executing our strategy, we seek to balance the risks of owning specific types of investments with the earnings opportunity on the investment. At various times during the last decade, we have allocated capital to a variety of investments including adjustable-rate and fixed-rate Agency RMBS, Agency CMBS, investment grade and unrated non-Agency RMBS and CMBS, Agency and non-Agency CMBS IO, and residual interests in securitized mortgage loans. Our investments in non-Agency MBS are generally higher quality senior or mezzanine classes (typically rated 'A' or better by one or more of the nationally recognized statistical rating organizations) because they are typically more liquid (i.e., they are more easily converted into cash either through sales or pledges as collateral for repurchase agreement borrowings) and have less exposure to credit losses than lower-rated non-Agency MBS. We regularly review our existing operations to determine whether our investment strategy or business model should change, including through capital reallocation, changing our targeted investments, and shifting our risk position.

RMBS. Substantially all of our investments in RMBS as of December 31, 2018 were Agency issued securities collateralized primarily by fixed-rate single-family mortgage loans. The remainder of our RMBS portfolio is collateralized by adjustable-rate mortgage loans (“ARMs”), which have interest rates that generally adjust at least annually to an increment over a specified interest rate index, and hybrid ARMs, which are loans that have a fixed rate of interest for a specified period (typically three to ten years) and then adjust their interest rate at least annually to an increment over a specified interest rate index (primarily one-year LIBOR).

We also purchase to-be-announced securities (“TBAs” or “TBA securities”) as a means of investing in non-specified fixed-rate Agency RMBS. A TBA security is a forward contract (“TBA contract”) for the purchase (“long position”) or sale (“short position”) of a fixed-rate Agency MBS at a predetermined price with certain principal and interest terms and certain types of collateral, but the particular Agency securities to be delivered are not identified until shortly before the settlement date. Our TBA purchases are financed by executing a series of transactions which effectively delay the settlement of a forward purchase of a non-specified Agency RMBS by entering into an offsetting TBA short position, net settling the paired-off positions in cash, and simultaneously entering into an identical TBA long position with a later settlement date. These net long TBA positions are referred to as “dollar roll positions”, and we view them as economically equivalent to investing in and financing Agency RMBS using short-term repurchase agreements. TBAs purchased for a forward settlement month are generally priced at a discount relative to TBAs sold for settlement in the current month. This discount, often referred to as “drop income”, represents the economic equivalent of net interest income (interest income less implied financing cost) on the underlying Agency security from trade date to settlement date. We account for TBAs as derivative instruments because we cannot assert that it is probable at inception and throughout the term of an individual TBA transaction that its settlement will result in physical delivery of the underlying Agency RMBS, or the individual TBA transaction will not settle in the shortest period possible.

CMBS. Substantially all of our CMBS investments as of December 31, 2018 were fixed-rate Agency-issued securities backed by multifamily housing loans. Loans underlying CMBS are generally fixed-rate, mature in eight to eighteen years, have amortization terms of up to 30 years, and are geographically dispersed. These loans typically have some form of prepayment protection provisions (such as prepayment lock-out) or prepayment compensation provisions (such as yield maintenance or prepayment penalty). Yield maintenance and prepayment penalty requirements are intended to create an economic disincentive for the loans to prepay. From time to time we have invested in non-Agency CMBS backed by loans on multifamily housing, office buildings, retail, hospitality, and health care properties.

CMBS IO. CMBS IO are interest-only securities issued as part of a CMBS securitization and represent the right to receive a portion of the monthly interest payments (but not principal cash flows) on the unpaid principal balance of the underlying pool of commercial mortgage loans. We invest in both Agency-issued and non-Agency issued CMBS IO. The loans collateralizing CMBS IO pools are very similar in composition to the pools of loans that collateralize CMBS as discussed above. Since CMBS IO securities have no principal associated with them, the interest payments received are based on the unpaid principal balance of the underlying pool of mortgage loans, which is often referred to as the notional amount. Most loans in these securities have some form of prepayment protection from early repayment including absolute loan prepayment lock-outs, loan prepayment penalties, or yield maintenance requirements similar to those typical for CMBS described above. There are no prepayment protections, however, if the loan defaults and is partially or wholly repaid earlier because of loss mitigation actions taken by the underlying loan servicer, and therefore yields on CMBS IO investments are dependent upon the underlying loan performance. Because Agency-issued MBS generally contain higher credit quality loans, Agency CMBS IO are expected to have a lower risk of default than non-Agency CMBS IO. Our CMBS IO investments are investment grade-rated with the majority rated ‘AAA’ by at least one of the nationally recognized statistical rating organizations.

The performance of our investment portfolio will depend on many factors including but not limited to interest rates, trends of interest rates, the steepness of interest rate curves, prepayment rates on our investments, demand for our investments, general market liquidity, and economic conditions and their impact on the credit performance of our investments. In addition, our business model may be impacted by other factors such as the state of the overall credit markets, which could impact the availability and costs of financing. See “Factors that Affect Our Results of Operations and Financial Condition” below, "Risk Factors-Risks Related to Our Business" in Item 1A of Part I, and Item 7A of Part II, “Quantitative and Qualitative Disclosures About Market Risk”, of this Annual Report on Form 10-K for further discussion.

Financing Strategy

We use leverage to enhance the returns on our invested capital by pledging our investments as collateral for borrowings primarily through the use of uncommitted repurchase agreements with major financial institutions and broker-dealers. We generally use the proceeds of these borrowings to acquire investment securities. The amount of leverage we utilize depends upon a variety of factors, including but not limited to general economic, political and financial market conditions; the actual and anticipated liquidity and price volatility of our assets; the gap between the duration of assets and liabilities, including hedges; the availability and cost of financing the assets; our opinion of the credit worthiness of financing counterparties; the health of the U.S. residential mortgage and housing markets; our outlook for the level, slope and volatility of interest rates; the credit quality of the loans underlying our investments; the rating assigned to securities; and our outlook for asset spreads. Repurchase agreements generally have original terms to maturity of overnight to six months, though in some instances we may enter into longer-dated maturities depending on market conditions. We pay interest on our repurchase agreement borrowings at a rate usually based on a spread to a short-term interest rate such as LIBOR and fixed for the term of the borrowing. Borrowings under these repurchase agreements are renewable at the discretion of our lenders and do not contain guaranteed roll-over terms.

Repurchase agreement financing is provided principally by major financial institutions and broker-dealers acting as financial intermediaries for money market funds and securities lenders that provide funds to the repurchase agreement markets. Repurchase agreement financing exposes us to counterparty risk to such financial intermediaries, principally related to the excess of our collateral pledged over the amount borrowed. We seek to mitigate this risk by diversifying our repurchase agreement lenders and limiting borrowings from lesser capitalized or lightly regulated counterparties. In limited instances, a money market fund or securities lender has directly provided funds to us without the involvement of a financial intermediary typically at a lower cost than we would incur borrowing from the financial intermediary. Borrowing directly from these sources also reduces our risk to the financial intermediaries.

Please refer to "Risk Factors-Risks Related to Our Business" in Item 1A of Part I of this Annual Report on Form 10-K for additional information regarding significant risks related to repurchase agreement financing.

Hedging Strategy

We use derivative instruments to economically hedge our exposure to adverse changes in interest rates resulting from our ownership of primarily fixed-rate investments financed with short-term repurchase agreements. Changes in interest rates can impact net interest income, the market value of our investments, and book value per common share. In a period of rising interest rates, our earnings and cash flow may be negatively impacted by borrowing costs increasing faster than interest income from our assets, and our book value may decline as a result of declining market values of our MBS. As of December 31, 2018, we primarily utilized pay-fixed interest rate swaps to hedge our interest rate risk. An interest rate swap is a contractual agreement between two counterparties under which each agrees to make periodic interest payments to the other for an agreed upon period based upon a notional amount. Under our pay-fixed interest rate swap agreements, we pay a fixed interest rate and receive a floating interest rate based on one or three-month LIBOR. We may from time to time also enter into “receive-fixed” interest rate swap agreements. Interest rate swap agreements with a forward starting date do not have an exchange of these interest costs until the effective date of such agreement.

To help manage the adverse impact of interest rate changes on the market value of our portfolio as well as our net interest earnings, we may at times enter into forward or futures contracts, including short securities, net short TBA positions, options, futures, swaps, caps, or similar instruments. During portions of 2018, we utilized net short TBA positions, Eurodollar futures, and U.S. Treasury futures to hedge interest rate risk.

In conducting our hedging activities, we intend to comply with REIT and tax limitations on our hedging instruments which could limit our activities and the instruments that we may use. We also intend to enter into derivative contracts only with the counterparties that we believe have a strong credit rating to help mitigate the risk of counterparty default or insolvency.

Operating Policies and Risk Management

We invest and manage our capital pursuant to Operating Policies approved by our Board of Directors. Our Operating Policies set forth investment and risk limitations as they relate to the Company's investment activities and set parameters for the Company's investment and capital allocation decisions. They require that we manage our operations and investments to comply with various REIT limitations (as discussed further below in “Federal Income Tax Considerations”) and to avoid qualifying as an investment company as such term is defined in the Investment Company Act of 1940 (the "1940 Act") or as a commodity pool operator under the Commodity Exchange Act.

Our Operating Policies place limits on certain risks to which we are exposed, such as interest rate and convexity risk, earnings at risk, and shareholders’ equity at risk from changes in fair value of our investment securities as a result of changes in interest rates, prepayment rates, investment prices and spreads, and other items. As part of our risk management process, our Operating Policies require us to perform a variety of stress tests to model the effect of adverse market conditions on our investment portfolio value and our liquidity.

Our Operating Policies limit our investment in non-Agency MBS that are rated BBB+ or lower at the time of purchase by any of the nationally recognized statistical ratings organizations to $250 million in market value and limit our shareholders’ equity at risk to a maximum of $50 million. We also conduct our own independent evaluation of the credit risk on any non-Agency MBS, such that we do not rely solely on the security’s credit rating. In addition, our purchases of non-rated MBS in recent years have been shorter duration securities which we believe to have less credit risk than typical non-rated MBS. Our Operating Policies also set forth limits for the Company’s overall leverage.

Within the overall limits established by our Operating Policies, our investment and capital allocation decisions depend on prevailing market conditions and other factors and may change over time in response to opportunities available in different economic and capital market environments. The Board may adjust the Operating Policies of the Company from time to time based on macroeconomic expectations, market conditions, and risk tolerances.

Factors that Affect Our Results of Operations and Financial Condition

Our financial performance is driven by the performance of our investment portfolio and related financing and hedging activity. In assessing our financial performance, management primarily focuses on net interest income, net interest spread, net income, comprehensive income, book value per common share, and core net operating income to common shareholders (a non-GAAP measure) and total economic return (measured as dividends declared plus changes in book value). Our financial performance may be impacted by a number of factors, many of which are related to or influenced by macroeconomic conditions, market volatility, geopolitical conditions, U.S. Federal Reserve policy, U.S. fiscal and regulatory policy, and foreign central bank and government policy. Other factors that may impact our financial performance include, but are not limited to, the absolute level of interest rates, the relative slope of interest rate curves, changes in interest rates and market expectations of future interest rates, actual and estimated future prepayment rates on our investments, supply of investments, competition for investments, economic conditions and their impact on the credit performance of our investments, and market required yields as reflected by market spreads. These factors are influenced by market forces beyond our control.

Our business model may also be impacted by the availability and cost of financing and the state of the overall credit markets. Reductions or limitations in the availability of financing for our investments could significantly impact our business or force us to sell assets, potentially at losses. Repurchase agreement lending markets have been stable for the last several years, but lending by larger U.S. domiciled banks has declined in recent years due to increased regulation and changes to regulatory capital requirements. Their repurchase market participation has been replaced by smaller independent broker dealers that are generally less regulated and by U.S. domiciled broker dealer subsidiaries of foreign financial institutions. It is uncertain how these relatively new participants will react during periods of market stress. Other factors that could also impact our business include changes in regulatory requirements, including requirements to qualify for registration under the 1940 Act, and REIT requirements.

We believe that regulatory impacts on financial institutions, many of which are our trading and financing counterparties, pose a potential threat to the overall liquidity in the capital markets. In 2017, the Federal Reserve began curtailing its reinvestment of principal payments received on its Agency RMBS portfolio. Prices in Agency RMBS generally have not been significantly impacted by the reduction, however prices may be more significantly impacted as the amount of curtailment increases each successive quarter. Market liquidity of our investments and the financing markets could be negatively impacted if the Federal Reserve's Federal Open Market Committee (or "FOMC") suddenly changes market expectations of the target Federal Funds Rate or takes other actions which have the effect of tightening monetary policy that are not anticipated by the market. And finally, there remains uncertainty as to the ultimate impact or outcome of certain regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), and restrictions on market-making activities of large U.S. financial institutions could result in reduced liquidity in times of market stress.

As discussed above, investing in mortgage-related securities (including on a leveraged basis) subjects us to many risks including interest rate risk, prepayment and reinvestment risk, credit risk, spread risk, and liquidity risk. Please refer to Part I, Item 1A, "Risk Factors" as well as Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 7A, "Quantitative and Qualitative Disclosures about Market Risk" of this Annual Report on Form 10-K for a detailed discussion of these factors and others that have the potential to impact our results of operations and financial condition.

From time to time, we also consider expanding our capital base as well as merger, acquisition or divestiture opportunities. We analyze and evaluate potential business opportunities that we identify or are presented to us, including possible merger, acquisition, or divestiture transactions, that might be a strategic fit for our investment strategy or asset allocation or otherwise maximize value for our shareholders. Pursuing such an opportunity or transaction could require us to issue additional equity or debt securities.

COMPETITION

The business models of mortgage REITs range from investing only in Agency MBS to investing substantially in non-investment grade MBS and originating and securitizing mortgage loans and investing in mortgage servicing rights. Some mortgage REITs will invest in RMBS and related investments only, some in CMBS and related investments only, and some in a mix. Each mortgage REIT will assume various types and degrees of risk in its investment strategy. In purchasing investments and obtaining financing, we compete with other mortgage REITs, broker dealers and investment banking firms, mutual funds, banks, hedge funds, mortgage bankers, insurance companies, governmental bodies, and other entities, many of which have greater financial resources and a lower cost of capital than we do. Increased competition in the market may reduce the available supply of investments and may drive prices of investments to unacceptable levels which would negatively impact our ability to earn an acceptable amount of income from these investments. Competition can also reduce the availability of borrowing capacity at our repurchase agreement counterparties as such capacity is not unlimited, and many of our repurchase agreement counterparties limit the amount of financing they offer to the mortgage REIT industry.

FEDERAL INCOME TAX CONSIDERATIONS

As a REIT, we are required to abide by certain requirements for qualification as a REIT under the Internal Revenue Code of 1986, as amended (the “Code”). To retain our REIT status, the REIT rules generally require that we invest primarily in real estate-related assets, that our activities be passive rather than active and that we distribute annually to our shareholders substantially all of our taxable income, after certain deductions, including deductions for our tax net operating loss (“NOL”) carryforward. We could be subject to income tax if we failed to satisfy those requirements. We use the calendar year for both tax and financial reporting purposes.

We may utilize our NOL carryforward to offset our taxable earnings after taking the REIT distribution requirements into account. As a result of our public offering of common stock in February 2012, we incurred an "ownership change" as such term is defined in Section 382 of the Code. Because of this ownership change, the amount of the NOL carryforward that we may use each year is limited to approximately $13.5 million, and portions of this amount not utilized are accumulated and rolled forward to the following year. The Tax Cuts and Jobs Act (“TCJA”) permits an NOL generated after December 31, 2017 to be carried forward indefinitely, but NOL carryforwards generated prior to that date are still subject to expiration 20 years after the year in which they are created. The majority of our NOL carryforward will expire in 2020. The following table provides a rollforward of our NOL carryforward for the periods indicated:

	NOL Available for Use	**Total NOL**
As of December 31, 2015:	$ 25,190	$ 89,775
NOL limitation release for the years ended:		
December 31, 2016	13,451	
December 31, 2017	13,451	
December 31, 2018	13,451	
NOL used for the years ended:		
December 31, 2016	—	—
December 31, 2017	—	—
December 31, 2018 (1)	—	—
As of December 31, 2018	$ 65,543	$ 89,775

(1) Subject to completion of our 2018 federal income tax return.

There may be differences between taxable income and net income computed in accordance with U.S. generally accepted accounting principles (“GAAP”). These differences primarily arise from timing differences in the recognition of revenue and expense for tax and GAAP purposes.

Failure to satisfy certain Code requirements could cause us to lose our status as a REIT. If we failed to qualify as a REIT for any taxable year, we may be subject to federal income tax at regular corporate rates and would not receive deductions for dividends paid to shareholders. We could, however, utilize our NOL carryforward to offset all or part of our taxable income to the extent the NOL is available to us based on the limitations described above. If we lost or otherwise surrendered our status as a REIT, we could not elect REIT status again for five years. Several of our investments in securitized mortgage loans have ownership restrictions limiting their ownership to REITs. Therefore, if we fail to maintain our REIT status, we would have to sell these investments or otherwise provide for REIT ownership of these investments. In addition, many of our repurchase agreement lenders and interest rate swap counterparties require us to maintain our REIT status. If we were to lose our REIT status, these lenders would have the right to terminate any repurchase agreement borrowings and interest rate swaps outstanding at that time.

Qualification as a REIT

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

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

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

Nature and Diversification of Assets. At the end of each calendar quarter, we must meet multiple asset tests. Under the “75% asset test”, at least 75% of the value of our total assets must represent cash or cash items (including receivables), government

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securities or real estate assets. Under the “10% asset test,” we may not own more than 10% of the outstanding voting power or value of securities of any single non-governmental issuer, provided such securities do not qualify under the 75% asset test or relate to taxable REIT subsidiaries. Under the “5% asset test,” ownership of any stocks or securities that do not qualify under the 75% asset test must be limited, in respect of any single non-governmental issuer, to an amount not greater than 5% of the value of our total assets (excluding ownership of any taxable REIT subsidiaries).

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

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

TCJA

TCJA made significant changes to the U.S. federal income tax laws applicable to businesses and their owners, including REITs and their stockholders. Pursuant to this legislation, among other items, as of January 1, 2018, (1) the federal income tax rate applicable to corporations was reduced to 21%, (2) the highest marginal individual income tax rate was reduced to 37%, (3) the corporate alternative minimum tax was repealed and (4) the allowable NOL deduction for a given year was reduced to 80% of a corporation’s (including a REIT’s) pre-NOL deduction taxable income. In addition, under the TCJA, individuals, estates and trusts may deduct up to 20% of certain pass-through income, including ordinary REIT dividends that are not “capital gain dividends” or “qualified dividend income,” subject to certain limitations. For taxpayers qualifying for the full deduction, the effective maximum tax rate on ordinary REIT dividends is 29.6% (plus a 3.8% surtax on net investment income, if applicable). The maximum rate of withholding with respect to our distributions to certain foreign owners that are treated as attributable to gains from the sale or exchange of U.S. real property interests was also reduced from 35% to 21%. The deductibility of net interest expense is limited for all businesses; however, certain businesses, including certain real estate businesses, may elect to not be subject to such limitations, in which case they would be required to depreciate their real property-related assets over longer depreciable lives. To the extent that a taxable REIT subsidiary has interest expense that exceeds its interest income, the net interest expense limitation could potentially apply to such taxable REIT subsidiary. The reduced corporate tax rate of 21% applies to our taxable REIT subsidiaries. The individual and collective impact of these changes on REITs and their security holders remains uncertain and may not become evident for some period. Prospective and current investors should consult their tax advisors regarding the implications of the TCJA on their investment.

EMPLOYEES

As of December 31, 2018, we have 19 employees and our corporate office is located in Glen Allen, Virginia. None of our employees are covered by any collective bargaining agreements, and we are not aware of any union organizing activity relating to our employees.

Executive Officers of the Company

Name (Age)	Current Title	Business Experience
Byron L. Boston (60)	Chief Executive Officer, President, Co-Chief Investment Officer, and Director	Chief Executive Officer and Co-Chief Investment Officer effective January 1, 2014; President and Director since 2012; Chief Investment Officer since 2008.
Stephen J. Benedetti (56)	Executive Vice President, Chief Financial Officer, and Chief Operating Officer	Executive Vice President and Chief Operating Officer since 2005; Executive Vice President and Chief Financial Officer from 2001 to 2005 and beginning again in 2008.
Smriti L. Popenoe (50)	Executive Vice President and Co-Chief Investment Officer	Executive Vice President and Co-Chief Investment Officer effective January 1, 2014; Chief Risk Officer of PHH Corporation between 2010 and 2013; Senior Vice President, Balance Sheet Management, of Wachovia Bank, from 2006 to 2009.

AVAILABLE INFORMATION

We are subject to the reporting requirements of the Exchange Act and its rules and regulations. The Exchange Act requires us to file reports, proxy statements, and other information with the Securities Exchange Commission (the "SEC"). These materials may be obtained electronically by accessing the SEC's home page at www.sec.gov.

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

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

ITEM 1A. RISK FACTORS

The following is a summary of the risk factors that we believe are most relevant to our business. These are factors which, individually or in the aggregate, we think could cause our actual results to differ significantly from anticipated or historical results. In addition to understanding the key risks described below, investors should understand that it is not possible to predict or identify all risk factors, and consequently, the following is not a complete discussion of all potential risks or uncertainties.

RISKS RELATED TO OUR BUSINESS

Our use of leverage to enhance returns to shareholders increases the risk of volatility in our results and could lead to material decreases in net interest income, net income, comprehensive income, dividends, book value per common share, and liquidity.

Leverage increases returns on our invested capital if we can earn a greater return on investments than our cost of borrowing, but can decrease returns if borrowing costs increase and we have not adequately hedged against such an increase. Further, using leverage magnifies the potential losses to shareholders' equity and book value per common share if the market value of our investments declines, net of associated hedges.

We also have increased liquidity risk stemming from the potential for margin calls by our lenders for fluctuations in investment collateral values, or if the lender fails to renew or roll over the financing at maturity. If we are unable to access leverage at reasonable terms, our ability to generate adequate returns for our shareholders will be severely impacted. Our ability to access leverage in the conduct of our operations is impacted by the following:

- market conditions and overall market volatility and liquidity;
- regulation of our lenders and other regulatory factors;
- the liquidity of our investments;
- the market value of our investments;
- the advance rates by our lenders on investment collateral pledged, and;
- the willingness of our lenders to finance the types of investments we choose.

Many of these factors are beyond our control and are difficult to predict, which could lead to sudden and material adverse effects on our results of operations, financial condition, business, liquidity, and ability to make distributions to shareholders, and could force us to sell assets at significantly depressed prices to maintain adequate liquidity.

For more information about our operating policies regarding leverage and historic leverage levels, please see “Liquidity and Capital Resources” within Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operation.”

Fluctuations in the market value of our investments could negatively impact our net income, comprehensive income, shareholders' equity, book value per common share, and liquidity.

Our investments fluctuate in value due to changes in credit spreads, spot and forward interest rates, actual and anticipated prepayments, and other factors. Our investments may also fluctuate in value due to increased or reduced demand for the types of investments we own which could be impacted by, among other things, interest rates, capital flows, and government and regulatory policies. Changes in the market values of our investments are reflected in our consolidated financial statements in other comprehensive income, shareholders' equity and book value per common share. Changes in credit spreads represent the market's valuation of the perceived riskiness of assets relative to risk-free rates, and widening credit spreads reduce the market value of our investments as market participants require additional yield to hold riskier assets. Credit spreads could change based on macro-economic or systemic factors specific to a particular security such as prepayment performance or credit performance. Other factors that could impact credit spreads include technical issues such as supply and demand for a particular type of security, market psychology, and FOMC monetary policy. In addition, most of our investments are fixed rate or reset in rate over a period of time, and as interest rates rise, the market value of these investments will decrease. If market values decrease significantly, we may be forced to sell assets at losses in order to maintain liquidity and repay or renew repurchase agreements at maturity.

Our use of hedging strategies to mitigate our interest rate exposure may not be effective and may adversely affect our net income, comprehensive income, liquidity, shareholders’ equity and book value per common share.

We may use interest rate swap agreements, Eurodollar futures, interest rate caps, options, forward contracts and other derivative transactions (collectively, “hedging instruments”) to help mitigate increased financing costs and volatility in the market value of our investments (and therefore shareholders’ equity and book value) from adverse changes in interest rates. Our hedging activity will vary in scope based on. among other things, our portfolio construction and objectives, the actual and implied level and volatility of interest rates, our forecast of future interest rates, and financing sources used. No hedging strategy can completely insulate us from the interest rate risks to which we are exposed, and there can be no assurance that the implementation of any hedging strategy will have the desired impact on our results of operations or financial condition. Hedging instruments we use may adversely affect our results of operations and book value (particularly if interest rates decline) as the fair value of hedging instruments fluctuates with changes in rates (and require us to post margin to counterparties) and also involve an expense that we will incur regardless of the effectiveness of the hedging activity. In periods of rapidly changing interest rates, particularly declining interest rates, our liquidity could be negatively impacted if declines in the value of the hedges is greater than the increase in fair value of the hedged investments.

Our hedging instruments can be traded on an exchange or administered through a clearing house or under bilateral agreements between us and a counterparty. Bilateral agreements expose us to increased counterparty risk, and we may be at risk of loss of any collateral held by a hedging counterparty if the counterparty becomes insolvent or files for bankruptcy.

Interest rate hedging may fail to protect or could adversely affect us because, among other things:

- The performance of instruments used to hedge may not completely correlate with the performance of the assets or liabilities being hedged;
- Interest rate hedging can be expensive, particularly during periods of volatile interest rates;
- Available hedging instruments may not correspond directly with the interest rate risk from which we seek protection;
- The duration of the hedge may not match the duration of the related asset or liability given management's expectation of future changes in interest rates or a result of the inaccuracies of models in forecasting cash flows on the asset being hedged;
- The value of derivatives used for hedging will be adjusted from time to time in accordance with GAAP to reflect changes in fair value, and downward adjustments, or “mark-to-market losses,” would reduce our earnings, shareholders’ equity, and book value;
- The amount of income that a REIT may earn from hedging transactions (other than through taxable REIT subsidiaries) to offset interest rate losses may be limited by U.S. federal income tax provisions governing REITs;
- The credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
- The party owing money in the hedging transaction may default on its obligation to pay.

Our hedging transactions, which are intended to limit losses, may actually adversely affect our earnings, which could reduce our ability to pay dividends to our shareholders.

Fluctuations in interest rates may have various negative effects on us and could lead to reduced net interest income, comprehensive income, book value per common share, and liquidity.

Fluctuations in interest rates impact us in a number of ways. For example, in a period of rising rates, particularly increases in the targeted Federal Funds Rate, we may experience a decline in our profitability from borrowing rates increasing faster than interest coupons on our investments reset or our investments mature. We may also experience a decline in profitability from our investments adjusting less frequently or relative to a different index (e.g., six month or one-year LIBOR) from our borrowings (repurchase agreements are typically based on short-term rates like one-month or three-month LIBOR). Once the Federal Reserve announces a higher targeted range or if markets determine that the Federal Reserve is likely to announce a higher targeted range for the Federal Funds Rate, our borrowing costs are likely to immediately increase, thereby negatively impacting our results of operations, financial condition, and book value per common share.

Fluctuations in interest rates may also negatively affect the market value of our securities. Since our MBS are fixed rate or adjust generally over longer-term periods, rising interest rates will reduce the market value of our MBS as a result of higher yield requirements by the market for these types of securities. Reductions in the market value of our MBS could result in margin calls from our lenders, potentially forcing us to sell securities at a loss. Conversely, while declining interest rates are more favorable for us, we may experience increasing prepayments, resulting in reduced profitability due to reinvestment of our capital in lower yielding investments.

Repurchase agreements are generally uncommitted short-term financings with no guaranty of renewal at maturity. Changes to terms of such financing may adversely affect our profitability and our liquidity.

The majority of our repurchase agreements are uncommitted financings from lenders with an average term of ninety days or less. Because repurchase agreements are short-term financing commitments, changes in conditions in the repurchase markets may make it more difficult for us to secure continued financing particularly in periods of high volatility. Additionally, regulatory capital requirements imposed on our lenders by financial and banking regulators have changed significantly in recent years, and as a result, the cost of financing has increased and may continue to increase. In addition, many lenders may find it unprofitable to lend against certain collateral types due to higher regulatory costs and regulatory capital requirements, and thus restrict their lending against such collateral. Because we rely heavily on borrowings under repurchase agreements to finance our investments, our ability to achieve our investment and profitability objectives can depend on our ability to access repurchase agreement financing in sufficient amounts and on favorable terms, and to renew or replace maturing financings on a continuing basis. If the terms on which we borrow change in a meaningful way, or if borrowings are not available, we may be forced to sell assets or our borrowing costs could increase, potentially reducing our profitability and dividends to our shareholders.

We invest in to-be-announced, or TBA, securities and execute TBA dollar roll transactions. It could be uneconomical to roll our TBA contracts or we may be unable to meet margin calls on our TBA contracts, which could negatively affect our financial condition and results of operations.

The Company executes TBA dollar roll transactions which effectively delay the settlement of a forward purchase of a TBA by entering into an offsetting TBA short position, net settling the paired-off positions in cash, and simultaneously entering an identical TBA long position with a later settlement date. Under certain market conditions, TBA dollar roll transactions may result in negative net interest income whereby the Agency RMBS purchased for forward settlement under a TBA contract are priced at a premium to Agency RMBS for settlement in the current month. Market conditions could also adversely impact the TBA dollar roll market. In particular, the announced reduction in the Federal Reserve’s reinvestment of principal payments on Agency RMBS could adversely impact the TBA dollar roll market as this reduction is implemented. Under such conditions, it may be uneconomical to roll our TBA positions prior to the settlement date, and we could have to take physical delivery of the underlying securities and settle our obligations for cash. We may not have sufficient funds or alternative financing sources available to settle such obligations. In addition, pursuant to the margin provisions established by the Mortgage-Backed Securities Division ("MBSD") of the Fixed Income Clearing Corporation we are subject to margin calls on our TBA contracts and our trading counterparties may require us to post additional margin above the levels established by the MBSD. Negative income on TBA dollar roll transactions or failure to procure adequate financing to settle our obligations or meet margin calls under our TBA contracts could result in defaults or force us to sell assets under adverse market conditions or through foreclosure and adversely affect our financial condition and results of operations.

We invest in assets that are traded in over-the-counter (“OTC”) markets which are less liquid and have less price transparency than securities exchanges. Owning securities that are traded in OTC markets may increase our liquidity risk, particularly in a volatile market environment, because our assets may be more difficult to borrow against or sell in a prompt manner and on terms acceptable to us, and we may not realize the full value at which we previously recorded the investments and/or may incur losses upon sale of these assets.

Though Agency MBS are generally deemed to be very liquid securities, turbulent market conditions in the past have at times significantly and negatively impacted the liquidity of these assets, resulting in reductions in their market value. Non-Agency MBS are typically more difficult to value, less liquid, and experience greater price volatility than Agency MBS. In addition, market values for non-Agency MBS are typically more subjective than Agency MBS. Because of these factors, the number of lenders willing to provide financing for non-Agency MBS or accept them as collateral has generally been limited compared to Agency MBS. Given the trading of our investments in OTC markets, in an extreme case of market stress, a market may not exist for certain of our assets at any price. If the MBS market were to experience a severe or extended period of illiquidity, lenders may refuse to accept our assets as collateral for repurchase agreement financing, which could have a material adverse effect on our results of operations, financial condition and business. A sudden reduction in the liquidity of our investments could limit our ability to finance or could make it difficult to sell investments if the need arises. If we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the fair value at which we have previously recorded our investments which would result in lower than anticipated gains or higher losses.

Purchases and sales of Agency RMBS by the Federal Reserve may adversely affect the price and return associated with Agency RMBS, which could negatively impact the value of our investments, comprehensive income, book value per common share, and liquidity.

The Federal Reserve owns approximately $1.6 trillion of Agency RMBS as of December 31, 2018. The Federal Reserve is gradually reducing its investment in Agency RMBS by approximately $20 billion a month by not reinvesting principal repayments up to that amount. Any announced or actual increase in the reduction, or if the reduction is not slowed in response to market conditions, prices of Agency RMBS could materially decline which would have a negative impact on the market value of our investments, negatively impacting our comprehensive income, book value per common share, and our liquidity.

Our repurchase agreements and agreements governing certain derivative instruments may contain financial and non-financial covenants. Our inability to meet these covenants could adversely affect our financial condition, results of operations, and cash flows.

In connection with certain of our repurchase agreements and interest rate swap agreements, we are required to maintain certain financial and non-financial covenants. As of January 31, 2019, the most restrictive financial covenants require that we have a minimum of $30 million of liquidity and declines in shareholders' equity no greater than 25% in any quarter and 35% in any year. In addition, virtually all of our repurchase agreements and interest rate swap agreements require us to maintain our status as a REIT and to be exempted from the provisions of the 1940 Act. Compliance with these covenants depends on market factors and the strength of our business and operating results. Various risks, uncertainties and events beyond our control, including significant fluctuations in interest rates and changes in market conditions, could affect our ability to comply with these covenants. Failure to comply with these covenants could result in an event of default, termination of an agreement, acceleration of all amounts owed under an agreement, and generally would give the counterparty the right to exercise certain other remedies under the repurchase agreement, including the sale of the asset subject to repurchase at the time of default, unless we were able to negotiate a waiver in connection with any such default related to failure to comply with a covenant. Any such waiver could be conditioned on an amendment to the underlying agreement and any related guaranty agreement on terms that may be unfavorable to us. If we are unable to negotiate a covenant waiver or replace or refinance our assets under a new repurchase facility on favorable terms or at all, our financial condition, results of operations and cash flows could be adversely affected. Further, certain of our repurchase agreements and interest rate swap agreements have cross-default, cross-acceleration or similar provisions, such that if we were to violate a covenant under one agreement, that violation could lead to defaults, accelerations, or other adverse events under other agreements, as well.

Prepayment rates on the mortgage loans underlying our investments may adversely affect our profitability and the market value of our investments. Changes in prepayment rates may also subject us to reinvestment risk.

We are subject to prepayment risk to the extent that we own investments at premiums to their par value or at yields at a premium to current market yields. Our investment portfolio consists substantially of RMBS and CMBS owned at premiums, and CMBS IO securities which consist entirely of premium, representing the right to receive interest payments on the underlying pools of CMBS loans included in the securitization trust. We amortize the premiums we pay on a security using the effective yield method, which is impacted by actual and projected borrower prepayments of principal on the loans. Prepayments on our investments can occur both on a voluntary and involuntary (i.e., a loan default and subsequent foreclosure and liquidation) basis. Voluntary prepayments tend to increase when interest rates are declining or based on the shape of the yield curve. CMBS and CMBS IO are generally protected from voluntary prepayment for a portion of their expected lives either by an absolute prepayment lock-out on the loan or by yield maintenance or prepayment penalty provisions which serve as full or partial compensation for future lost interest income on the loan. In certain circumstances, compensation for voluntary prepayment on CMBS IO securities may not be sufficient to compensate us for the loss of future excess interest as a result of the prepayment, thereby adversely affecting our results of operations. RMBS provide no specific protection from voluntary prepayment. The actual level of prepayments on our investments will be impacted by economic and market conditions, the absolute levels of interest rates and relative levels of interest rates, the general availability of mortgage credit, and other factors. We have no protection from involuntary prepayments which tend to increase in periods of economic stress and may occur for any of our investment types. Involuntary prepayments on CMBS IO are particularly acute since the investment consists entirely of premium. If we experience actual prepayments in excess of our projections or increase our expectations of future prepayment activity, we will amortize investment premiums at an accelerated rate which could materially reduce our interest income, net income and comprehensive income. In addition, we may reinvest prepayments in lower yielding investments which could lead to lower net interest income and reduced profitability.

Increases in actual prepayment rates or market expectations of prepayment rates could also negatively impact the market value of our investments. Faster prepayments generally negatively impact the market value of RMBS due to less predictability of payments on the underlying mortgage loans and will increase the required market yield on such security. Faster prepayments will also negatively impact the market value of CMBS IO, depending on the amount of prepayment protection for a given security. Increasing prepayments will typically reduce the value of our securities owned at premiums which will negatively impact our book value. We are also more likely to experience margin calls from our lenders as a result of the decline in value of our securities.

Prepayments on large balance, single loan Agency CMBS could result in margin calls by lenders in excess of our available liquidity. As such, we may be at risk of defaulting on a repurchase agreement which could force us to sell assets at a loss.

We may own large balance Agency CMBS which are collateralized by a single-loan. While these Agency CMBS have some form of prepayment protection such as yield maintenance which would compensate us for the prepayment, these securities are collateralizing repurchase agreements. If the single loan CMBS prepays, typically there is a 20-day delay between the announcement of such prepayment and the receipt of cash from the prepayment; however, the repurchase agreement lender may initiate a margin call when the prepayment is announced. If the margin call were large enough, we might not be able to meet such margin call from available liquidity, and we could be forced to sell assets quickly and on terms unfavorable to us to meet the margin call. If we cannot meet the margin call, we may be in default under the repurchase agreement until we receive the cash from the prepayment. Because some of our repurchase agreement borrowings contain cross-default provisions, such default could trigger defaults on and margin calls with respect to other of our repurchase agreement borrowings.

Provisions requiring yield maintenance charges, prepayment penalties, defeasance, or lock-outs in CMBS IO securities may not be enforceable.

Provisions in loan documents for mortgages in CMBS IO securities in which we invest requiring yield maintenance charges, prepayment penalties, defeasance, or lock-out periods may not be enforceable in some states and under federal bankruptcy law. Provisions in the loan documents requiring yield maintenance charges and prepayment penalties may also be interpreted as constituting the collection of interest for usury purposes. Accordingly, we cannot be assured that the obligation of a borrower to pay any yield maintenance charge or prepayment penalty under a loan document in a CMBS IO security will be enforceable. Also, we cannot be assured that foreclosure proceeds under a loan document in a CMBS IO security will be sufficient to pay an enforceable yield maintenance charge. If yield maintenance charges and prepayment penalties are not collected, or if a lock-out period is not enforced, we may incur losses to write-down the value of the CMBS IO security for the present value of the amounts not collected, and we will experience lower yields and lower interest income. This would also likely cause margin calls from any lender on the CMBS IO impacted which could have a material adverse effect on our liquidity.

We invest in securities guaranteed by Fannie Mae and Freddie Mac which are currently under conservatorship by the Federal Housing Finance Administration (the "FHFA"). As conservator, the FHFA has assumed all the powers of the shareholders, directors and officers of the GSEs with the goal of preserving and conserving their assets. Both Fannie Mae's and Freddie Mac's solvency is being supported by the Treasury through their committed purchases of Fannie Mae and Freddie Mac preferred stock. The ultimate impact on the operations of Fannie Mae and Freddie Mac from the conservatorships and the support they receive from the U.S. government is not determinable and could affect Fannie Mae and Freddie Mac in such a way that our business, operations and financial condition may be adversely affected.

The FHFA placed Fannie Mae and Freddie Mac under federal conservatorship in 2008. As its conservator, the FHFA has broad regulatory powers over Fannie Mae and Freddie Mac and has entered into Preferred Stock Purchase Agreements, as amended, ("PSPAs") pursuant to which the Treasury ensures that Fannie Mae and Freddie Mac will separately maintain a positive net worth by committing to purchase their preferred stock. The FHFA as the regulator of the GSEs has proposed several reforms including, among other things, building a common, single, securitization platform between the two entities and gradually contracting their presence in the mortgage marketplace. In addition, the U.S. Congress at various times has considered structural changes to the GSEs, including winding down the GSEs and replacing them with a privately capitalized system that is intended to preserve market liquidity and protect taxpayers from future GSE losses due to economic downturns.

The outcome of the conservatorship and the scope and nature of actions that may ultimately be taken by the U.S. Congress to reform the GSEs and the housing finance system, are not predictable at this point. Actions limiting the guarantee on future Agency MBS could impact the amount of Agency MBS available to be purchased which could lead to increased competition and reduced returns from these assets. It could also negatively impact our ability to comply with the provisions of the 1940 Act (see further discussion below regarding the 1940 Act). On the other hand, actions expanding the guarantee on future Agency MBS could make Agency MBS more expensive and could impact potential returns on these investments.

Fannie Mae’s and Freddie Mac’s long-term financial viability is highly dependent on governmental support. If the Treasury withdraws its support, the value of Agency MBS could significantly decline, which would make it difficult for us to obtain repurchase agreement financing and could force us to sell assets at substantial losses. In addition, future policies that change the relationship between Fannie Mae and Freddie Mac and the U.S. government, including those that result in their winding down, release from conservatorship, nationalization, privatization, or elimination, may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by Fannie Mae and Freddie Mac. As a result, such policies could increase the risk of loss on investments in Agency MBS. It also is possible that such policies could adversely impact the market for such securities and spreads at which they trade, and thereby adversely impact the profitability of our investments.

All of the foregoing could materially adversely affect the availability, pricing, liquidity, market value and financing of our assets and materially adversely affect our business, operations and financial condition.

Our investment strategy includes investing in non-Agency MBS with credit risk. Many of these securities have some form of subordinate credit enhancement within the security structure. The performance of these securities is dependent in large part on the performance of the underlying mortgage loans relative to the amount of the subordinate credit enhancement within the security structure. These mortgage loans are subject to defaults, foreclosure timeline extension, fraud, price depreciation, and unfavorable modification of loan principal amount, interest rate, and premium, any of which could result in losses to us.

Non-Agency MBS are secured by mortgage loans (generally single-family residential properties for RMBS and pools of commercial mortgage loans for CMBS) that have no guarantee of repayment. Typically, non-Agency MBS have non-rated or low rated tranches or classes that are subordinate to principal payments to higher rated classes and absorb losses on the liquidation of the underlying loans. We own securities that generally have some form of credit subordination to our investment with respect to credit losses on the underlying mortgage loans. We bear a risk of loss of principal on our security to the extent losses experienced on the loans in these securities are in excess of such subordination.

Commercial mortgage loans that collateralize CMBS and CMBS IO generally have a higher principal balance, and the ability of a borrower to repay a loan secured by an income-producing property typically is dependent upon the successful operation of the property rather than upon the existence of independent income or assets of the borrower. If the net operating income of a commercial property is reduced, the borrower's ability to repay the loan may be impaired. Net operating income of an income-producing property can be affected by, among other things, economic conditions, tenancy, location and condition, property management decisions, competition, regulations, environmental conditions, occupancy rates, interest rates and real estate tax rates and other operating expenses. Losses on underlying commercial mortgage loans will potentially impact the yield on the CMBS and CMBS IO securities we own and could also negatively impact their market value. Negative impacts on yields will reduce our net income and reductions in market values could lead to margin calls by our lenders which, if significant, could force us to sell assets possibly at losses to meet margin calls.

RMBS securities are generally collateralized by pools of single-family mortgage loans which have less idiosyncratic risk than CMBS and CMBS IO. The ability of a borrower to repay a mortgage loan secured by a residential property is dependent upon the income or assets of the borrower. Many factors may impair borrowers’ abilities to repay their loans, including among other things, their employment situation, economic conditions, and the availability of refinancing. In the event of defaults on the residential mortgage loans that underlie our investments in RMBS and the exhaustion of any underlying or any additional credit support, we may not realize our anticipated return on our investments and we may incur a loss on these investments.

The implementation of the Single Security Initiative may adversely affect our financial condition and results of operations.

The Single Security Initiative is a joint initiative of Fannie Mae and Freddie Mac, under the direction of the FHFA, the GSEs’ regulator and conservator, to develop a common MBS that will be issued by the GSEs. The 2014 Strategic

Plan for the Conservatorships of Fannie Mae and Freddie Mac includes the goal of developing a common MBS. The Single Security would finance the same types of fixed-rate mortgages that currently back Agency MBS eligible for delivery into the TBA market. The GSEs expect to complete the Single Security initiative and issue the first Single Security in the second quarter of 2019 with the impact on forward trading in the TBA market to commence in the first quarter of 2019. Because our primary investments are Agency MBS, we may be adversely impacted by the Single Security Initiative in ways including, but not limited to:

- the Single Security Initiative may introduce uncertainty and/or negative impacts to the Agency mortgage-backed market which reduce our liquidity, affect asset values, or increase our financing costs;

- our operational preparations may be insufficient, resulting in operational impacts or missed opportunities;
- opting to convert legacy Freddie Mac positions to the Uniform Mortgage-Backed Securities (UMBS) will increase the number of delay days between factor changes and payment which could negatively impact our liquidity.

Changes in the method of determining LIBOR, or the replacement of LIBOR with an alternative reference rate, may adversely affect interest expense related to outstanding debt.

In 2012, as the result of an investigation into the manipulation of LIBOR, British regulators published a report concluding that LIBOR should undergo comprehensive reform if it was to be retained as a benchmark. Based on this report, final rules for the regulation and supervision of LIBOR by the Financial Conduct Authority ("FCA") were published and came into effect on April 2, 2013 (the "FCA Rules"). In particular, the FCA Rules include requirements that (i) an independent LIBOR administrator monitor and survey LIBOR submissions to identify breaches of practice standards and/or potentially manipulative behavior, and (ii) firms submitting LIBOR-related data to the administrator establish and maintain a clear conflict-of-interest policy and appropriate systems and controls. In response, ICE Benchmark Administration Limited ("IBA") was appointed as the independent LIBOR administrator, effective in early 2014. It is not possible to predict the effect of the FCA Rules, any changes in the methods pursuant to which LIBOR is determined, the administration of LIBOR by IBA, and any other reforms to LIBOR that will be enacted in the United Kingdom and elsewhere. In addition, any changes announced by the British Banker's Association (the "BBA"), FCA, IBA, or any other successor governance or oversight body, or future changes adopted by such body, in the method pursuant to which LIBOR is determined, as well as manipulative practices or the cessation thereof, may result in a sudden or prolonged increase or decrease in reported LIBOR, which could have an adverse impact on the level of the index. Fluctuation or discontinuation of LIBOR could affect our interest expense and the fair value of certain of our derivative instruments. We rely on interest rate hedges to mitigate our exposure to such interest rate risk on a portion of our debt obligations, but there is no assurance these arrangements will be effective in reducing our exposure to changes in interest rates.

In November 2014, the U.S. Federal Reserve established a working group composed of large U.S. financial institutions, the Alternative Reference Rates Committee ("ARRC"), to identify a set of alternative interest reference rates to LIBOR. In June 2017, the ARRC selected the Secured Overnight Financing Rate ("SOFR"), a new index calculated by reference to short-term repurchase agreements backed by U.S. Treasury securities, as its preferred replacement for U.S. dollar LIBOR. SOFR is an observed, backward looking, overnight rate for which it is not currently feasible to create reliable, forward-looking term rates and so SOFR stands in contrast to LIBOR, which is an estimated forward-looking rate and relies, to some degree, on the expert judgment of submitting panel members. Given that SOFR is a secured rate backed by government securities, it does not incorporate bank credit risk (as is the case with LIBOR). SOFR is therefore likely to be lower than LIBOR and is less likely to correlate with the funding costs of financial institutions. The development of a SOFR term structure is uncertain, presenting risks regarding how various types of financial instruments and securitization vehicles should react to a discontinuation of LIBOR. Therefore, whether or not SOFR attains market acceptance as a LIBOR replacement tool remains in question.

On July 27, 2017, the FCA announced that it would phase out LIBOR as a benchmark by the end of 2021. It is unclear whether new methods of calculating LIBOR will be established such that it continues to exist after 2021. When LIBOR ceases to exist, we may need to amend certain agreements with our lenders that utilize LIBOR as a factor in determining the interest rate based on a new standard that is established, if any. The transition to an alternative rate will require careful and deliberate consideration and implementation so as not to disrupt the stability of financial markets. There is no guarantee that a transition from LIBOR to an alternative will not result in financial market disruptions, significant increases in benchmark rates, or borrowing costs to borrowers, any of which could have an adverse effect on our business, results of operations, and our financial condition.

We may change our investment strategy, operating policies, dividend policy, and/or asset allocations without shareholder consent and/or in a manner in which shareholders, analysts, and capital markets may not agree,

which could adversely affect our financial condition, results of operations, the market price of our common stock, and our ability to pay dividends to our shareholders.

A change in our investment strategy or asset allocation may materially change our exposure to interest rate and/or credit risk, default risk and real estate market fluctuations. These changes could have a material impact on our ability to continue to pay a dividend at a level that we had previously paid before the change in strategy. Furthermore, if any change in investment strategy, asset allocation, operating or dividend policy is perceived negatively by the markets or analysts covering our stock, our stock price may decline. Part of our investment strategy includes deciding whether to reinvest payments received on our existing investment portfolio. Based on market conditions, our leverage, and our liquidity profile, we may decide to not reinvest the cash flows we receive from our investment portfolio. If we retain, rather than reinvest, these cash flows, the size of our investment portfolio and the amount of net interest income generated by our investment portfolio will likely decline. In addition, if the assets we acquire in the future earn lower yields than the assets we currently own, our reported earnings per share will likely decline over time as the older assets pay down or are sold.

Competition may prevent us from acquiring new investments at favorable yields, and we may not be able to achieve our investment objectives which may potentially have a negative impact on our profitability.

Our comprehensive income will largely depend on our ability to acquire mortgage-related assets with acceptable risk-return profiles at favorable spreads over our borrowing costs. The availability of mortgage-related assets meeting our investment criteria depends upon, among other things, the level of activity in the real estate market and the quality of and demand for securities in the mortgage securitization and secondary markets. The size and level of activity in real estate lending markets depends on various factors, including interest rates, regional and national economic conditions, and real estate values. In acquiring investments, we may compete with other purchasers of these types of investments, including but not limited to other mortgage REITs, broker-dealers, hedge funds, banks, insurance companies, mutual funds, GSEs and other entities that purchase assets similar to ours, many of which have greater financial resources than we do. Because of these factors, we may not be able to acquire sufficient assets at acceptable spreads to our borrowing costs, which would adversely affect our profitability.

Clearing facilities or exchanges may increase the margin requirements we are required to post when entering into derivative instruments, which may negatively impact our ability to hedge and our liquidity.

We are required to post margin when entering into a hedging instrument which is traded on an exchange or administered through a clearing house. The amount of margin is set for each derivative by the exchange or clearinghouse and in prior periods, exchanges have required additional margin in response to events having or expected to have adverse economic consequences. In the event that future adverse economic developments or market uncertainty (including those due to governmental, regulatory, or legislative action or inaction) result in increased margin requirements for our hedging instruments, it could materially adversely affect our liquidity position, business, financial condition and results of operations.

We may be subject to the risks associated with inadequate or untimely services from third-party service providers, which may negatively impact our results of operations. We also rely on corporate trustees to act on behalf of us and other holders of securities in enforcing our rights.

Loans underlying non-Agency MBS we own are serviced by third-party service providers. These servicers provide for the primary and special servicing of these securities. In that capacity these service providers control all aspects of loan collection, loss mitigation, default management and ultimate resolution of a defaulted loan including as applicable the foreclosure and sale of the real estate owned. The servicer has a fiduciary obligation to act in the best interest of the securitization trust, but significant latitude exists with respect to certain of its servicing activities. We have no contractual rights with respect to these servicers, and our risk management operations may not be successful in limiting future delinquencies, defaults, and losses. If a third-party servicer fails to perform its duties under the securitization documents, this may result in a material increase in delinquencies or losses to the securities. As a result, the value of the securities may be impacted, and we may incur losses on our investment.

In addition, should a servicer experience financial difficulties, it may not be able to perform its obligations. Due to application of provisions of bankruptcy law, servicers who have sought bankruptcy protection may not be required to make advance payments required under the terms of the agreements governing the securities of amounts due from loan borrowers. Even if a servicer were able to advance amounts in respect of delinquent loans, its obligation to make the advances may be limited to the extent that is does not expect to recover the advances due to the deteriorating credit of the delinquent loans.

We also rely on corporate trustees to act on behalf of us and other holders of securities in enforcing our rights. Under the terms of most securities we hold we do not have the right to directly enforce remedies against the issuer of the security, but instead must rely on a trustee to act on behalf of us and other security holders. Should a trustee not be required to take action under the terms of the securities, or fail to take action, we could experience losses.

Credit ratings assigned to debt securities by the credit rating agencies may not accurately reflect the risks associated with those securities. Changes in credit ratings for securities we own or for similar securities might negatively impact the market value of these securities.

Rating agencies rate securities based upon their assessment of the safety of the receipt of principal and interest payments on the securities. Rating agencies do not consider the risks of fluctuations in fair value or other factors that may influence the value of securities and, therefore, the assigned credit rating may not fully reflect the true risks of an investment in securities. Also, rating agencies may fail to make timely adjustments to credit ratings based on available data or changes in economic outlook or may otherwise fail to make changes in credit ratings in response to subsequent events, so the credit quality of our investments may be better or worse than the ratings indicate. We attempt to reduce the impact of the risk that a credit rating may not accurately reflect the risks associated with a particular debt security by not relying solely on credit ratings as the indicator of the quality of an investment. We make our acquisition decisions after factoring in other information that we have obtained about the loans underlying the security and the credit subordination structure of the security. Despite these efforts, our assessment of the quality of an investment may also prove to be inaccurate and we may incur credit losses in excess of our initial expectations.

Credit rating agencies may change their methods of evaluating credit risk and determining ratings on securities backed by real estate loans and securities. These changes may occur quickly and often. The market's ability to understand and absorb these changes, and the impact to the securitization market in general, are difficult to predict. Such changes may have a negative impact on the value of securities that we own.

If a lender to us in a repurchase transaction defaults on its obligation to resell the underlying security back to us at the end of the transaction term, or if we default on our obligations under a repurchase agreement, we will incur losses.

Repurchase agreement transactions are legally structured as the sale of a security to a lender in return for cash from the lender. These transactions are accounted for as financing agreements because the lenders are obligated to resell the same securities back to us at the end of the transaction term. Because the cash we receive from the lender when we initially sell the securities to the lender is less than the value of those securities, if the lender defaults on its obligation to resell the same securities back to us, we would incur a loss on the transaction equal to the difference between the value of the securities sold and the amount borrowed from the lender. The lender may default on its obligation to resell if it experiences financial difficulty or if the lender has re-hypothecated the security to another party who fails to transfer the security back to the lender. Additionally, if we default on one of our obligations under a repurchase agreement, the lender can terminate the transaction, sell the underlying collateral and cease entering into any other repurchase transactions with us. Any losses we incur on our repurchase transactions could adversely affect our earnings and reduce our ability to pay dividends to our shareholders.

In the event of bankruptcy either by ourselves or one or more of our third-party lenders, under the U.S. Bankruptcy Code, assets pledged as collateral under repurchase agreements may not be recoverable by us. We may incur losses equal to the excess of the collateral pledged over the amount of the associated repurchase agreement borrowing.

In the event that one of our lenders under a repurchase agreement files for bankruptcy, it may be difficult for us to recover our assets pledged as collateral to such lender. In addition, if we ever file for bankruptcy, lenders under our repurchase agreements may be able to avoid the automatic stay provisions of the U.S. Bankruptcy Code and take possession of and liquidate our collateral under our repurchase agreements without delay. In the event of a bankruptcy by one of our lenders, or us, we may incur losses in amounts equal to the excess of our collateral pledged over the amount of repurchase agreement borrowing due to the lender.

If we fail to properly conduct our operations, we could become subject to regulation under the 1940 Act. Conducting our business in a manner so that we are exempt from registration under and compliance with the 1940

Act may reduce our flexibility and could limit our ability to pursue certain opportunities.

We seek to conduct our operations to avoid falling under the definition of an investment company pursuant to the 1940 Act. Specifically, we seek to conduct our operations under the exemption provided under Section 3(c)(5)(C) of the 1940 Act, a provision available to companies primarily engaged in the business of purchasing and otherwise acquiring mortgages and other liens on and interests in real estate. According to SEC no-action letters, companies relying on this exemption must ensure that at least 55% of their assets are mortgage loans and other qualifying assets, and at least 80% of their assets are real estate-related.

The 1940 Act requires that we and each of our subsidiaries evaluate our qualification for exemption under the Act. Our subsidiaries will rely either on Section 3(c)(5)(C) or other sections that provide exemptions from registering under the 1940 Act, including Sections 3(a)(1)(C) and 3(c)(7). The SEC issued a concept release in 2011 announcing that it was reviewing the Section 3(c)(5)(C) exemption, particularly as it relates to mortgage REITs, but has not taken any action or issued any interpretive guidance since that time. We believe that we are operating our business in accordance with the exemption requirements of Section 3(c)(5)(C).

Under the 1940 Act, an investment company is required to register with the SEC and is subject to extensive restrictive and potentially adverse regulations relating to, among other things, operating methods, management, capital structure, leverage, dividends, and transactions with affiliates. If we were determined to be an investment company, our ability to use leverage and conduct business as we do today would be substantially impaired.

If we fail to abide by certain Commodity Futures Trading Commission ("CFTC") rules and regulations, we may be subject enforcement action by the CFTC.

On December 7, 2012, the CFTC's Division of Swap Dealer and Intermediary Oversight (the "Division") issued no-action relief from commodity pool operator ("CPO") registration to mortgage REITs that use CFTC-regulated products ("commodity interests") and that satisfy certain enumerated criteria. Pursuant to the no-action letter, the Division will not recommend that the CFTC take enforcement action against a mortgage REIT if its operator fails to register as a CPO, provided that the mortgage REIT (i) submits a claim to take advantage of the relief and (ii) the mortgage REIT: (a) limits the initial margin and premiums required to establish its commodity interest positions to no greater than 5% of the fair market value of the mortgage REIT's total assets; (b) limits the net income derived annually from its commodity interest positions, excluding the income from commodity interest positions that are "qualifying hedging transactions," to less than 5% of its annual gross income; (c) does not market interests in the mortgage REIT to the public as interests in a commodity pool or otherwise in a vehicle for trading in the commodity futures, commodity options or swaps markets; and (d) either: (A) identified itself as a "mortgage REIT" in Item G of its last U.S. income tax return on Form 1120-REIT; or (B) if it has not yet filed its first U.S. income tax return on Form 1120-REIT, it discloses to its shareholders that it intends to identify itself as a "mortgage REIT" in its first U.S. income tax return on Form 1120-REIT.

We believe that we have complied with all of the requirements set forth above as of and for the year ended December 31, 2018. If we fail to satisfy the criteria set forth above, or if the criteria change, we may become subject to CFTC regulation or enforcement action, the consequences of which could have a material adverse effect on our financial condition or results of operations.

We are highly dependent on information and communication systems and third parties, and systems failures or cybersecurity incidents could significantly disrupt our business or lead to significant losses, which may, in turn, negatively affect the market price of our common and preferred stocks and our ability to operate our business.

Our business is highly dependent on communications and information systems particularly as it relates to the custodians of our investments and our lenders. Any failure or interruption of our communication or information systems, or any cyber-attack or security breach of our networks or systems, could cause delays or other problems in our trading or borrowing activities, including MBS trading and repurchase agreement borrowing activities, or could lead to unauthorized trading activity, any of which could have a significant adverse effect on our financial condition or results of operations. A disruption or breach could also lead to unauthorized access to and release, misuse, loss or destruction of our confidential information or personal or confidential information of our employees or third parties, which could lead to regulatory fines, costs of remediating the breach, reputational harm, and fewer third parties that are willing to conduct business with us. In addition, we also face the risk of operational failure, termination or capacity constraints of any of the third parties with which we do business or that facilitate our business activities, including custodians, clearing agents or other financial intermediaries we use to facilitate our securities transactions, if their respective communication or information systems experience failure, interruption, cyber-attacks, or security breaches. We may face increased costs as we continue to evolve our cyber defenses in order to contend with changing risks and to monitor our systems for cyber-attacks and security threats. These costs and losses associated with these risks are difficult to predict and quantify and could have a significant adverse effect on our results of operations.

Computer malware, viruses, computer hacking. and phishing attacks have become more prevalent and may occur on our systems. Although we have not detected a material cybersecurity breach to date, other financial services institutions have reported material breaches of their systems, some of which have been significant. Even with all reasonable security efforts, not every breach can be prevented or even detected, and it is possible that we have experienced an undetected breach. There is no assurance that we, or the third parties that facilitate our business activities, have not or will not experience a breach. It is difficult to determine what, if any, negative impact may directly result from any specific interruption or cyber-attacks or security breaches of our networks or systems (or the networks or systems of third parties that facilitate our business activities) or any failure to maintain performance, reliability and security of our technical infrastructure, but such computer malware, viruses, and computer hacking and phishing attacks may negatively affect our operations. We rely heavily on our financial, accounting and other data processing systems, and any failure to maintain performance, reliability and security of these systems and our other technical infrastructure could have a significant adverse effect on our financial condition or results of operations.

We pay a monthly dividend to our shareholders. A monthly dividend strategy could attract shareholders that are especially sensitive to the level and frequency of the dividend. If we were to reduce the dividend or change back to a quarterly payment cycle, our share price could materially decline.

Our strategy of paying a monthly dividend is designed in part to attract retail shareholders that invest in stocks which pay a monthly dividend. The ownership of our stock may become overly concentrated in shareholders who only invest in monthly dividend paying stocks. These shareholders may be more sensitive to reductions in the dividend or a change in the payment cycle and our share price could materially decline if we were to reduce the dividend or change the payment cycle of our dividend.

RISKS RELATED TO REGULATORY POLICY

The effects of legislative and regulatory changes on our business, the housing finance industry, and the markets in which we invest and borrow are uncertain and may be adverse to our business, results of operations, and financial condition.

As a result of the financial crisis in 2007 to 2008, Congress passed the Dodd-Frank Act in July 2010 which significantly increased the regulation of, and as a result significantly reduced certain activities of affected financial institutions. It also created agencies such as the Consumer Financial Protection Bureau ("CFPB") and expanded certain powers of government regulatory agencies in an effort to enhance oversight of the financial services industry, including the housing finance industry. Although much of the Dodd-Frank Act has been implemented, there are some key aspects of the legislation not yet implemented. There is significant uncertainty regarding the legislative and regulatory changes that will be implemented or proposed by the administration of President Trump and the current U.S. Congress, particularly regarding the possible repeal of portions of the Dodd-Frank Act, housing policy and housing finance reform in the U.S., and the future roles of regulatory agencies such as the CFPB. Due to this uncertainty, it is not possible for us to predict how legislative or regulatory changes will affect our business, and there can be no assurance that these regulations will not have an adverse impact on our business, results of operations, or financial condition.

In addition, there is an ongoing debate over the degree and kind of regulation that should be applied to entities that participate in what is popularly referred to as “shadow banking.” While there is no authoritative definition of what “shadow banking” is, it generally refers to financial intermediation involving entities and activities outside of the traditional depositary banking system, such as mortgage REITs, repurchase agreement financing, securitizations, private equity funds and hedge funds. A general policy concern is that an aspect or component of shadow banking that is not subject to banking regulation - such as safety and soundness regulation and capital requirements - or other government oversight could be a source of financial instability or pose systemic risk to the broader banking and financial markets. Several organizations, including the Financial Stability Board (an international organization comprised of representatives from national financial authorities, central banks and international finance organizations primarily from the Group of Twenty Nations) and the Financial Stability Oversight Council (established by the Dodd-Frank Act) have issued policy recommendations to strengthen oversight and regulation of shadow banking. While at this stage it is difficult to predict the type and scope of any new regulations that may be adopted, if such regulations were to extend the regulatory and supervisory requirements currently applicable to banks, such as capital and liquidity standards, to our business or that of our financing counterparties or mortgage originators, or were to otherwise classify all or a portion of our business (including financing strategy) as shadow banking, our regulatory and operating costs, particularly borrowing costs, could increase, which may have a material adverse effect on our business.

RISKS RELATED TO OUR TAXATION AS A REIT AND OTHER TAX RELATED MATTERS

Qualifying as a REIT involves highly technical and complex provisions of the Code, and a technical or inadvertent violation could jeopardize our REIT qualification. Maintaining our REIT status may reduce our flexibility to manage our operations.

Qualification as a REIT involves the application of highly technical and complex Code provisions for which only limited judicial and administrative authorities exist. Even a technical or inadvertent violation could jeopardize our REIT qualification. Our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis. Our operations and use of leverage also subject us to interpretations of the Code, and technical or inadvertent violations of the relevant requirements under the Code could cause us to lose our REIT status or to pay significant penalties and interest. In addition, our ability to satisfy the requirements to qualify as a REIT depends in part on the actions of third parties over which we have no control or only limited influence, including in cases where we own an equity interest in an entity that is classified as a partnership for U.S. federal income tax purposes.

Maintaining our REIT status may limit flexibility in managing our operations. For instance:

- If we make frequent asset sales from our REIT entities to persons deemed customers, we could be viewed as a “dealer,” and thus subject to 100% prohibited transaction taxes or other entity level taxes on income from such transactions.
- Compliance with the REIT income and asset requirements may limit the type or extent of hedging that we can undertake and could limit our ability to invest in TBA securities.
- Our ability to own non-real estate related assets and earn non-real estate related income is limited. Our ability to own equity interests in other entities is limited. If we fail to comply with these limits, we may be forced to liquidate attractive assets on short notice on unfavorable terms in order to maintain our REIT status.
- Our ability to invest in taxable subsidiaries is limited under the REIT rules. Maintaining compliance with this limitation could require us to constrain the growth of future taxable REIT affiliates.
- Notwithstanding our NOL carryforward, meeting minimum REIT dividend distribution requirements could reduce our liquidity. Earning non-cash REIT taxable income could necessitate our selling assets, incurring debt, or raising new equity in order to fund dividend distributions.
- Stock ownership tests may limit our ability to raise significant amounts of equity capital from one source.

If we do not qualify as a REIT or fail to remain qualified as a REIT, we may be subject to tax as a regular corporation and could face a tax liability, which would reduce the amount of cash available for distribution to our shareholders.

We intend to operate in a manner that will allow us to qualify as a REIT for federal income tax purposes. Our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis. Our ability to satisfy the asset tests depends upon our analysis of the characterization and fair market values of our assets, some of which are not susceptible to a precise determination, and for which we will not obtain independent appraisals. Our compliance with the REIT income and quarterly asset requirements also depends upon our ability to successfully manage the composition of our income and assets on an ongoing basis.

If we were to fail to qualify as a REIT in any taxable year, we would be subject to federal income tax, after consideration of our NOL carryforward but not considering any dividends paid to our shareholders during the respective tax year. If we could not otherwise offset this taxable income with our NOL carryforward, the resulting corporate tax liability could be material to our results and would reduce the amount of cash available for distribution to our shareholders, which in turn could have an adverse impact on the value of our common stock. Unless we were entitled to relief under certain Code provisions, we also would be disqualified from taxation as a REIT until the fifth taxable year following the year for which we failed to qualify as a REIT.

The passage of TCJA may adversely affect the U.S. residential housing market, which could adversely affect our business.

The TCJA includes changes that could have an adverse impact on the U.S. residential housing and housing finance markets and potentially impact the market value of our investments. Among other items, the TCJA imposes new restrictions on the deductibility of interest on mortgage debt, state and local income taxes, and sales and property taxes, which may reduce home affordability and/or demand for residential real estate and adversely affect home prices. In addition, such changes may increase taxes payable by certain borrowers, thereby reducing their available cash and adversely impacting their ability to make payments on their residential mortgages, which in turn, could cause losses on our investments.

Dividends payable by REITs do not qualify for the reduced tax rates available for some dividends.

The maximum tax rate applicable to "qualified dividend income" payable to U.S. stockholders that are taxed at individual rates is lower than corresponding maximum ordinary income tax rates. Dividends payable by REITs, however, are generally not eligible for the reduced rates on qualified dividend income. Rather, under the recently enacted TCJA, qualified REIT dividends constitute "qualified business income" and thus a 20% deduction is available to individual taxpayers with respect to such dividends, resulting in a 29.6% maximum federal tax rate (plus the 3.8% surtax on net investment income, if applicable) for individual U.S. stockholders. Additionally, without further legislative action, the 20% deduction applicable to qualified REIT dividends will expire on January 1, 2026. The more favorable rates applicable to regular corporate qualified dividends could cause investors who are taxed at individual rates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the shares of REITs, including our common stock.

Legislative or other actions affecting REITs could materially and adversely affect us and our stockholders.

The rules dealing with U.S. federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Department of the Treasury. Changes to the tax laws, with or without retroactive application, could materially and adversely affect us and our stockholders. We cannot predict how changes in the tax laws might affect us or our stockholders. New legislation, U.S. Treasury regulations, administrative interpretations or court decisions could significantly and negatively affect our ability to qualify as a REIT or the U.S. federal income tax consequences of such qualification.

In addition, the effect of substantive changes made by the TCJA is highly uncertain, both in terms of their direct effect on the taxation of an investment in our common stock and their indirect effect on the value of our assets. Furthermore, many of the provisions of the TCJA will require guidance through the issuance of U.S. Treasury regulations in order to assess their effect. There may be a substantial delay before such regulations are promulgated, increasing the uncertainty as to the ultimate effect of the statutory amendments on us. It is also likely that there will be technical corrections legislation proposed with respect to the TCJA, the timing and effect of which cannot be predicted and may be adverse to us or our stockholders.

We have not established a minimum dividend payment level and we cannot assure you of our ability to pay dividends in the future.

We intend to pay regular dividends to our common stockholders and to make distributions to our shareholders in amounts such that all or substantially all of our taxable income, subject to certain adjustments including utilization of our NOL, is distributed. However, we have not established a minimum dividend payment level, and the amount of our dividend will fluctuate. Our ability to pay dividends may be adversely affected by the risk factors described herein. All distributions will be made at the discretion of our Board of Directors and will depend on our GAAP and tax earnings, our financial condition, the requirements for REIT qualification and such other factors as our Board of Directors may deem relevant from time to time. We may not be able to make distributions, or our Board of Directors may change our dividend policy in the future. To the extent that we decide to pay dividends in excess of our current and accumulated tax earnings and profits, such distributions would generally be considered a return of capital for federal income tax purposes. A return of capital reduces the basis of a stockholder's investment in our common stock to the extent of such basis and is treated as capital gain thereafter.

Our ability to invest in and dispose of TBA securities could be limited by our REIT status, and we could lose our REIT status as a result of these investments.

The Code is unclear regarding whether TBA securities are qualifying assets for the 75% asset test and whether income and gains from dispositions of TBA securities are qualifying income for the 75% gross income test. In addition, there is uncertainty under the Code pursuant to the “5% asset test,” whereby ownership of any stocks or securities that do not qualify under the 75% asset test must be limited, in respect of any single non-governmental issuer, to an amount not greater than 5% of the value of our total assets (excluding ownership of any taxable REIT subsidiaries). Given the uncertainty regarding the tax treatment of TBAs, we will seek to limit our investment in TBAs and any other non-qualifying assets to no more than 25% of our assets at the end of any calendar quarter and will limit our investments in TBAs with a single counterparty to no more than 5% of our total assets at the end of any calendar quarter. Further, we will attempt to limit our gains from TBA transactions and any other non-qualifying income to no more than 25% of our gross income for each calendar year. Accordingly, our ability to invest in TBAs utilizing dollar roll transactions could be limited. If at some point in the future we receive a written opinion that TBAs are more likely than not to be qualifying assets for the 75% asset test and to generate qualifying income for the 75% gross income test, we may subsequently increase our investment in TBAs.

Moreover, even if we receive an opinion that TBAs and the related transactions should be treated as qualifying assets or that income and gains from dispositions of TBAs should be treated as qualifying income, the IRS could successfully challenge that position. In that event, we could be subject to a penalty tax or we could fail to qualify as a REIT if (i) the value of our TBAs, together with our other non-qualifying assets for the 75% asset test, exceeded 25% of our gross assets at the end of any calendar quarter or if the value of our investments in TBAs with a single counterparty exceeded 5% of our total assets at the end of any calendar quarter or (ii) our income and gains from the disposition of TBAs, together with our other non-qualifying income for the 75% gross income test, exceeded 25% of our gross income for any taxable year. Any such penalty tax or failure to qualify as a REIT could adversely affect our business operations, financial condition or results of operations.

For REIT test purposes, we treat repurchase agreement transactions as financing of the investments pledged as collateral. If the IRS disagrees with this treatment our ability to qualify as a REIT could be adversely affected.

Repurchase agreement financing arrangements are structured legally as a sale and repurchase whereby we sell certain of our investments to a counterparty and simultaneously enter into an agreement to repurchase these securities at a later date in exchange for a purchase price. Economically, these agreements are financings which are secured by the investments sold pursuant thereto. We believe that we would be treated for REIT asset and income test purposes as the owner of the securities that are the subject of any such sale and repurchase agreement, notwithstanding that such agreement may legally transfer record ownership of the securities to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the securities during the term of the sale and repurchase agreement, in which case we could fail to qualify as a REIT.

Even if we remain qualified as a REIT, we may face other tax liabilities that reduce our cash flow and our profitability.

Even if we remain qualified for taxation as a REIT, we may be subject to certain federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure or considered prohibited transactions under the Code, and state or local income taxes. Any of these taxes would decrease cash available for distribution to our shareholders. In addition, in order to meet the REIT qualification requirements, or to avert the imposition of a 100% tax that applies to certain gains derived by a REIT from prohibited transactions, we may hold some of our assets through a taxable REIT subsidiary (“TRS”) or other subsidiary corporations that will be subject to corporate-level income tax at regular rates to the extent that such TRS does not have an NOL carryforward. Any of these taxes would decrease cash available for distribution to our shareholders.

Recognition of excess inclusion income by us could have adverse consequences to us or our shareholders.

Certain of our securities have historically generated excess inclusion income and may continue to do so in the future. Certain categories of shareholders, such as foreign shareholders eligible for treaty or other benefits, shareholders with NOLs, and certain tax-exempt shareholders that are subject to unrelated business income tax, could be subject to increased taxes on a portion of their dividend income from us that is attributable to excess inclusion income. In addition, to the extent that our stock is owned by tax-exempt “disqualified organizations,” such as certain government-related entities and charitable remainder trusts that are not subject to tax on unrelated business income, we may incur a corporate level tax on a portion of our income. In that case, we may reduce the amount of our distributions to any disqualified organization whose stock ownership gave rise to the tax.

Our future use of our tax NOL carryforward is limited under Section 382 of the Code, which could result in higher taxable income and greater distribution requirements in order to maintain our REIT status. Further, if we unknowingly undergo another ownership change pursuant to Section 382, or miscalculate the limitations imposed by a known ownership change,

and utilize an impermissible amount of the NOL, we may fail to meet the distribution requirements of a REIT and therefore we could lose our REIT status.

We can use our tax NOL carryforward to offset our taxable earnings after taking the REIT distribution requirements into account. Section 382 of the Code limits the amount of NOL that could be used to offset taxable earnings after an “ownership change” occurs. A Section 382 ownership change generally occurs if one or more shareholders who own at least 5% of our stock, or certain groups of shareholders, increase their aggregate ownership by more than 50 percentage points over their lowest ownership percentage within a rolling three-year period.

In 2012, we experienced an ownership change under Section 382 and based on management's analysis and expert third-party advice, which necessarily includes certain assumptions regarding the application of Section 382, we determined that the ownership change under Section 382 will limit our ability to use our NOL carryforward to offset our taxable income to an estimated maximum amount of $13.5 million per year. This annual limitation may effectively limit the cumulative amount of pre-ownership change losses and certain recognized built-in losses that we may utilize. This would result in higher taxable income and greater distribution requirements in order to maintain REIT qualification than if such limitation were not in effect.

We may incur additional ownership changes under Section 382 in the future, in which case the use of our NOL could be further limited. If further ownership changes occur, Section 382 would impose stricter annual limits on the amount of pre-ownership change NOLs and other losses we could use to reduce our taxable income.

If we unknowingly undergo another ownership change under Section 382 or miscalculate the limitations imposed by a known ownership change, the use of the NOL could be more limited than we have determined, and we may utilize (or may have utilized) more of the NOL than we otherwise expected. In such an instance, we may be required to pay taxes, penalties, and interest on the excess amount of NOL used, or we may be required to declare a deficiency dividend to our shareholders for the excess amount. In addition, if any impermissible use of the NOL led to a failure to comply with the REIT distribution requirements, we could fail to qualify as a REIT.

RISKS RELATED TO OUR CORPORATE STRUCTURE

The stock ownership limit imposed by the Code for REITs and our Articles of Incorporation may restrict our business combination opportunities. The stock ownership limitation may also result in reduced liquidity in our stock and may result in losses to an acquiring shareholder.

To qualify as a REIT under the Code, not more than 50% in value of our outstanding stock may be owned, directly or indirectly, by five or fewer individuals (as defined in the Code to include certain entities) at any time during the last half of each taxable year. Our Articles of Incorporation, with certain exceptions, authorize our Board of Directors to take the actions that are necessary and desirable to qualify as a REIT. Pursuant to our Articles of Incorporation, no person may beneficially or constructively own more than 9.8% of our capital stock (including our common stock, Series A Preferred Stock, and Series B Preferred Stock). Our Board of Directors may grant an exemption from this 9.8% stock ownership limitation, in its sole discretion, subject to such conditions, representations and undertakings as it may determine are reasonably necessary.

Whether we would waive the ownership limitation for any other shareholder will be determined by our Board of Directors on a case by case basis. Our Articles of Incorporation’s constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed as constructively owned by one individual or entity. As a result, the acquisition of less than these percentages of the outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of these percentages of the outstanding stock and thus be subject to the ownership limit. The Board of Directors has the right to refuse to transfer any shares of our capital stock in a transaction that would result in ownership in excess of the ownership limit. In addition, we have the right to redeem shares of our capital stock held in excess of the ownership limit.

The ownership limits imposed by the tax law are based upon direct or indirect ownership by “individuals,” but only during the last half of a tax year. The ownership limits contained in our Articles of Incorporation apply to the ownership at any time by any “person,” which includes entities, and are intended to assist us in complying with the tax law requirements and to minimize administrative burdens. However, these ownership limits might also delay or prevent a transaction or a change in our control that might involve a premium price for our stock or otherwise be in the best interest of our shareholders.

The stock ownership limit imposed by the Code for REITs and our Articles of Incorporation may impair the ability of holders to convert shares of our Series A Preferred Stock or Series B Preferred Stock into shares of our common stock upon a change of control.

The terms of our Series A Preferred Stock and Series B Preferred Stock provide that, upon occurrence of a change of control (as defined in the Articles of Incorporation), each holder of Series A Preferred Stock or Series B Preferred Stock will potentially have the right to convert in conjunction with a change in control all or part of the Series A Preferred Stock and Series B Preferred Stock held by such holder into a number of shares of our common stock per share of Series A Preferred Stock or Series B Preferred Stock, respectively, based on formulas set forth in our Articles of Incorporation. However, the stock ownership restrictions in our Articles of Incorporation also restrict ownership of shares of our Series A Preferred Stock and Series B Preferred Stock. As a result, no holder of Series A Preferred Stock or Series B Preferred Stock will be entitled to convert such stock into our common stock to the extent that receipt of our common stock would cause the holder to exceed the ownership limitations contained in our Articles of Incorporation, endanger the tax status of one or more real estate mortgage investment conduits ("REMICs") in which we have or plan to have an interest, or result in the imposition of a direct or indirect penalty tax on us. These provisions may limit the ability of a holder of Series A Preferred Stock or Series B Preferred Stock to convert shares of Series A Preferred Stock or Series B Preferred Stock into our common stock upon a change of control, which could adversely affect the market price of shares of our Series A Preferred Stock or of our Series B Preferred Stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

There are no unresolved comments from the SEC Staff.

ITEM 2. PROPERTIES

We lease one facility located at 4991 Lake Brook Drive, Suite 100, Glen Allen, Virginia 23060 which provides 9,350 square feet of office space for our executive officers and employees. The term of the lease expires in March 2020 but may be renewed at our option for four additional periods of one year each at a rental rate 2.5% greater than the rate in effect during the preceding 12-month period or for one additional five-year period at the fair market rental rate for the period such determination is being made for office space of comparable condition and location.

ITEM 3. LEGAL PROCEEDINGS

As previously disclosed, the Company and DCI Commercial, Inc. (“DCI”), a former affiliate of the Company and formerly known as Dynex Commercial, Inc., were defendants in litigation filed by Basic Capital Management, Inc., et al. (the “DCI Plaintiffs”) regarding the activities of DCI while it was an operating subsidiary of an affiliate of the Company (the “DCI Litigation”). The DCI Litigation concluded in 2004 and, after various appeals by the DCI Plaintiffs, no judgment or damages were entered against the Company. Final judgment in the principal amount of $46.5 million, including damages of $25.6 million and attorneys' fees and post-judgment interest of $20.9 million, was entered in the DCI Litigation against only DCI (the “DCI Judgment”). On April 26, 2017, the DCI Plaintiffs filed a suit, case no. DC-17-04848 (the “Suit”), in the 191st District Court of Dallas County, Texas, (the “191st District Court”) naming the Company and DCI as co-defendants. The case was removed to the United States District Court for the Northern District of Texas (the “U.S. District Court, Northern District of Texas”). The Suit represents the DCI Plaintiffs’ attempt to collect the DCI Judgment from the Company and alleges that the Company and DCI conspired to fraudulently transfer DCI assets to the Company and to commit related acts to defraud the DCI Plaintiffs with respect to recovery on the DCI Judgment. The Suit also alleges that the Company and DCI are a single business enterprise. On May 7, 2018, the Suit was dismissed, and the DCI Plaintiffs filed an amended complaint on June 4, 2018, adding former corporate affiliates of the Company and a current executive officer as defendants. On January 25, 2019, the U.S. District Court, Northern District of Texas, dismissed the amended complaint, finding that the DCI Plaintiffs’ allegations as they relate to the single enterprise claims were conclusory without alleging particular supporting facts to state a claim, and in the case of the former corporate affiliates and our executive officer, for lack of personal jurisdiction. The U.S. District Court, Northern District of Texas, also found that the DCI Plaintiffs' allegations as they relate to fraudulent transfers did not sufficiently allege facts to enable the Court to draw reasonable inference that the Company or DCI acted with constructive or actual fraudulent intent. The DCI Plaintiffs have until March 8, 2019 to file an amended complaint.

One of the DCI Plaintiffs also filed a claim against the Company for $11.3 million on May 24, 2018 in the 68th District Court of Dallas County, Texas (the “68th District Court”) seeking payment allegedly pursuant to the provisions of a litigation cost sharing agreement, as amended, entered into initially in December 2000 between the Company and DCI. On June 20, 2018, the Company removed the matter to the United States District Court, and on June 21, 2018, the Company filed a motion to transfer the lawsuit to the U.S. District Court for the Eastern District of Virginia. The Company has filed a declaratory judgment action in the Eastern District of Virginia seeking a declaration that the Company is not obligated under the litigation cost sharing agreement to pay any portion of the DCI Judgment. On January 30, 2019, the U.S. District Court, Northern District of Texas, remanded the case back to the 68th District Court. The Company has moved to dismiss the case from the 68th District Court for lack of subject matter jurisdiction. The declaratory judgment action in the U.S. District Court in the Eastern District of Virginia is still pending as of February 27, 2019.

The Company believes that the above matters against it are baseless and without merit and intends to continue to defend itself vigorously in these actions. The Company believes, based upon information currently available, that the above matters will be resolved without a material adverse effect on the Company’s consolidated financial statements as a whole. The outcome, however, of any legal proceeding, including the above matters, cannot be predicted with certainty. As such, no assurances can be given that the Company will be successful in its defense of these actions on the merits or otherwise. If the Company is not successful in its defense efforts, the resolution of these matters could have a material adverse effect on the Company’s consolidated financial statements in a given future reporting period.

Separately, and as previously disclosed, in 2014, third parties were awarded a judgment against certain of the DCI Plaintiffs in a matter not involving the Company or DCI. Those parties (the “Garnishment Plaintiffs”) are currently pursuing a garnishment action against the DCI Judgment. The Garnishment Plaintiffs have requested from the Company and DCI via post-judgment discovery certain information related to DCI while it was an operating subsidiary of an affiliate of the Company and certain other information related to the activities of DCI.

Other than as described above, to the Company’s knowledge, there are no pending or threatened legal proceedings, which, in management’s opinion, individually or in the aggregate, would have a material adverse effect on the Company’s results of operations or financial condition.

ITEM 4. MINE SAFETY DISCLOSURES

None.

PART II.

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

Our common stock is traded on the New York Stock Exchange under the trading symbol “DX”. The common stock was held by approximately 21,742 holders of record as of February 20, 2019. On that date, the closing price of our common stock on the New York Stock Exchange was $6.03 per share.

When declaring dividends, the Board of Directors considers the requirements for maintaining our REIT status and maintaining compliance with dividend requirements of the Series A Preferred Stock and Series B Preferred Stock. In addition, the Board considers, among other things, the Company's long-term outlook, the Company’s financial conditions and results of operations during recent financial periods, and trends in the investment and financing markets.

The following table summarizes dividends declared per share and their related tax characterization for the years ended December 31, 2018 and December 31, 2017:

	Tax Characterization			Total Dividends Declared Per Share
	Ordinary	Capital Gain	Return of Capital	
Common dividends declared:				
Year ended December 31, 2018	$0.1586272	$ —	$0.5613728	$ 0.7200
Year ended December 31, 2017	$0.2151908	$ —	$0.5048092	$ 0.7200
Preferred Series A dividends declared:				
Year ended December 31, 2018	$2.1250000	$ —	$—	$ 2.1250
Year ended December 31, 2017	$2.1250000	$ —	$—	$ 2.1250
Preferred Series B dividends declared:				
Year ended December 31, 2018	$1.9062500	$ —	$—	$ 1.9063
Year ended December 31, 2017	$1.9062500	$ —	$—	$ 1.9063

The following graph is a five-year comparison of cumulative total returns for the shares of our common stock, the Standard & Poor’s 500 Stock Index (“S&P 500”), the Bloomberg Mortgage REIT Index, and the SNL U.S. Finance REIT Index. The table below assumes $100 was invested at the close of trading on December 31, 2013 in each of our common stock, the S&P 500, the Bloomberg Mortgage REIT Index, and the SNL U.S. Finance REIT Index and assumes reinvestment of dividends.

Index	Cumulative Total Stockholder Returns as of December 31,					
	2013	**2014**	**2015**	**2016**	**2017**	**2018**
Dynex Capital, Inc. Common Stock	$100.00	$115.98	$102.02	$123.68	$140.64	$128.69
S&P 500	$100.00	$113.68	$115.24	$129.02	$157.17	$150.27
Bloomberg Mortgage REIT Index	$100.00	$119.43	$107.61	$131.58	$158.25	$153.65
SNL U.S. Finance REIT Index	$100.00	$114.52	$105.02	$129.36	$150.94	$145.09

The sources of this information are Bloomberg, SNL Financial, and Standard & Poor’s, which management believes to be reliable sources. The historical information set forth above is not necessarily indicative of future performance. Accordingly, we do not make or endorse any predictions as to future share performance.

The Company’s Board of Directors has authorized the repurchase up to $40 million of the Company’s outstanding shares of common stock through December 31, 2020. Subject to applicable securities laws and the terms of the Series A Preferred Stock designation and the Series B Preferred Stock designation, both of which are contained in our Articles of Incorporation, future repurchases of common stock will be made at times and in amounts as the Company deems appropriate, provided that the repurchase price per share is less than the Company's estimate of the current net book value of a share of common stock. Repurchases may be suspended or discontinued at any time. The Company did not repurchase any shares during the three months ended December 31, 2018.

ITEM 6. SELECTED FINANCIAL DATA

Our selected financial data presented below is derived from our audited financial statements and should be read in conjunction with our consolidated financial statements and the accompanying notes included under Item 8 of this Annual Report on Form 10-K.

	As of/For the Year Ended December 31,				
	2018	2017	2016	2015	2014
Balance Sheet Data:	*($ in thousands except per share data)*				
Mortgage-backed securities	$3,749,464	$3,026,989	$3,212,084	$3,493,701	$3,516,239
U.S. Treasuries	—	146,530	—	—	—
Total assets	3,886,089	3,305,778	3,397,731	3,670,048	3,688,311
Repurchase agreements	3,267,984	2,565,902	2,898,952	2,589,420	3,013,110
Total liabilities	3,358,936	2,748,720	2,930,547	3,178,023	3,081,009
Shareholders’ equity	527,153	557,058	467,184	492,025	607,302
Common shares outstanding	62,817,218	55,831,549	49,153,463	49,047,335	54,739,111
Book value per common share	$6.02	$7.34	$7.18	$7.71	$9.02
Leverage (1)	8.0	6.4	6.3	6.5	5.1
Statement of Comprehensive Income Data:					
Interest income	$110,051	$94,502	$91,898	$100,244	$105,644
Interest expense	59,574	36,178	25,231	22,605	25,915
Net interest income	50,477	58,324	66,667	77,639	79,729
(Loss) gain on sale of investments, net	(23,373)	(11,530)	(4,238)	(978)	16,223
(Loss) gain on derivative instruments, net	(3,461)	3,044	(5,606)	(43,128)	(53,393)
General and administrative expenses	(15,105)	(15,819)	(14,707)	(17,668)	(16,007)
Net (loss) income to common shareholders	(4,778)	23,099	33,914	7,368	18,630
Comprehensive (loss) income to common shareholders	(31,860)	47,011	14,073	(26,716)	73,762
Average common shares outstanding	57,704,818	50,416,520	49,114,497	52,847,197	54,701,485
Net (loss) income per common share-basic and diluted	$(0.08)	$0.46	$0.69	$0.14	$0.34
Comprehensive (loss) income per common share-basic and diluted	$(0.55)	$0.93	$0.29	$(0.51)	$1.35
Dividends declared per share:					
Common	$0.72	$0.72	$0.84	$0.96	$1.00
Series A Preferred	$2.13	$2.13	$2.13	$2.13	$2.13
Series B Preferred	$1.91	$1.91	$1.91	$1.91	$1.91

(1) *Leverage is calculated by dividing total liabilities by total shareholders’ equity as of each period end except for December 31, 2018 and December 31, 2017 which include TBA long positions at cost (as if settled) of $882.2 million and $829.4 million, respectively, within total liabilities.*

	For the Year Ended December 31,				
	2018	2017	2016	2015	2014
Other Data Including Non-GAAP Financial Measures:	*($ in thousands except per share data)*				
Adjusted interest expense (1)	$53,981	$39,863	$27,943	$24,836	$27,345
Adjusted net interest income (1)	70,756	63,817	63,955	75,408	78,299
Core net operating income to common shareholders (1)	42,283	37,003	40,943	49,174	54,162
Core net operating income per common share (1)	$0.73	$0.73	$0.83	$0.93	$0.99
Average interest earning assets	$3,219,642	$3,052,372	$3,236,903	$3,685,936	$3,822,870
Average balance of borrowings	2,734,855	2,697,601	2,912,426	3,269,711	3,347,701
Effective yield (2)	3.37 %	3.06 %	2.82 %	2.71 %	2.76 %
Cost of funds (2)	2.15 %	1.32 %	0.85 %	0.68 %	0.76 %
Net interest spread	1.22 %	1.74 %	1.97 %	2.03 %	2.00 %
Adjusted cost of funds (1)	1.94 %	1.46 %	0.94 %	0.75 %	0.81 %
Adjusted net interest spread (3)	1.48 %	1.64 %	1.88 %	1.96 %	1.95 %

(1) Represents a non-GAAP financial measure. See reconciliations provided below.
(2) Recalculation of weighted average effective yields using interest income and cost of funds using interest expense may not be possible because certain income and expense items are based on a 360-day year for the calculation while others are based on actual number of days in the year.
(3) Adjusted net interest spread is calculated by adding the impact of drop income from TBA dollar roll positions to effective yield and deducting adjusted cost of funds.

Non-GAAP Financial Measures

In addition to the Company's operating results presented in accordance with GAAP, the information presented above and within Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Annual Report on Form 10-K contains the following non-GAAP financial measures: core net operating income to common shareholders (including per common share), adjusted interest expense, adjusted net interest income, and the related metrics adjusted cost of funds and adjusted net interest spread. Because these measures are used in the Company's internal analysis of financial and operating performance, management believes that they provide greater transparency to our investors of management's view of our economic performance. Management also believes the presentation of these measures, when analyzed in conjunction with the Company's GAAP operating results, allows investors to more effectively evaluate and compare the performance of the Company to that of its peers, although the Company's presentation of its non-GAAP measures may not be comparable to other similarly-titled measures of other companies. Schedules reconciling core net operating income to common shareholders, adjusted interest expense, and adjusted net interest income to GAAP financial measures are provided below.

Management views core net operating income to common shareholders as an estimate of the Company’s financial performance excluding changes in fair value of its investments and derivatives. In addition to the non-GAAP reconciliation set forth below, which derives core net operating income to common shareholders from GAAP net income to common shareholders as the nearest GAAP equivalent measure, core net operating income to common shareholders can also be determined by adjusting net interest income to include interest rate swap periodic interest costs, drop income on TBA dollar roll positions, general and administrative expenses, and preferred dividends. Management includes drop income, which is included in "gain (loss) on derivatives instruments, net" on the Company's consolidated statements of comprehensive income, in core net operating income and in adjusted net interest income because TBA dollar roll positions are viewed by management as economically equivalent to holding and financing Agency RMBS using short-term repurchase agreements. Management also includes periodic interest costs from its interest rate swaps, which are also included in "gain (loss) on derivatives instruments, net", in adjusted net interest expense, and in adjusted net interest income because interest rate swaps are used by the Company to economically hedge the impact of changing interest rates on its borrowing costs from repurchase agreements, and including periodic interest costs from interest rate swaps is a helpful indicator of the Company's total cost of financing in addition to GAAP interest expense. However, these non-GAAP measures do not provide a full perspective on our results of operations, and therefore, their usefulness is limited. For example, these non-GAAP measures do not include gains or losses from available-for-sale investments, changes in fair value of and costs of terminating interest rate swaps, as well as realized and unrealized gains or losses from any instrument used by management to economically hedge the impact of changing interest rates on its portfolio and book value per common share. **As a result, these non-GAAP measures should be considered as a supplement to, and not as a substitute for, the Company's GAAP results as reported on its consolidated statements of comprehensive income.**

	For the Year Ended December 31,				
	2018	**2017**	**2016**	**2015**	**2014**
Reconciliations of GAAP to Non-GAAP Financial Measures:	*($ in thousands except per share data)*				
GAAP net (loss) income to common shareholders	$(4,778)	$23,099	$33,914	$7,368	$18,630
Less:					
Change in fair value of derivative instruments, net [1]	23,977	2,717	3,145	37,398	45,175
Loss (gain) on sale of investments, net	23,373	11,530	4,238	978	(16,223)
(Accretion) amortization of de-designated cash flow hedges [2]	(237)	(268)	(251)	3,499	6,788
Fair value adjustments, net	(52)	(75)	(103)	(69)	(208)
Core net operating income to common shareholders	$42,283	$37,003	$40,943	$49,174	$54,162
Average common shares outstanding	57,704,818	50,416,520	49,114,497	52,847,197	54,701,485
Core net operating income per common share	$0.73	$0.73	$0.83	$0.93	$0.99
GAAP interest expense	$59,574	$36,178	$25,231	$22,605	$25,915
Add: net periodic interest (benefit) cost of derivative instruments	(5,830)	3,417	2,461	5,730	8,218
Less: accretion (amortization) of de-designated cash flow hedges [2]	237	268	251	(3,499)	(6,788)
Adjusted interest expense	$53,981	$39,863	$27,943	$24,836	$27,345
Average balance of borrowings	2,734,855	2,697,601	2,912,426	3,269,711	3,347,701
Adjusted cost of funds	1.94 %	1.46 %	0.94 %	0.75 %	0.81 %
GAAP net interest income	$50,477	$58,324	$66,667	$77,639	$79,729
Add:					
TBA drop income	14,686	9,178	—	—	—
Net periodic interest benefit (cost) of derivative instruments	5,830	(3,417)	(2,461)	(5,730)	(8,218)
Less: (accretion) amortization of de-designated cash flow hedges [1]	(237)	(268)	(251)	3,499	6,788
Adjusted net interest income	$70,756	$63,817	$63,955	$75,408	$78,299
Adjusted net interest spread	1.48 %	1.64 %	1.88 %	1.96 %	1.95 %

(1)
(2)

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

The following discussion should be read in conjunction with our financial statements and the related notes included in Item 8, "Financial Statements and Supplementary Data" in this Annual Report on Form 10-K.
This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors including, but not limited to, those disclosed in Item 1A, "Risk Factors" elsewhere in this Annual Report on Form 10-K and in other documents filed with the SEC and otherwise publicly disclosed. Please refer to "Forward-Looking Statements" contained within this Item 7 for additional information. This discussion also contains non-GAAP financial measures. Please refer to Item 6 of this Annual Report on Form 10-K for reconciliations of these non-GAAP measures and additional information.
For a complete description of our business including our operating policies, investment philosophy and strategy, financing and hedging strategies, and other important information, please refer to Item 1 of Part I of this Annual Report on Form 10-K.

EXECUTIVE OVERVIEW

Our investment strategy of maintaining a diversified portfolio of residential and commercial MBS with higher liquidity and lower credit risk continued to benefit our shareholders in spite of a volatile and challenging global economic environment. During 2018, we were able to maintain steady quarterly dividends for our shareholders as we generated solid cash flow from our investment portfolio despite the 100-basis point increase in the U.S. Federal Funds rate and corresponding increases in our funding costs. Though we experienced a lower return environment and our book value declined throughout 2018, we were able to raise new capital and maintain strong liquidity into the fourth quarter when the most recent return of market volatility led to opportunities to invest capital at wider credit spreads and higher expected returns.

Though interest rates along the entire curve increased during 2018, longer-term interest rates were range bound while shorter-term interest rates rose in response to continued increases in the Federal Funds rate causing both the U.S. Treasury and swap curves to flatten during the year. Economic growth in the U.S. was steady and inflation remained well contained throughout the year, limiting the upward pressure on medium and long-term interest rates. In the fourth quarter of 2018, market participants grew increasingly concerned over the potential negative impact on economic growth from U.S. monetary and fiscal policy, causing credit spreads on risk assets to widen while Treasury and swap rates rallied. As a result of the wider credit spreads, the fair value of our MBS declined significantly late in the fourth quarter of 2018, causing the majority of the Company's loss of $(1.32) in its book value per common share during 2018, which ended the year at $6.02 per common share compared to $7.34 as of December 31, 2017.

The chart below shows the highest and lowest rates during the year ended December 31, 2018 as well as the rates as of December 31, 2018 and December 31, 2017 for the indicated U.S. Treasury securities:

The chart below shows the highest and lowest swap rates during the year ended December 31, 2018 as well as the swap rates as of December 31, 2018 and December 31, 2017:

A flattening yield curve puts pressure on our net interest spread because our repurchase agreement borrowing costs, which are based on short-term interest rates, increase faster than the interest income we earn on our investments. The table below shows the declines in net interest spread for the majority of our investments as a result of higher funding costs and the flatter yield curve:

	Agency MBS (1)			**CMBS IO (2)**		
Quarter Ended	**Yield**	**Cost (3)**	**Net Interest Spread**	**Yield**	**Cost (3)**	**Net Interest Spread**
December 31, 2018	3.28%	2.41%	0.87 %	3.89%	2.99%	0.90 %
September 30, 2018	3.12%	2.13%	0.99 %	3.98%	2.76%	1.22 %
June 30, 2018	2.94%	1.93%	1.01 %	3.78%	2.59%	1.19 %
March 31, 2018	2.85%	1.60%	1.25 %	3.84%	2.33%	1.51 %
December 31, 2017	2.77%	1.36%	1.41 %	3.82%	2.13%	1.69 %

(1) Includes Agency RMBS and CMBS.
(2) Includes Agency and non-Agency issued securities.
(3) Excludes net periodic interest benefit/cost of interest rate swaps used to economically hedge the interest rate risk of using repurchase agreement borrowings to finance our investments.

Summary of 2018 Results

For the year ended December 31, 2018, we reported a comprehensive loss to common shareholders of $(31.9) million, which consisted of net loss to common shareholders of $(4.8) million and other comprehensive loss of $(27.1) million. Higher interest rates and wider credit spreads drove larger declines in the fair value of our MBS (including TBAs) relative to the increases in the fair value of our derivative instruments used to hedge interest rate risk from our assets. Net unrealized losses on MBS of $(50.2) million and net realized losses on TBA dollar roll positions of $(10.7) million were partially offset by net realized gains of $7.3 million on our hedging instruments. Net interest income declined during 2018 to $50.5 million compared to $58.3 million during 2017 as the impact of the higher interest rate environment on our repurchase agreement borrowing costs outpaced the benefits of increased leverage and having a larger investment portfolio during 2018. The remainder of our net loss for 2018 was primarily comprised of general and administrative expenses of $(15.1) million and preferred dividends $(11.8) million. Please refer to “Results of Operations” within this Item 7 for further discussion of these components of comprehensive loss.

For the year ended December 31, 2017, we reported comprehensive income to common shareholders of $47.0 million, which was comprised of net income to common shareholders of $23.1 million and other comprehensive income of $23.9 million. Because the fair value of our financial instruments is influenced by market factors outside of management’s control, it is difficult to compare our net income (loss) and comprehensive income (loss) with those same measures in other reporting periods, particularly those periods with significant market volatility. As such, management uses a non-GAAP measure, core net operating income to common shareholders, to evaluate and compare the Company’s performance to prior periods because it excludes the impact of market volatility on the fair value of its financial instruments. Core net operating income to common shareholders was $42.3 million for the year ended December 31, 2018 compared to $37.0 million for the year ended December 31, 2017. We received a net benefit of $5.8 million on our interest rate swaps for the year ended December 31, 2018 compared to a net cost of $(3.4) million for the prior year, which partially offset the increase in our repurchase agreement borrowing costs mentioned above. In addition, TBA drop income increased $5.5 million due to a larger volume of TBA dollar roll transactions and general and administrative expenses decreased $(0.7) million for the year ended December 31, 2018 compared to the prior year. Please refer to “Non-GAAP Financial Measures” contained within Item 6 of this Annual Report on Form 10-K for additional important information regarding the Company’s use of non-GAAP financial measures.

Management Outlook

As asset managers and investors of capital, we seek to assess the probability of events and to identify the most dominant factors that may ultimately influence the future path of economic activity, interest rates, and global asset prices. Today, we believe that we are in a lower return environment characterized by interest rates that will spend more time in a narrower range than in recent history. Fundamentally, we believe that increasing global debt, demographic trends, technology advances, and human conflict could keep the 10-year U.S. Treasury below 3.5% and within a broader range of 2% to 4% substantially into the future. As of February 15, 2019, negative interest rates on debt globally is trending higher again after trending lower since a peak in 2016. Additionally, there are multiple global factors that could rapidly force interest rates to and even below the lower bound of this narrower interest rate range.

Negative side effects of monetary policy tightening are already developing in the global economy and impacting global capital markets, which has limited the most recent rise in interest rates in the U.S. Markets have quickly repriced the expected number of Federal Funds rate increases for the remainder of this cycle. As tightening cycles end, typically the yield curve steepens, increasing returns on capital in marginal investment opportunities. Such a steepening may take a number of quarters to evolve, but even if the yield curve remains relatively flat, we anticipate that MBS will continue to provide attractive leveraged returns on investment capital during 2019.

Longer term, there are factors that management believes continue to favor our business model. An increasingly aging population worldwide continues to support a growing demand for cash yield which should favorably benefit long-term valuations of mortgage REITs. We believe securitized mortgage assets supported by the U.S. government are among the safest yielding investments in an uncertain global environment. In addition, as the Federal Reserve reduces its investment in Agency RMBS and if, as widely expected, the GSEs are reformed, we believe the need for private capital in the U.S. housing finance system will create new investment opportunities with attractive total return profiles. In the meantime, we believe our investment strategy of maintaining a diversified highly liquid, low credit risk portfolio allows us to generate solid cash flow while also providing us with flexibility to respond to surprising global events.

Market volatility experienced in the fourth quarter of 2018 has modestly subsided thus far in 2019, resulting in tighter credit spreads on Agency RMBS and CMBS, thereby improving our book value per common share since December 31, 2018. In addition, we raised approximately $46.1 million in capital at the end of January 2019 by closing a public offering of over 8 million shares of our common stock. The timing of this capital raise was crucial as it allowed us to deploy the proceeds into assets we believe will provide higher returns relative to the returns available in recent history.

CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based in large part upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of our consolidated financial statements requires management to make estimates, judgments and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. We base these estimates and judgments on historical experience and assumptions believed to be reasonable under current facts and circumstances. Actual results, however, may differ from the estimated amounts we have recorded.
Critical accounting policies are defined as those that require management's most difficult, subjective or complex judgments, and which may result in materially different results under different assumptions and conditions. The following discussion provides information on our accounting policies that require the most significant management estimates, judgments, or assumptions, or that management believes includes the most significant uncertainties, and are considered most critical to our results of operations or financial position.

Fair Value Measurements. Our Agency MBS, as well as a majority of our non-Agency MBS, are substantially similar to securities that either are actively traded or have been recently traded in their respective market. Pricing services and brokers have access to observable market information through trading desks and various information services. We receive a price evaluation for each of our MBS from a primary pricing service selected by the Company. To determine each security's valuation, the primary pricing service uses either a market approach or income approach, both of which rely on observable market data. The market approach uses prices and other relevant information that is generated by market transactions of identical or similar securities, while the income approach uses valuation techniques to convert estimated future cash flows to a discounted present value. Management reviews the assumptions and inputs utilized in the valuation techniques. Examples of these observable inputs and assumptions include market interest rates, credit spreads, and projected prepayment speeds, among other things. The Company compares the price received from its primary pricing service to other prices received from additional third-party pricing services and multiple broker quotes for reasonableness.

We typically receive a total of three to six bid-side prices from pricing services and brokers for each of our securities; prices obtained from brokers are not binding on either the broker or us. Management does not adjust the prices received, but, for securities on which we receive five or more prices, the high and low prices are excluded from the calculation of the average price. In addition, management reviews the prices received for each security by comparing those prices to actual purchase and sale transactions, our internally modeled prices that are calculated based on observable market rates and credit spreads, and the prices that our borrowing counterparties use in financing our securities. Management reviews prices which vary significantly from the pricing service and may exclude such prices from its calculation of fair value. The decision to exclude any price from use in the calculation of the fair values used in our consolidated financial statements is reviewed and approved by management independent of the pricing process. The average of the remaining prices received is used for the fair values included in our consolidated financial statements. If the price of a security is obtained from quoted prices for similar instruments or model-derived valuations whose inputs are observable, the security is classified as a level 2 security. The security is classified as a level 3 security if the inputs are unobservable, resulting in an estimate of fair value based primarily on management's judgment. As of December 31, 2018, less than 0.1% of our MBS are level 3 securities. Please refer to Note 5 of the Notes to our Consolidated Financial Statements contained within Part II, Item 8 of this Annual Report on Form 10-K for additional information on fair value measurements.

Other-than-Temporary Impairments. When the fair value of an available-for-sale security is less than its amortized cost as of the reporting date, the security is considered impaired. We assess our securities for impairment on at least a quarterly basis and determine if the impairments are either temporary or other-than-temporary. We assess our ability to hold any Agency MBS or non-Agency MBS with an unrealized loss until the recovery in its value. Our ability to hold any such MBS is based on our current investment strategy and significance of the related investment as well as our current leverage and anticipated liquidity. Although Fannie Mae and Freddie Mac are not explicitly backed by the full faith and credit of the United States, given their guarantee and commitments for support received from the Treasury as well as the credit quality inherent in Agency MBS, we do not typically consider any of the unrealized losses on our Agency MBS to be credit-related. For our non-Agency MBS, we review the credit ratings of these MBS and the seasoning of the mortgage loans collateralizing these securities as well as the estimated future cash flows, which include any projected losses, in order to evaluate whether we believe any portion of the unrealized loss at the reporting date is related to credit losses.

The determination as to whether an other-than-temporary impairment ("OTTI") exists, as well as its amount, is subjective, as such determinations are based not only on factual information available at the time of assessment but also on management’s estimates of future performance and cash flow projections. As a result, the timing and amount of any OTTI may constitute a material estimate that is susceptible to significant change. Our expectations with respect to our securities in an unrealized loss position may change over time, given, among other things, the dynamic nature of markets and other variables. For example, if the GSEs suffer losses or cease to exist, our view of the credit worthiness of our Agency MBS could materially change, which may affect our assessment of OTTI for Agency MBS in future periods. Future sales or changes in our expectations with respect to Agency or non-Agency securities in an unrealized loss position could result in us recognizing other-than-temporary impairment charges or realizing losses on sales of MBS in the future.

FINANCIAL CONDITION

Our investment portfolio is comprised mostly of Agency fixed-rate investments. As of December 31, 2018, approximately 65% of our investments are 30-year Agency RMBS including TBA dollar roll positions, which we continue to invest in given their more favorable risk-return profile and current liquidity in the market versus other types of MBS. Approximately 23% of our investments are Agency CMBS, mainly in the multifamily sector. Relative to RMBS, CMBS have more predictable prepayment profiles and are therefore less costly to hedge. The following charts compare our portfolio investment allocations as of December 31, 2018 to December 31, 2017:

(1) Includes securities pending settlement as of the periods indicated.

(2) Includes net long positions in TBAs used for investment purposes at their implied market value as if settled. All TBAs are accounted for as "derivative assets (liabilities)" on our consolidated balance sheet.

The following table provides a summary of the amortized cost and fair value of our investment portfolio (including TBA dollar roll positions and securities pending settlement) used for investment purposes as of the dates indicated:

	December 31, 2018		**December 31, 2017**	
($ in thousands)	**Amortized Cost**	**Fair Value**	**Amortized Cost**	**Fair Value**
Agency RMBS, fixed-rate	$2,142,717	$2,124,810	$903,270	$898,678
TBAs, fixed-rate (1)	882,230	888,469	829,425	830,908
Agency RMBS, adjustable rate	32,666	33,211	289,304	285,583
Agency CMBS, fixed-rate	1,080,424	1,057,015	1,134,409	1,124,351
CMBS IO (2)	527,743	532,154	683,833	692,522
Non-Agency other (3)	1,859	2,274	23,536	25,855
U.S. Treasuries	—	—	148,267	146,530
Mortgage loans held for investment, net (4)	11,527	8,566	15,738	12,973
Total investment portfolio including TBA dollar roll positions	$4,679,166	$4,646,499	$4,027,782	$4,017,400

(1) Consists of long positions in TBAs used for investment purposes at their implied cost basis and implied market value, respectively, as if settled and excludes short positions in TBAs used for economic hedging purposes. All TBAs are accounted for as "derivative assets (liabilities)" on our consolidated balance sheet.

(2)

(3)

(4) Recorded on consolidated balance sheet at amortized cost.

The following table details the activity related to our MBS portfolio including TBA dollar roll positions during the year ended December 31, 2018:

($ in thousands)	**Agency Fixed-Rate 30-Year RMBS [1] [2]**	**Agency Fixed-Rate CMBS**	**CMBS IO [3]**	**Agency Adjustable Rate RMBS**	**Non-Agency Other [4]**	**Total**
Balance as of December 31, 2017	$1,729,586	$1,124,351	$692,522	$285,583	$25,855	$3,857,897
Purchases	1,396,408	235,897	4,780	—	—	1,637,085
Principal payments	(99,246)	(36,348)	—	(29,809)	(23,675)	(189,078)
Sales	—	(251,247)	(24,198)	(225,622)	—	(501,067)
(Amortization) accretion	(4,910)	(2,287)	(136,672)	(1,207)	1,998	(143,078)
Change in fair value	(8,559)	(13,351)	(4,278)	4,266	(1,904)	(23,826)
Balance as of December 31, 2018	$3,013,279	$1,057,015	$532,154	$33,211	$2,274	$4,637,933

(1) Includes securities pending settlement as of dates indicated.

(2) Includes long positions in TBAs used for investment purposes at their implied market value as if settled and excludes short positions in TBAs used for economic hedging purposes. All TBAs are accounted for as "derivative assets (liabilities)" on our consolidated balance sheet.

(3)

(4)

RMBS

The following table provides information on our Agency RMBS investments including securities pending settlement and TBA dollar roll positions as of the dates indicated:

	December 31, 2018						
				Weighted Average			
Coupon	Par	Amortized Cost/ Implied Cost Basis (1)(3)	Fair Value (2)(3)	Original Loan Balance (4)	Loan Age (in months) (4)	3 Month CPR (4)(5)	Duration (6)
	($ in thousands)						
30-year fixed-rate:							
3.0%	$223,573	$225,148	$218,286	$233,855	26	5.7 %	5.66
4.0%	1,651,854	1,699,012	1,687,390	272,159	10	5.2 %	4.06
4.5%	211,429	218,557	219,134	291,874	5	5.3 %	2.48
TBA 4.0%	110,000	111,175	112,101	n/a	n/a	n/a	3.54
TBA 4.5%	750,000	771,055	776,368	n/a	n/a	n/a	2.61
Total 30-year fixed-rate	$2,946,856	$3,024,947	$3,013,279	$270,053	11	5.3 %	3.67
Adjustable-rate:							
4.3% (7)	$31,782	$32,666	$33,211	$210,597	132	25.6 %	0.52
Total Agency RMBS (including TBA dollar roll positions)	$2,978,638	$3,057,613	$3,046,490	$269,161	13	5.6 %	3.63

	December 31, 2017						
				Weighted Average			
Coupon	Par	Amortized Cost/ Implied Cost Basis (1)(3)	Fair Value (2)(3)	Original Loan Balance (4)	Loan Age (in months) (4)	3 Month CPR (4)(5)	Duration (6)
	($ in thousands)						
30-year fixed-rate:							
3.0%	$244,374	$246,155	$244,818	$233,584	13	5.0 %	6.30
4.0%	623,293	657,114	653,860	274,965	4	4.0 %	3.91
TBA 4.0%	795,000	829,425	830,908	n/a	n/a	n/a	2.95
Total 30-year fixed-rate	$1,662,667	$1,732,694	$1,729,586	$263,310	6	4.3 %	3.80
Adjustable-rate:							
3.1% (7)	$278,886	$289,305	$285,583	$271,516	74	16.0 %	2.28
Total Agency RMBS (including TBA dollar roll positions)	$1,941,553	$2,021,999	$2,015,169	$265,306	23	7.1 %	3.58

(1) *Implied cost basis of TBA dollar roll positions represents the forward price to be paid for the underlying Agency MBS as if settled.*

(2) *Fair value of TBA dollar roll positions is the implied market value of the underlying Agency security as of the end of the period if settled.*

(3) *The net carrying value of TBA dollar roll positions, which is the difference between their implied market value and implied cost basis, was $6.2 million as of December 31, 2018 and $1.5 million as of December 31, 2017 and is included on the consolidated balance sheet within "derivative assets".*

(4) *TBA dollar roll positions are excluded from this calculation as they do not have a defined weighted-average loan balance or age until mortgages have been assigned to the pool.*

(5) *Constant prepayment rate ("CPR") represents the 3-month CPR of Agency RMBS held as of date indicated. Securities with no prepayment history are excluded from this calculation.*
(6) *Duration measures the sensitivity of a security's price to the change in interest rates and represents the percent change in price of a security for a 100-basis point increase in interest rates. We calculate duration using third-party financial models and empirical data. Different models and methodologies can produce different estimates of duration for the same securities.*
(7) *Coupon of adjustable-rate Agency RMBS represents the weighted average coupon based on amortized cost.*

CMBS

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

	December 31, 2018			**December 31, 2017**		
($ in thousands)	**Par Value**	**Amortized Cost**	**Months to Estimated Maturity** (1)	**Par Value**	**Amortized Cost**	**Months to Estimated Maturity** (1)
Year of Origination:						
2008 and prior	$20,302	$18,868	33	$34,065	$31,026	41
2009 to 2012	74,935	76,567	23	106,619	109,234	27
2013 to 2014	13,516	13,790	73	20,237	20,600	82
2015	210,679	212,755	97	468,296	469,657	103
2016	238,559	240,033	98	239,139	240,831	110
2017	280,530	283,567	106	282,112	285,527	118
2018	236,425	235,847	142	—	—	—
	$1,074,946	$1,081,427	102	$1,150,468	$1,156,875	99

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

Because Agency CMBS are guaranteed by the GSEs with respect to return of principal, our credit exposure is limited to any unamortized premium remaining on those securities. The amortized cost of our non-Agency CMBS as of December 31, 2018 declined to $1.0 million compared to $22.5 million as of December 31, 2017 due to significant prepayment activity during 2018. The non-Agency CMBS remaining as of December 31, 2018 are comprised of securities collateralized by loans originated prior to 2000.

CMBS IO

As of December 31, 2018, our CMBS IO investments comprised approximately 11% of our total portfolio, of which approximately 55% are Agency-issued, relatively unchanged since December 31, 2017. Given supply-demand imbalances in CMBS IO markets, which have led to less attractive marginal returns, we have not actively purchased these securities in 2018.

Income earned from CMBS IO is based on interest payments received on the underlying commercial mortgage loan pools. Our return on these investments may be negatively impacted by any change in scheduled cash flows such as modifications of the mortgage loans or involuntary prepayments including defaults, foreclosures, and liquidations on or of the underlying mortgage loans prior to its contractual maturity date. In order to manage our exposure to credit performance, we generally invest in senior tranches of these securities and where we have evaluated the credit profile of the underlying loan pool and can monitor credit performance. In addition, to address changes in market fundamentals and the composition of mortgage loans collateralizing an investment, we consider the year of origination of the loans underlying CMBS IO in our selection of investments.

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The following table presents our CMBS IO investments as of December 31, 2018 by year of origination:

($ in thousands)	December 31, 2018			December 31, 2017		
	Amortized Cost	Fair Value	Remaining WAL (1)	Amortized Cost	Fair Value	Remaining WAL (1)
Year of Origination:						
2010	$3,493	$3,474	8	$6,421	$6,554	13
2011	16,542	17,295	13	25,652	26,720	18
2012	39,558	39,994	19	71,615	72,913	22
2013	72,649	73,073	22	103,730	104,568	28
2014	134,114	134,808	30	171,285	173,043	34
2015	143,163	144,673	35	170,663	172,974	40
2016	67,625	68,015	41	82,698	83,444	47
2017	46,125	46,336	48	51,769	52,306	53
2018	4,474	4,486	73	—	—	—
	$527,743	$532,154	32	$683,833	$692,522	36

(1) Remaining weighted average life ("WAL") represents an estimate of the number of months of interest earnings remaining for the investments by year of origination.

Derivative Assets and Liabilities

We regularly monitor and adjust our hedging portfolio in response to many factors including, but not limited to, changes in our investment portfolio, shifts in the yield curve, and our expectations with respect to the future path of interest rates and interest rate volatility. Please refer to "Quantitative and Qualitative Disclosures about Market Risk" in Part I, Item 3 of this Annual Report on Form 10-K for more information.

<u>Interest rate derivatives.</u> As of December 31, 2018, we used interest rate swaps to hedge a portion of our earnings and book value exposure to fluctuations in interest rates. As of December 31, 2017, we held interest rate swaps as well as Eurodollar futures. The following graphs present the effective notional balance outstanding and weighted average net pay-fixed rate for our interest rate derivatives outstanding as of the periods indicated:

(1) Includes one receive-fixed interest rate swap at a notional amount of $100.0 million with a receive-fixed rate of 1.70% as of December 31, 2017.

During the year ended December 31, 2018, we added interest rate swaps with a combined notional balance of $1.8 billion at a weighted average net pay-fixed rate of 2.97% in order to increase our protection from rising short-term interest rates. We had interest rate swaps with a notional balance of $2.4 billion and a weighted average pay-fixed rate of 1.32% mature during the twelve months ended December 31, 2018. During that same period, we realized a gain of $7.2 million from terminated interest rate swaps with a notional balance of $0.7 billion and realized a gain of $2.6 million for Eurodollar futures with a notional balance of $2.0 billion that matured during that same period.
During the year ended December 31, 2018, we terminated options on U.S. Treasury futures with an aggregate notional balance of $800.0 million, for which we realized a loss of $0.7 million. We entered the options to enhance returns if interest rates decline while limiting our downside to the premium paid if interest rates increase. Additionally, during the twelve months ended December 31, 2018, we added U.S. Treasury futures with an aggregate notional balance of $0.5 billion and terminated $0.4 billion with a realized loss of $3.4 million. Utilizing U.S. Treasury futures and options on U.S. Treasury futures enabled us to mitigate the impact of interest rate changes on our tangible net asset value. In addition, these instruments provided economic advantages compared to other hedging alternatives given the market environment during the year.
TBAs. Please refer to “RMBS” above in this section of Part I, Item 2 for additional information about long positions in TBAs, or TBA dollar roll positions, which are used as a means of investing in and financing fixed-rate Agency RMBS. We may also periodically enter into short positions in TBAs to partially hedge the impact of adverse changes in interest rates on the fair value of our fixed-rate Agency RMBS. We did not hold any short positions in TBA securities as of December 31, 2018. As of December 31, 2017, we held one TBA short position with a coupon of 3.5% and an implied cost basis (if settled) of $(153.8) million, which is included in our derivative liabilities at that date at its net carrying value of $(0.3) million.

Repurchase Agreements

The majority of our repurchase agreement borrowings are collateralized with Agency MBS which have historically had lower liquidity risk than non-Agency MBS. As of December 31, 2018, all non-Agency MBS pledged as collateral for repurchase agreements were CMBS IO, of which approximately 82% are rated AAA and less than 4% are rated A or below. As of December 31, 2017, approximately 77% of non-Agency MBS pledged as collateral for repurchase agreements were CMBS IO rated AAA and less than 11% were CMBS and CMBS IO rated A or below. Please refer to Note 3 of the Notes to the Consolidated Financial Statements contained within this Annual Report on Form 10-K as well as “Results of Operations” and “Liquidity and Capital Resources” contained within this Item 2 for additional information relating to our repurchase agreement borrowings.

Shareholder’s Equity

During the year ended December 31, 2018, we issued 65.9 thousand shares of Series B Preferred Stock under our preferred stock ATM program at a discount of approximately 3% to the par value of $25.00 per share. Cash proceeds were $1.6 million, net of 1.5% broker commissions and other fees. We also issued 6.8 million shares of common stock pursuant to our ATM common stock program during 2018 for net cash proceeds of $41.7 million at an average share price of $6.21. We typically use the cash proceeds from these capital raises in combination with repurchase agreement borrowings to purchase additional interest earning assets for our investment portfolio. Please refer to Note 11 of the Notes to the Consolidated Financial Statements contained within this Annual Report on Form 10-K for information regarding a public offering and sale of common stock subsequent to December 31, 2018.

We recorded other comprehensive loss of $(27.1) million for the year ended December 31, 2018 related primarily to declines in fair value of our available-for-sale debt securities. The decline in fair value for the majority of our MBS was primarily the result of increasing interest rates throughout 2018 and widening credit spreads during the fourth quarter of 2018. The following table includes detail of the accumulated other comprehensive income (loss) position and change in fair value by type of debt security as of and for the periods indicated:

($ in thousands)	**Accumulated Other Comprehensive (Loss) Income As of December 31, 2017**	**Other Comprehensive (Loss) Income (1) For the Year Ended December 31, 2018**	**Accumulated Other Comprehensive (Loss) Income As of December 31, 2018**
Fixed-rate Agency RMBS	$ (4,592)	$ (13,315)	$ (17,907)
Adjustable-rate Agency RMBS	(3,721)	4,266	545
Agency CMBS	(10,058)	(13,351)	(23,409)
CMBS IO (2)	8,689	(4,278)	4,411
Non-Agency other (3)	2,319	(1,904)	415
U.S. Treasuries	(1,737)	1,737	—
De-designated cash flow hedges	403	(237)	166
Total	$ (8,697)	$ (27,082)	$ (35,779)

(1) Includes amounts reclassified from accumulated other comprehensive loss into net income as “gain (loss) on sale of investments, net” as well as amounts reclassified into “interest expense” related to the accretion of the balance remaining in accumulated other comprehensive loss as a result of the Company's discontinuation of cash flow hedge accounting effective June 30, 2013.

(2)

(3)

RESULTS OF OPERATIONS

The discussions below provide information on certain items on our consolidated statements of comprehensive income. These discussions include both GAAP and non-GAAP financial measures which management utilizes in its internal analysis of financial and operating performance. Please read the section “Non-GAAP Financial Measures” at the end of “Executive Overview” in Item 2 of this Annual Report on Form 10-K for additional important information about these measures.

Year Ended December 31, 2018 Compared to Year Ended December 31, 2017

Net Interest Income for the Year Ended December 31, 2018 Compared to the Year Ended December 31, 2017

Net interest income and net interest spread declined for the year ended December 31, 2018 compared to the same period in 2017 due to higher borrowing costs as a result of significant increases in short-term interest rates and lower prepayment penalty compensation and discount accretion on our CMBS and CMBS IO during the year ended December 31, 2018. The following table presents certain information about our interest-earning assets and interest-bearing liabilities and their performance for the year ended December 31, 2018 and December 31, 2017:

($ in thousands)	**Year Ended December 31, 2018** Interest Income/Expense	Average Balance (1)(2)	Effective Yield/ Cost of Funds (3)(4)	**2017** Interest Income/Expense	Average Balance (1)(2)	Effective Yield/ Cost of Funds (3)(4)
Interest-earning assets:						
Agency RMBS-fixed rate	$44,017	$1,325,261	3.32 %	$5,995	$200,908	2.98 %
Agency CMBS-fixed rate	30,053	1,033,094	2.87 %	35,011	1,234,913	2.80 %
Agency RMBS-adjustable rate	3,472	151,273	2.30 %	13,276	773,331	1.72 %
CMBS IO (5)	25,987	606,280	4.29 %	32,177	736,773	4.37 %
Non-Agency other (6)	2,644	7,806	33.87 %	6,198	60,162	10.30 %
U.S. Treasuries	2,012	82,136	2.45 %	616	28,848	2.14 %
Other investments (7)	1,866	13,792	4.21 %	1,229	17,437	4.01 %
Total:	$110,051	$3,219,642	3.37 %	$94,502	$3,052,372	3.06 %
Interest-bearing liabilities:						
Repurchase agreements	$59,674	$2,730,295	2.16 %	$36,345	$2,691,650	1.33 %
Non-recourse collateralized financing	137	4,560	2.97 %	101	5,951	1.68 %
De-designated cash flow hedge accretion (8)	(237)	n/a	(0.01)%	(268)	n/a	(0.01)%
Total:	$59,574	$2,734,855	2.15 %	$36,178	$2,697,601	1.32 %
Net interest income/net interest spread	$50,477		1.22 %	$58,324		1.74 %

(1) *Average balance for assets is calculated as a simple average of the daily amortized cost and excludes unrealized gains and losses as well as securities pending settlement if applicable.*

(2) *Average balance for liabilities is calculated as a simple average of the daily borrowings outstanding during the period.*

(3) *Effective yield is calculated by dividing the sum of gross interest income and scheduled premium amortization/discount accretion (both of which are annualized for any reporting period less than 12 months) and prepayment compensation and premium amortization/discount accretion adjustments (collectively, "prepayment adjustments"), which are not annualized, by the average balance of asset type outstanding during the reporting period.*

(4) *Cost of funds is calculated by dividing annualized interest expense by the total average balance of borrowings outstanding during the period with an assumption of 360 days in a year.*

(5)

(6)

(7) *Interest income for other investments consists of $583 thousand from mortgage loans held for investment, net and $1,283 thousand from cash and cash equivalents for the year ended December 31, 2018 compared to $698 thousand and $531 thousand for the year ended December 31, 2017, respectively. Average balances and yields shown for other investments includes amortized cost of mortgage loans held for investment and excludes cash.*

(8)

Interest income increased $15.5 million for the year ended December 31, 2018 compared to the same period in 2017 due to the growth in the average interest earning assets in our portfolio, particularly into higher yielding 30-year fixed-rate Agency RMBS. Interest expense increased $23.4 million for the year ended December 31, 2018 compared to the same period in 2017 due to higher borrowing rates on our repurchase agreements. Our borrowing rates are based primarily on one-month LIBOR which averaged approximately 2.02% during the year ended December 31, 2018 compared to an average of 1.11% for the same period in 2017.

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Rate/Volume Analysis. The following table presents the estimated impact on our net interest income due to changes in rate (effective yield/cost of funds) and changes in volume (average balance) of our interest-earning assets and interest-bearing liabilities for the periods indicated:

	Year Ended December 31, 2018 Compared to December 31, 2017			
	Increase (Decrease) Due to Change In			**Total Change in Interest Income/Expense**
($ in thousands)	**Rate**	**Volume**	**Prepayment Adjustments (1)**	
Interest-earning assets:				
Agency RMBS-fixed rate	$4,473	$33,549	$ —	$ 38,022
Agency CMBS-fixed rate	825	(5,619)	(164)	(4,958)
Agency RMBS-adjustable rate	500	(12,093)	1,789	(9,804)
CMBS IO (2)	45	(4,867)	(1,368)	(6,190)
Non-Agency other (3)	855	(3,542)	(867)	(3,554)
Treasuries	258	1,138	—	1,396
Other investments (4)	36	601	—	637
Total increase (decrease) in interest income	$6,992	$9,167	$ (610)	$ 15,549
Interest-bearing liabilities:				
Repurchase agreements	$22,485	$844	$ —	$ 23,329
Non-recourse collateralized financing, net of other (5)	109	(42)	—	67
Total increase in interest expense	22,594	802	—	23,396
Total net change in net interest income	$(15,602)	$8,365	$ (610)	$ (7,847)

(1) *Prepayment adjustments represent effective interest amortization adjustments related to changes in actual and projected prepayment speeds for adjustable-rate RMBS and prepayment compensation, net of amortization adjustments for CMBS and CMBS IO and are not annualized in the calculation of effective yield.*
(2) *Includes Agency and non-Agency issued securities.*
(3) *Includes privately-issued RMBS and CMBS.*
(4) *Increase of $752 thousand in other interest income from cash and cash equivalents is included as a change in volume.*
(5) *Decrease of $31 thousand in de-designated cash flow hedge accretion is included as a change in rate.*

The increase of $7.0 million in interest income due to rate is primarily related to our sales and pay downs of lower yielding MBS across most asset classes since December 31, 2017, which resulted in the average effective yield increasing for the remaining securities in our portfolio for the year ended December 31, 2018 compared to the same period in 2017. The proceeds from those sales and pay downs have been predominantly reinvested into higher yielding fixed-rate Agency RMBS since December 31, 2017. The average effective yield for CMBS IO declined 8 basis points, which was primarily due to lower prepayment penalty compensation during the year ended December 31, 2018 compared to the same period in 2017.

Adjusted Net Interest Income for the Year Ended December 31, 2018 Compared to the Year Ended December 31, 2017

Management includes drop income from TBA dollar roll transactions and net periodic interest benefit (cost) of interest rate swaps in a non-GAAP financial measure “adjusted net interest income” when evaluating the economic performance of its investments and financings. Please refer to “Non-GAAP Financial Measures” of Item 6 of this Annual Report on Form 10-K for additional information and a reconciliation of this non-GAAP measure.

Adjusted net interest income increased $6.9 million for the year ended December 31, 2018 compared to the same period in 2017 primarily because we received a net periodic interest benefit from interest rate swaps of $5.8 million for the year ended December 31, 2018 compared to a net cost of $(3.4) million for the year ended December 31, 2017. The floating rate we receive on the majority of our pay-fixed interest rate swaps is based on 3-month LIBOR which averaged approximately 2.31% for the year ended December 31, 2018 compared to 1.26% for the same period in 2017. Please refer to “(Loss) Gain on Derivatives, Net” below for additional information regarding our interest rate swaps.

In addition, higher TBA drop income due to a larger volume of TBA dollar roll transactions contributed to the increase in our adjusted net interest income for the year ended December 31, 2018 compared to the same period in 2017. The following table summarizes information related to our drop income from TBA dollar roll transactions for the periods indicated:

	Year Ended December 31,				**Year Ended December 31, 2018 Compared to Year Ended December 31, 2017**		
	2018		**2017**		**Total Change**	**Due to Change In**	
($ in thousands)	**Amount**	**Average Yield/Cost**	**Amount**	**Average Yield/Cost**		**Rate**	**Volume**
TBA implied interest income [(1)]	$31,335	3.63 %	$15,162	3.01 %	$16,173	$5,463	$10,710
TBA implied interest expense [(2)]	16,649	1.93 %	5,984	1.19 %	10,665	6,438	4,227
TBA drop income/net yield [(3)]	$14,686	1.70 %	$9,178	1.82 %	$5,508	$(975)	$6,483
Average amortized cost basis	$861,483		$504,859				

(1) *Average yield for TBA dollar roll positions is extrapolated by adding average cost (see footnote 2) to the net yield (see footnote 3). Implied interest income is calculated by multiplying the average yield by the TBA cost basis outstanding during the period.*

(2) *Average funding cost for TBA dollar roll positions is determined using the "price drop" between the near settling TBA contract and the price for the same contract with a later settlement date and market-based assumptions regarding the "cheapest-to-deliver" collateral that can satisfy the TBA contract, such as the security's coupon, maturity, and projected prepayment rate anticipated for the collateral. TBA implied interest expense is calculated by multiplying the average funding cost by the average TBA cost basis outstanding during the period.*

(3) *TBA net yield is calculated by dividing drop income by the average TBA cost basis outstanding during the period.*

(Loss) Gain on Derivative Instruments, Net

Changes in the fair value of derivative instruments and net periodic interest costs are impacted by changing market interest rates and adjustments that we may make to our derivative positions in any given period. Because of the changes made to our derivatives portfolio from one reporting period to the next, results of any given reporting period are generally not comparable to results of another.

The following table provides information on our financial instruments accounted for as derivative instruments for the periods indicated:

	Year Ended December 31,	
($ in thousands)	**2018**	**2017**
Interest rate derivatives:		
Interest rate swaps:		
Net periodic interest benefit (cost)	$5,830	$(3,417)
Change in fair value (1)	4,533	785
Total interest rate swap gains (losses), net	10,363	(2,632)
U.S. Treasury and Eurodollar futures:		
Change in fair value (1)	(2,722)	821
TBA short positions (economic hedges):		
Change in fair value (2)	293	(902)
Total interest rate derivative gains (losses), net	7,934	(2,713)
TBA dollar roll positions:		
TBA drop income	14,686	9,178
Change in fair value (2)	(25,423)	(3,421)
Total TBA dollar roll (losses) gains, net	(10,737)	5,757
Other derivatives:		
Options on U.S. Treasury futures	(658)	—
Total gain (loss) on derivative instruments, net	$(3,461)	$3,044

(1) Changes in fair value for interest rate swaps and Eurodollar futures include unrealized gains (losses) from current and forward starting derivative instruments and realized gains (losses) from terminated derivative instruments.

(2) Changes in fair value for TBA positions include unrealized gains (losses) from open TBA contracts and realized gains (losses) on paired off or terminated positions.

Loss on derivative instruments, net for the year ended December 31, 2018 included net realized gains of $7.2 million on interest rate swaps terminated during the year and a net realized loss of $(0.8) million on Eurodollar and U.S. Treasury futures that matured during 2018. The decline in fair value of TBA dollar roll positions of $(10.7) million was driven primarily by the increase in interest rates during 2018 and is comprised of a net realized loss of $(15.5) million and a net unrealized gain of $4.8 million. For the year ended December 31, 2017, gain (loss) on derivative instruments, net included $(6.0) million of net losses on terminated interest rate swaps with a net notional balance of $1.1 billion and $3.6 million of net gains on TBAs that were realized during the year.

During 2018, we maintained our interest rate swap hedge position at approximately 80% of our average borrowings and net TBAs outstanding as shown in the table below. The floating rate we receive on the majority of our pay-fixed interest rate swaps is based on 3-month LIBOR which increased to an average of 2.31% during the year ended December 31, 2018 compared to 1.26% for the year ended December 31, 2017. As a result, we earned a net periodic interest benefit of $5.8 million from our interest rate swaps during 2018 compared to a net periodic interest cost of $(3.4) million during 2017, which partially offset the increase in our interest expense from higher interest rates on our repurchase agreement borrowings. The following table provides details on the effective interest rate swaps outstanding during the periods indicated:

($ in thousands)	Year Ended December 31, 2018	2017
Average repurchase agreement borrowings outstanding	$2,730,295	$2,691,650
Average net TBAs outstanding - at cost (1)	845,931	498,059
Average borrowings and net TBAs outstanding	3,576,226	3,189,709
Average notional amount of interest rate swaps outstanding (excluding forward starting swaps)	2,863,877	2,409,918
Ratio of average interest rate swaps to average borrowings and net TBAs outstanding (1)	0.8	0.8
Average interest rate swap net pay-fixed rate (excluding forward starting swaps) (2)	1.95 %	1.38 %
Average interest rate swap net receive-floating rate (2)	2.12 %	1.22 %
Average interest rate swap net pay/(receive) rate	(0.17)%	0.16 %

(1) Because the Company executes TBA dollar roll transactions, which economically represent the purchase and financing of fixed-rate Agency RMBS, the average TBAs outstanding are included in the ratio calculation.
(2) Net rates include receive-fixed (pay-floating) interest rate swaps.

As mentioned in “Financial Condition” of this Annual Report on Form 10-K, we hold long positions in TBA securities which management views as economically equivalent to investing in and financing Agency RMBS using short-term repurchase agreements. We execute a series of transactions which effectively delay the settlement of a forward purchase of a non-specified Agency RMBS by entering into an offsetting TBA short position, net settling the paired-off positions in cash, and simultaneously entering into an identical TBA long position with a later settlement date. A portion of the total change in fair value of TBAs is referred to by management as “drop income (loss)” and is calculated as the difference in price between the TBA security purchased for a forward settlement month and the price of a TBA security sold for settlement in the current month times its notional amount.

Loss on Sale of Investments, Net

Sales of our investments occur in the ordinary course of business as we manage our risk, capital and liquidity profiles, and as we reallocate capital to various investments. The following tables provide information related to our loss on sale of investments, net for the periods indicated:

Year Ended
December 31,
2018