

DYNEX CAPITAL INC  
Form 10-Q  
November 06, 2018

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

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended September 30, 2018  
or

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 (I.R.S. Employer  
incorporation or organization) 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)

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

Yes  No

Indicate by check mark whether the registrant has submitted electronically 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  No

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  Accelerated filer

Non-accelerated filer  Smaller reporting company

Emerging growth company

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.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

On October 31, 2018, the registrant had 59,688,862 shares outstanding of common stock, \$0.01 par value, which is the registrant's only class of common stock.

DYNEX CAPITAL, INC.  
FORM 10-Q  
INDEX

PART  
I. FINANCIAL INFORMATION

Page

Item 1. Financial Statements

Consolidated Balance Sheets as of September 30, 2018 (unaudited) and December 31, 2017	<u>1</u>
Consolidated Statements of Comprehensive Income (Loss) for the three and nine months ended September 30, 2018 (unaudited) and September 30, 2017 (unaudited)	<u>2</u>
Consolidated Statement of Shareholders' Equity for the nine months ended September 30, 2018 (unaudited)	<u>3</u>
Consolidated Statements of Cash Flows for the nine months ended September 30, 2018 (unaudited) and September 30, 2017 (unaudited)	<u>4</u>

<u>Notes to the Unaudited Consolidated Financial Statements</u>	<u>5</u>
---	----------

<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>23</u>
--	-----------

<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>52</u>
---	-----------

<u>Item 4. Controls and Procedures</u>	<u>56</u>
--	-----------

PART  
II. OTHER INFORMATION

<u>Item 1. Legal Proceedings</u>	<u>57</u>
----------------------------------	-----------

<u>Item 1A. Risk Factors</u>	<u>57</u>
------------------------------	-----------

<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>57</u>
--	-----------

<u>Item 3. Defaults Upon Senior Securities</u>	<u>57</u>
--	-----------

<u>Item 4. Mine Safety Disclosures</u>	<u>57</u>
--	-----------

<u>Item 5. Other Information</u>	<u>57</u>
----------------------------------	-----------

<u>Item 6. Exhibits</u>	<u>58</u>
-------------------------	-----------

<u>SIGNATURES</u>	<u>59</u>
-------------------	-----------



## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

## CONSOLIDATED BALANCE SHEETS

(amounts in thousands except share data)

	September 30, 2018	December 31, 2017
	(unaudited)	
<b>ASSETS</b>		
Investments in securities, at fair value:		
Mortgage-backed securities (including pledged of \$2,877,985 and \$2,640,884 respectively)	\$ 3,294,510	\$ 3,026,989
U.S. Treasuries (including pledged of \$0 and \$124,215, respectively)	—	146,530
Mortgage loans held for investment, net	12,342	15,738
Cash and cash equivalents	55,251	40,867
Restricted cash	58,334	46,333
Derivative assets	2,612	2,940
Accrued interest receivable	19,575	19,819
Other assets, net	5,555	6,562
Total assets	\$ 3,448,179	\$ 3,305,778
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities:		
Repurchase agreements	\$ 2,690,858	\$ 2,565,902
Payable for unsettled securities	182,922	156,899
Non-recourse collateralized financing	3,709	5,520
Derivative liabilities	2,039	269
Accrued interest payable	5,676	3,734
Accrued dividends payable	13,121	12,526
Other liabilities	3,101	3,870
Total liabilities	2,901,426	2,748,720
Shareholders' equity:		
Preferred stock, par value \$.01 per share; 50,000,000 shares authorized; 5,941,659 and 5,888,680 shares issued and outstanding, respectively (\$148,541 and \$147,217 aggregate liquidation preference, respectively)	\$ 142,574	\$ 141,294
Common stock, par value \$.01 per share, 200,000,000 shares authorized; 59,016,554 and 55,831,549 shares issued and outstanding, respectively	590	558
Additional paid-in capital	795,630	775,873
Accumulated other comprehensive loss	(85,833	) (8,697 )
Accumulated deficit	(306,208	) (351,970 )
Total shareholders' equity	546,753	557,058
Total liabilities and shareholders' equity	\$ 3,448,179	\$ 3,305,778

See notes to the unaudited consolidated financial statements.

DYNEX CAPITAL, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
(UNAUDITED)

(amounts in thousands except per share data)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Interest income	\$26,925	\$23,103	\$78,037	\$70,378
Interest expense	14,751	9,889	40,521	26,122
Net interest income	12,174	13,214	37,516	44,256
Gain (loss) on derivative instruments, net	19,499	5,993	78,520	(9,634 )
Loss on sale of investments, net	(1,726 )	(5,211 )	(17,945 )	(10,628 )
Fair value adjustments, net	12	23	68	63
Other operating expense, net	(409 )	(109 )	(1,001 )	(150 )
General and administrative expenses:				
Compensation and benefits	(1,712 )	(2,070 )	(5,425 )	(6,356 )
Other general and administrative	(2,252 )	(1,529 )	(6,188 )	(5,620 )
Net income	25,586	10,311	85,545	11,931
Preferred stock dividends	(2,956 )	(2,808 )	(8,838 )	(7,885 )
Net income to common shareholders	\$22,630	\$7,503	\$76,707	\$4,046
Other comprehensive income:				
Unrealized (loss) gain on available-for-sale investments, net	\$(23,574)	\$981	\$(94,919)	\$28,087
Reclassification adjustment for loss on sale of investments, net	1,726	5,211	17,945	10,628
Reclassification adjustment for de-designated cash flow hedges	(66 )	(48 )	(162 )	(220 )
Total other comprehensive (loss) income	(21,914 )	6,144	(77,136 )	38,495
Comprehensive income (loss) to common shareholders	\$716	\$13,647	\$(429 )	\$42,541
Net income per common share-basic and diluted	\$0.39	\$0.15	\$1.35	\$0.08
Weighted average common shares-basic and diluted	57,727	49,832	56,638	49,411

See notes to the unaudited consolidated financial statements.

DYNEX CAPITAL, INC.  
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY  
(UNAUDITED)  
(\$ in thousands)

	Preferred Stock		Common Stock		Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Accumulated Deficit	Total Shareholders' Equity
	Shares	Amount	Shares	Amount				
Balance as of December 31, 2017	5,888,680	\$ 141,294	55,831,549	\$ 558	\$ 775,873	\$ (8,697 )	\$ (351,970 )	\$ 557,058
Stock issuance	52,979	1,290	3,028,983	31	19,250	—	—	20,571
Restricted stock granted, net of amortization	—	—	213,157	2	928	—	—	930
Adjustments for tax withholding on share-based compensation	—	—	(57,135 )	(1 )	(363 )	—	—	(364 )
Stock issuance costs	—	(10 )	—	—	(58 )	—	—	(68 )
Net income	—	—	—	—	—	—	85,545	85,545
Dividends on preferred stock	—	—	—	—	—	—	(8,838 )	(8,838 )
Dividends on common stock	—	—	—	—	—	—	(30,945 )	(30,945 )
Other comprehensive loss	—	—	—	—	—	(77,136 )	—	(77,136 )
Balance as of September 30, 2018	5,941,659	\$ 142,574	59,016,554	\$ 590	\$ 795,630	\$ (85,833 )	\$ (306,208 )	\$ 546,753

See notes to the unaudited consolidated financial statements.

DYNEX CAPITAL, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)  
(\$ in thousands)

	Nine Months Ended September 30, 2018	2017
Operating activities:		
Net income	\$ 85,545	\$ 11,931
Adjustments to reconcile net income to cash provided by operating activities:		
Decrease in accrued interest receivable	244	1,129
Increase (decrease) in accrued interest payable	1,942	(436 )
(Gain) loss on derivative instruments, net	(78,520 )	9,634
Loss on sale of investments, net	17,945	10,628
Fair value adjustments, net	(68 )	(63 )
Amortization of investment premiums, net	110,501	122,621
Other amortization and depreciation, net	937	983
Stock-based compensation expense	930	1,567
Change in other assets and liabilities, net	(896 )	(1,905 )
Net cash and cash equivalents provided by operating activities	138,560	156,089
Investing activities:		
Purchase of investments	(1,080,485 )	(772,590 )
Principal payments received on investments	137,362	248,298
Proceeds from sales of investments	642,900	792,984
Principal payments received on mortgage loans held for investment, net	3,375	2,641
	80,618	11,743

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

Net receipts on derivatives, including terminations			
Other investing activities	(72 )		(214 )
Net cash and cash equivalents (used in) provided by investing activities	(216,302 )		282,862
Financing activities:			
Borrowings under repurchase agreements	76,890,349		60,229,426
Repayments of repurchase agreement borrowings	(76,765,393 )		(60,609,148 )
Principal payments on non-recourse collateralized financing	(1,838 )		(747 )
Proceeds from issuance of preferred stock	1,290		25,884
Proceeds from issuance of common stock	19,281		14,495
Cash paid for stock issuance costs	(10 )		(61 )
Payments related to tax withholding for stock-based compensation	(364 )		(521 )
Dividends paid	(39,188 )		(35,479 )
Net cash and cash equivalents provided by (used in) financing activities	104,127		(376,151 )
Net increase in cash, cash equivalents, and restricted cash	26,385		62,800
Cash, cash equivalents, and restricted cash at beginning of period	87,200		98,889
Cash, cash equivalents, and restricted cash at end of period	\$ 113,585		\$ 161,689
Supplemental Disclosure of Cash			



Activity:

Cash paid for interest	\$	38,713		\$	26,766
------------------------	----	--------	--	----	--------

See notes to the unaudited consolidated financial statements.

4

---

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

DYNEX CAPITAL, INC.

(amounts in thousands except share data)

NOTE 1 – ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization

Dynex Capital, Inc., (“Company”) was incorporated in the Commonwealth of Virginia on December 18, 1987 and commenced operations in February 1988. The Company primarily earns income from investing on a leveraged basis in debt securities, the majority of which are specified pools of Agency and non-Agency mortgage-backed securities (“MBS”) consisting of residential MBS (“RMBS”), commercial MBS (“CMBS”) and CMBS interest-only (“IO”) securities that are issued or guaranteed by the U.S. Government or U.S. Government sponsored agencies (“Agency MBS”) and MBS issued by others (“non-Agency MBS”). The Company also invests in other types of mortgage-related securities, such as to-be-announced securities (“TBAs” or “TBA securities”), and in other debt securities, such as U.S. Treasury securities, which are not collateralized but are backed by the full faith and credit of the U.S. government.

Basis of Presentation

The accompanying unaudited consolidated financial statements of Dynex Capital, Inc. and its subsidiaries (together, “Dynex” or, as appropriate, the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information and with the instructions to the Quarterly Report on Form 10-Q and Article 10, Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements. In the opinion of management, all significant adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation of the consolidated financial statements have been included. Operating results for the three and nine months ended September 30, 2018 are not necessarily indicative of the results that may be expected for any other interim periods or for the entire year ending December 31, 2018. The unaudited consolidated financial statements included herein should be read in conjunction with the audited financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017 filed with the SEC.

Consolidation

The consolidated financial statements include the accounts of the Company and the accounts of its majority owned subsidiaries and variable interest entities (“VIE”) for which it is the primary beneficiary. As a primary beneficiary, the Company has both the power to direct the activities that most significantly impact the economic performance of the VIE and a right to receive benefits or absorb losses of the entity that could be potentially significant to the VIE. The Company is required to reconsider its evaluation of whether to consolidate a VIE each reporting period, based upon changes in the facts and circumstances pertaining to the VIE. The Company consolidates certain trusts through which it has securitized mortgage loans as a result of not meeting the sale criteria under GAAP at the time the financial assets were transferred to the trust. All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements as well as the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates. The most significant estimates used by management

include, but are not limited to, amortization of premiums and discounts, fair value measurements of its investments, and other-than-temporary impairments. These items are discussed further below within this note to the consolidated financial statements.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

### DYNEX CAPITAL, INC.

(amounts in thousands except share data)

#### Income Taxes

The Company has elected to be taxed as a real estate investment trust ("REIT") under the Internal Revenue Code of 1986 and the corresponding provisions of state law. To qualify as a REIT, the Company must meet certain tests including investing in primarily real estate-related assets and the required distribution of at least 90% of its annual REIT taxable income to stockholders after consideration of its net operating loss ("NOL") carryforward and not including taxable income retained in its taxable subsidiaries. As a REIT, the Company generally will not be subject to federal income tax on the amount of its income or capital gains that is distributed as dividends to shareholders.

The Company assesses its tax positions for all open tax years and determines whether the Company has any material unrecognized liabilities in accordance with Accounting Standards Codification ("ASC") Topic 740. The Company records these liabilities, if any, to the extent they are deemed more likely than not to have been incurred.

#### Net Income Per Common Share

The Company calculates basic net income per common share by dividing net income to common shareholders for the period by weighted-average shares of common stock outstanding for that period. The Company did not have any potentially dilutive securities outstanding during the three or nine months ended September 30, 2018 or September 30, 2017.

Holders of unvested shares of the Company's issued and outstanding restricted common stock are eligible to receive non-forfeitable dividends. As such, these unvested shares are considered participating securities as per ASC Topic 260-10 and therefore are included in the computation of basic net income per common share using the two-class method. Upon vesting, restrictions on transfer expire on each share of restricted stock, and each such share of restricted stock represents one unrestricted share of common stock.

Because the Company's 8.50% Series A Cumulative Redeemable Preferred Stock (the "Series A Preferred Stock") and 7.625% Series B Cumulative Redeemable Preferred Stock (the "Series B Preferred Stock") are redeemable at the Company's option for cash only and may convert into shares of common stock only upon a change of control of the Company, the effect of those shares and their related dividends is excluded from the calculation of diluted net income per common share.

#### Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

#### Restricted Cash

Restricted cash consists of cash the Company has pledged to cover initial and variation margin with its financing and derivative counterparties.

The Company has adopted Accounting Standards Update ("ASU") No. 2016-18, Statement of Cash Flows (Topic 230) - Restricted Cash, which requires amounts generally described as restricted cash or restricted cash equivalents to be included with cash and cash equivalents when reconciling the beginning of period and end of period total amounts

shown on the statement of cash flows. Because this ASU is to be applied retrospectively to each period presented, “net cash and cash equivalents used in financing activities” on the Company’s consolidated statement of cash flows for the nine months ended September 30, 2017 now omits the change in restricted cash as previously reported for that period, and that change is now included within “net increase in cash, cash equivalents, and restricted cash” in order to conform to the current period’s presentation.

The following table provides a reconciliation of cash, cash equivalents, and restricted cash reported on the Company's consolidated balance sheet as of September 30, 2018 that sum to the total of the same such amounts shown on the Company’s consolidated statement of cash flows for the nine months ended September 30, 2018:

6

---

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(amounts in thousands except share data)

	September 30, 2018
Cash and cash equivalents	\$ 55,251
Restricted cash	58,334
Total cash, cash equivalents, and restricted cash shown on consolidated statement of cash flows	\$ 113,585

## Investments in Debt Securities

The Company's investments in debt securities are designated as available-for-sale ("AFS") and are recorded at fair value on the Company's consolidated balance sheet. Changes in unrealized gain (loss) on the Company's debt securities are reported in other comprehensive income ("OCI") until the investment is sold, matures, or is determined to be other than temporarily impaired. Although the Company generally intends to hold its AFS securities until maturity, it may sell any of these securities as part of the overall management of its business. Upon the sale of an AFS security, any unrealized gain or loss is reclassified out of accumulated other comprehensive income ("AOCI") into net income as a realized "gain (loss) on sale of investments, net" using the specific identification method.

The fair value of the Company's debt securities pledged as collateral against repurchase agreements and derivative instruments is disclosed parenthetically on the Company's consolidated balance sheets.

**Interest Income, Premium Amortization, and Discount Accretion.** Interest income on debt securities is accrued based on the outstanding principal balance (or notional balance in the case of interest-only, or "IO", securities) and their contractual terms. Premiums or discounts associated with the purchase of Agency MBS as well as any non-Agency MBS rated 'AA' and higher are amortized or accreted into interest income over the expected life of such securities using the effective yield method, and adjustments to premium amortization and discount accretion are made for actual cash payments. The Company may also adjust premium amortization and discount accretion for changes in projected future cash payments. The Company's projections of future cash payments are based on input and analysis received from external sources and internal models, and include assumptions about the amount and timing of loan prepayment rates, fluctuations in interest rates, credit losses, and other factors. On at least a quarterly basis, the Company reviews and makes any necessary adjustments to its cash flow projections and updates the yield recognized on these assets. The Company does not estimate future prepayments on its fixed-rate Agency RMBS.

The Company holds certain non-Agency MBS that had credit ratings of less than 'AA' at the time of purchase or were not rated by any of the nationally recognized credit rating agencies. A portion of these non-Agency MBS were purchased at discounts to their par value, which management does not believe to be substantial. The discount is accreted into income over the security's expected life based on management's estimate of the security's projected cash flows. Future changes in the timing of projected cash flows or differences arising between projected cash flows and actual cash flows received may result in a prospective change in the effective yield on those securities.

**Determination of MBS Fair Value.** The Company estimates the fair value of the majority of its MBS based upon prices obtained from third-party pricing services and broker quotes. The remainder of the Company's MBS are valued by discounting the estimated future cash flows derived from cash flow models that utilize information such as the security's coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected losses, and credit enhancements as well as certain other relevant information. Refer to [Note 5](#) for further discussion of MBS fair value measurements.

Other-than-Temporary Impairment. An MBS is considered impaired when its fair value is less than its amortized cost. The Company evaluates all of its impaired MBS for other-than-temporary impairments (“OTTI”) on at least a quarterly basis. An impairment is considered other-than-temporary if: (1) the Company intends to sell the MBS; (2) it is more likely than not that the Company will be required to sell the MBS before its fair value recovers; or (3) the Company does not expect to recover the full amortized cost basis of the MBS. If either of the first two conditions is met, the entire amount of the impairment is recognized in earnings. If the impairment is solely due to the inability to fully recover the amortized cost basis, the security is further analyzed to quantify any credit loss, which is the difference between the present value of cash flows expected to be collected on the MBS and its amortized cost. The credit loss, if any, is then recognized in earnings, while the balance of impairment related to other factors is recognized in other comprehensive income.

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

DYNEX CAPITAL, INC.

(amounts in thousands except share data)

Following the recognition of an OTTI through earnings, a new cost basis is established for the security. Any subsequent recoveries in fair value may be accreted back into the amortized cost basis of the MBS on a prospective basis through interest income. Please see Note 2 for additional information related to the Company's evaluation for OTTI.

#### Repurchase Agreements

The Company's repurchase agreements, which are used to finance its purchases of debt securities, are accounted for as secured borrowings under which the Company pledges its securities as collateral to secure a loan, which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. The Company retains beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, the Company is required to repay the loan and concurrently receives back its pledged collateral from the lender or, with the consent of the lender, the Company may renew the agreement at the then prevailing financing rate. A repurchase agreement lender may require the Company to pledge additional collateral in the event of a decline in the fair value of the collateral pledged. Repurchase agreement financing is recourse to the Company and the assets pledged. Most of the Company's repurchase agreements are based on the September 1996 version of the Bond Market Association Master Repurchase Agreement, which generally provides that the lender, as buyer, is responsible for obtaining collateral valuations from a generally recognized source agreed to by both the Company and the lender, or, in an instance when such source is not available, the value determination is made by the lender.

#### Derivative Instruments

The Company's derivative instruments generally include interest rate swaps, Eurodollar futures, options on U.S. Treasury futures, and forward contracts for the purchase or sale of non-specified Agency RMBS, commonly referred to as "TBA securities" or "TBA contracts". Derivative instruments are accounted for at the fair value of their unit of account. Derivative instruments in a gain position are reported as derivative assets and derivative instruments in a loss position are reported as derivative liabilities on the Company's consolidated balance sheet. All periodic interest costs and changes in fair value of derivative instruments, including gains and losses realized upon termination, maturity, or settlement are recorded in "gain (loss) on derivative instruments, net" on the Company's consolidated statement of comprehensive income. Cash receipts and payments related to derivative instruments are classified in the investing activities section of the consolidated statements of cash flows in accordance with the underlying nature or purpose of the derivative transactions.

The Company's interest rate swap agreements are privately negotiated in the over-the-counter ("OTC") market and the majority of these agreements are centrally cleared through the Chicago Mercantile Exchange ("CME") with the rest being subject to bilateral agreements between the Company and the swap counterparty. The Company's CME cleared swaps require that the Company post initial margin as determined by the CME, and in addition, variation margin is exchanged, typically in cash, for changes in the fair value of the CME cleared swaps. Beginning in January 2017, as a result of a change in the CME's rulebook, the exchange of variation margin for CME cleared swaps is legally considered to be the settlement of the derivative itself as opposed to a pledge of collateral. Accordingly, beginning in 2017, the Company accounts for the daily exchange of variation margin associated with its CME cleared interest rate swaps as a direct increase or decrease to the carrying value of the related derivative asset or liability. The carrying value of derivative instruments on the Company's consolidated balance sheets is the unsettled fair value of the instruments subject to bilateral agreements and not centrally cleared through the CME.



A TBA security is a forward contract (“TBA contract”) for the purchase (“long position”) or sale (“short position”) of a non-specified 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. The Company accounts for long and short positions in TBAs as derivative instruments because the Company 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 time period possible.

Please refer to Note 4 for additional information regarding the Company’s derivative instruments as well as Note 5 for information on how the fair value of these instruments are calculated.

## NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

## DYNEX CAPITAL, INC.

(amounts in thousands except share data)

## Share-Based Compensation

Pursuant to the Company's 2018 Stock and Incentive Plan ("2018 Plan"), the Company may grant share-based compensation to eligible employees, non-employee directors or consultants or advisors to the Company, including restricted stock awards, stock options, stock appreciation rights, performance units, restricted stock units, and performance cash awards. The Company's restricted stock currently issued and outstanding may be settled only in shares of its common stock, and therefore are treated as equity awards with their fair value measured at the grant date and recognized as compensation cost over the requisite service period with a corresponding credit to shareholders' equity. The requisite service period is the period during which a participant is required to provide service in exchange for an award, which is equivalent to the vesting period specified in the terms of the time-based restricted stock award. None of the Company's restricted stock awards have performance based conditions. The Company does not currently have any share-based compensation issued or outstanding other than restricted stock issued to its employees, officers, and directors.

## Contingencies

In the normal course of business, there may be various lawsuits, claims, and other contingencies pending against the Company. On a quarterly basis, the Company evaluates whether to establish provisions for estimated losses from those matters. The Company recognizes a liability for a contingent loss when: (a) the underlying causal event has occurred prior to the balance sheet date; (b) it is probable that a loss has been incurred; and (c) there is a reasonable basis for estimating that loss. A liability is not recognized for a contingent loss when it is only possible or remotely possible that a loss has been incurred, however, possible contingent losses shall be disclosed. If the contingent loss (or an additional loss in excess of any accrual) is at least a reasonable possibility and material, then the Company discloses a reasonable estimate of the possible loss or range of loss, if such reasonable estimate can be made. If the Company cannot make a reasonable estimate of the possible material loss, or range of loss, then that fact is disclosed.

## NOTE 2 – INVESTMENTS IN DEBT SECURITIES

The majority of the Company's debt securities are pledged as collateral for the Company's repurchase agreements. The following tables present the Company's debt securities by investment type as of the dates indicated:

September 30, 2018

	Par	Net Premium (Discount)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	WAC (1)
<b>RMBS:</b>							
Agency	\$1,761,274	\$55,092	\$1,816,366	\$ 1,214	\$(42,428 )	\$1,775,152	3.92 %
Non-Agency	909	—	909	24	(20 )	913	6.75 %
	1,762,183	55,092	1,817,275	1,238	(42,448 )	1,776,065	
<b>CMBS:</b>							
Agency	987,266	9,792	997,058	363	(49,125 )	948,296	3.08 %
Non-Agency	7,027	(3,103 )	3,924	1,399	—	5,323	8.90 %
	994,293	6,689	1,000,982	1,762	(49,125 )	953,619	
<b>CMBS IO (2):</b>							
Agency	—	308,174	308,174	2,197	(1,141 )	309,230	0.59 %
Non-Agency	—	254,153	254,153	2,403	(960 )	255,596	0.59 %

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

	—	562,327	562,327	4,600	(2,101 )	564,826	
U.S. Treasuries:	—	—	—	—	—	—	— %
Total AFS securities:	\$2,756,476	\$624,108	\$3,380,584	\$ 7,600	\$(93,674 )	\$3,294,510	

9

---

- (1) The weighted average coupon (“WAC”) is the gross interest rate of the security weighted by the outstanding principal balance (or by notional balance in the case of an IO security).
- (2) The notional balance for Agency CMBS IO and non-Agency CMBS IO was \$13,238,960 and \$10,391,240 respectively, as of September 30, 2018.

	December 31, 2017						
	Par	Net Premium (Discount)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Fair Value	WAC <sup>(1)</sup>
<b>RMBS:</b>							
Agency <sup>(2)</sup>	\$1,146,553	\$46,021	\$1,192,574	\$1,626	\$(9,939)	\$1,184,261	3.56%
Non-Agency	1,070	—	1,070	41	(20)	1,091	6.75%
	1,147,623	46,021	1,193,644	1,667	(9,959)	1,185,352	
<b>CMBS:</b>							
Agency	1,123,967	10,442	1,134,409	3,514	(13,572)	1,124,351	3.03%
Non-Agency	26,501	(4,035)	22,466	2,298	—	24,764	5.47%
	1,150,468	6,407	1,156,875	5,812	(13,572)	1,149,115	
<b>CMBS IO<sup>(3)</sup>:</b>							
Agency	—	375,361	375,361	5,238	(293)	380,306	0.62%
Non-Agency	—	308,472	308,472	4,468	(724)	312,216	0.61%
	—	683,833	683,833	9,706	(1,017)	692,522	
U.S. Treasuries:	148,400	(133)	148,267	—	(1,737)	146,530	2.13%

Total AFS securities: \$2,446,491 \$736,128 \$3,182,619 \$17,185 \$(26,285) \$3,173,519

- (1) The WAC is the gross interest rate of the security weighted by the outstanding principal balance (or by notional balance in the case of an IO security).
- (2) Includes purchased securities pending settlement.
- (3) The notional balance for the Agency CMBS IO and non-Agency CMBS IO was \$14,196,122 and \$11,006,463, respectively, as of December 31, 2017.

Actual maturities of MBS are affected by the contractual lives of the underlying mortgage collateral, periodic payments of principal, prepayments of principal, and the payment priority structure of the security; therefore, actual maturities are generally shorter than the securities' stated contractual maturities. The following table categorizes the Company's debt securities according to their stated maturity as of the dates indicated:

	September 30, 2018		December 31, 2017	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Less than 1 year	\$47,271	\$47,217	\$4,480	\$4,542
>1 and <5 years	158,325	159,007	208,046	210,727
>5 and <10 years	935,687	893,930	1,334,795	1,326,178
> 10 years	2,239,301	2,194,356	1,635,298	1,632,072
	\$3,380,584	\$3,294,510	\$3,182,619	\$3,173,519

The following table presents information regarding the sales that generated the “loss on sale of investments, net” on the Company's consolidated statements of comprehensive income for the periods indicated:

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

	Three Months Ended			
	September 30, 2018		2017	
	Proceeds Received	Realized Gain (Loss)	Proceeds Received	Realized Gain (Loss)
Agency RMBS	\$—	\$—	\$393,502	\$(5,160 )
Agency CMBS	48,237	(1,720 )	13,433	(51 )
Agency CMBS IO	10,571	127	—	—
U.S. Treasuries	57,843	(133 )	—	—
	\$116,651	\$(1,726 )	\$406,935	\$(5,211 )

	Nine Months Ended			
	September 30, 2018		2017	
	Proceeds Received	Realized Gain (Loss)	Proceeds Received	Realized Gain (Loss)
Agency RMBS	\$217,837	\$(7,785 )	\$716,560	\$(12,392)
Agency CMBS	156,995	(3,771 )	206,993	523
Agency CMBS IO	10,571	127	—	—
Non-Agency CMBS	—	—	35,705	1,199
Non-Agency RMBS	—	—	16,407	42
Non-Agency CMBS IO	8,695	51	—	—
U.S. Treasuries	248,802	(6,567 )	—	—
	\$642,900	\$(17,945)	\$975,665	\$(10,628)

The following table presents certain information for the AFS securities in an unrealized loss position as of the dates indicated:

	September 30, 2018			December 31, 2017		
	Fair Value	Gross Unrealized Losses	# of Securities	Fair Value	Gross Unrealized Losses	# of Securities
Continuous unrealized loss position for less than 12 months:						
Agency MBS	\$1,540,220	\$(29,765 )	91	\$1,293,798	\$(9,769 )	71
Non-Agency MBS	79,326	(447 )	23	51,406	(421 )	11
U.S. Treasuries	—	—	0	146,530	(1,737 )	1
Continuous unrealized loss position for 12 months or longer:						
Agency MBS	\$1,064,620	\$(62,929 )	58	\$423,698	\$(14,035 )	30
Non-Agency MBS	31,282	(533 )	13	20,414	(323 )	12

Because the principal related to Agency MBS is guaranteed by the government-sponsored entities Fannie Mae and Freddie Mac which have the implicit guarantee of the U.S. government, the Company does not consider any of the unrealized losses on its Agency MBS to be credit related. Although the unrealized losses are not credit related, the Company assesses its ability and intent to hold any Agency MBS with an unrealized loss until the recovery in its value in accordance with GAAP.



This assessment is based on the amount of the unrealized loss and significance of the related investment as well as the Company's leverage and liquidity position. Based on this analysis, the Company has determined that the unrealized losses on its Agency MBS as of September 30, 2018 and December 31, 2017 were temporary.

The Company reviews any non-Agency MBS in an unrealized loss position to evaluate whether any decline in fair value represents an OTTI. The evaluation includes a review of the credit ratings of the non-Agency MBS, the credit characteristics of the mortgage loans collateralizing these securities, and the estimated future cash flows including projected collateral losses. The Company performed this evaluation for its non-Agency MBS in an unrealized loss position and has determined that there have not been any adverse changes in the timing or amount of estimated future cash flows that necessitate a recognition of OTTI amounts as of September 30, 2018 or December 31, 2017.

### NOTE 3 – REPURCHASE AGREEMENTS

The Company's repurchase agreements outstanding as of September 30, 2018 and December 31, 2017 are summarized in the following tables:

Collateral Type	September 30, 2018			December 31, 2017		
	Balance	Weighted Average Rate	Fair Value of Collateral Pledged	Balance	Weighted Average Rate	Fair Value of Collateral Pledged
Agency RMBS	\$1,362,687	2.26 %	\$1,423,415	\$836,281	1.47 %	\$867,120
Agency CMBS	840,346	2.22 %	897,077	1,003,146	1.44 %	1,071,904
Agency CMBS IO	271,305	2.72 %	302,403	324,163	2.17 %	372,077
Non-Agency CMBS IO	216,520	3.11 %	255,090	263,694	2.43 %	311,571
Non-Agency CMBS	—	— %	—	15,508	2.47 %	18,212
U.S. Treasuries	—	— %	—	123,110	1.85 %	124,215
Total repurchase agreements	\$2,690,858	2.36 %	\$2,877,985	\$2,565,902	1.67 %	\$2,765,099

The Company also had \$182,922 and \$156,899 payable to counterparties as of September 30, 2018 and December 31, 2017, respectively, which consisted of securities pending settlement as of those respective dates.

The following table provides information on the remaining term to maturity and original term to maturity for the Company's repurchase agreements as of the dates indicated:

Remaining Term to Maturity	September 30, 2018		December 31, 2017	
	Balance	WAVG Original Term to Maturity	Balance	WAVG Original Term to Maturity
Less than 30 days	\$2,081,391	45	\$2,240,791	49
30 to 90 days	609,467	91	274,231	90
91 to 180 days	—	—	50,880	121
Total	\$2,690,858	55	\$2,565,902	54

The following table lists the counterparties with whom the Company had approximately 10% or more of its shareholders' equity at risk (defined as the excess of collateral pledged over the borrowings outstanding):

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

Counterparty Name	September 30, 2018		
	Balance	Weighted Average Rate	Equity at Risk
Wells Fargo Bank, N. A. and affiliates	\$ 303,564	2.93 %	\$ 47,192

Of the amount outstanding with Wells Fargo Bank, N.A. and affiliates, \$228,992 is under a committed repurchase facility which has an aggregate maximum borrowing capacity of \$400,000 and is scheduled to mature on May 12, 2019, subject to early termination provisions contained in the master repurchase agreement. The facility is collateralized by CMBS IO, and its weighted average borrowing rate as of September 30, 2018 was 3.10%.

As of September 30, 2018, the Company had repurchase agreement amounts outstanding with 17 of its 35 available repurchase agreement counterparties. The Company's counterparties, as set forth in the master repurchase agreement with the counterparty, require the Company to comply with various customary operating and financial covenants, including, but not limited to, minimum net worth and earnings, maximum declines in net worth in a given period, and maximum leverage requirements as well as maintaining the Company's REIT status. In addition, some of the agreements contain cross default features, whereby default under an agreement with one lender simultaneously causes default under agreements with other lenders. To the extent that the Company fails to comply with the covenants contained in these financing agreements or is otherwise found to be in default under the terms of such agreements, the counterparty has the right to accelerate amounts due under the master repurchase agreement. The Company was in full compliance with all covenants as of September 30, 2018.

The Company's repurchase agreements are subject to underlying agreements with master netting or similar arrangements, which provide for the right of offset in the event of default or in the event of bankruptcy of either party to the transactions. The Company reports its repurchase agreements to these arrangements on a gross basis. The following tables present information regarding the Company's repurchase agreements as if the Company had presented them on a net basis as of September 30, 2018 and December 31, 2017:

	Gross Amount of Recognized Liabilities	Gross Amount Offset in the Balance Sheet	Net Amount of Liabilities in the Balance Sheet	Gross Amount Not Offset in the Financial Instruments Posted as Collateral	Cash Posted as Collateral	Net Amount
September 30, 2018						
Repurchase agreements	\$ 2,690,858	\$ —	—\$ 2,690,858	\$(2,690,858)	\$ —	—
December 31, 2017						
Repurchase agreements	\$ 2,565,902	\$ —	—\$ 2,565,902	\$(2,565,902)	\$ —	—

Amounts disclosed for collateral received by or posted to the same counterparty include cash and the fair value of (1) debt securities up to and not exceeding the net amount of the asset or liability presented in the balance sheet. The fair value of the total collateral received by or posted to the same counterparty may exceed the amounts presented.

Please see Note 4 for information related to the Company's derivatives which are also subject to underlying agreements with master netting or similar arrangements.

NOTE 4 – DERIVATIVES

The Company is a party to certain types of financial instruments that are accounted for as derivative instruments. Please refer to Note 1 for information related to the Company's accounting policy for its derivative instruments.



Types and Uses of Derivatives Instruments

Interest Rate Derivatives. Changing interest rates impact the fair value of the Company's investments as well as the interest rates on the Company's repurchase agreement borrowings used to finance its investments. The Company primarily uses

13

---

interest rate swaps and Eurodollar futures as economic hedges to mitigate declines in book value and to protect some portion of the Company's earnings from rising interest rates.

TBA Transactions. The Company also holds long positions in TBA securities 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 long positions in TBA securities (“dollar roll positions”) are viewed by management as economically equivalent to investing in and financing non-specified fixed-rate Agency RMBS. TBA securities purchased for a forward settlement month are generally priced at a discount relative to TBA securities 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.

Periodically, the Company may also hold short positions in TBA securities for the purpose of economically hedging a portion of the impact of changing interest rates on the fair value of the Company’s fixed-rate Agency RMBS. The Company did not hold any short positions in TBA securities as of September 30, 2018.

Other Derivatives. The Company periodically utilizes options on Treasury futures in order to manage the duration of the Company’s investment portfolio while minimizing the impact on the Company’s exposure to the spread risk inherent in owning MBS. The options on Treasury futures outstanding as of September 30, 2018 will expire during the fourth quarter of 2018.

The table below summarizes information about the fair value by type of derivative instrument on the Company’s consolidated balance sheets as of the dates indicated:

Type of Derivative Instrument	Balance Sheet Location	Purpose	September 30, 2018	December 31, 2017
Interest rate swaps	Derivative assets	Economic hedging	\$ 694	\$ 791
Eurodollar futures	Derivative assets	Economic hedging	—	666
TBA securities	Derivative assets	Trading	871	1,483
Call Options on U.S. Treasury futures	Derivative assets	Trading	328	—
Put Options on U.S. Treasury futures	Derivative assets	Trading	719	—
			\$ 2,612	\$ 2,940
TBA securities	Derivative liabilities	Trading	\$ (2,039 )	\$ —
TBA securities	Derivative liabilities	Economic hedging	—	(269 )
			\$ (2,039 )	\$ (269 )

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

The following tables present information about the Company's interest rate swaps as of the dates indicated:

September 30, 2018

Years to Maturity:	Weighted-Average:			Fair Value (3)
	Net Notional Amount (1)	Pay Rate (2)	Life Remaining (in Years)	
< 3 years	\$1,520,000	2.01 %	1.4	\$ 694
>3 and < 6 years	1,290,000	2.10 %	4.1	—
>6 and < 10 years	1,150,000	2.61 %	7.9	—
>10 years	220,000	2.81 %	22.2	—
Total	\$4,180,000	2.24 %	5.1	\$ 694

December 31, 2017

Years to Maturity:	Weighted-Average:			Fair Value (3)
	Net Notional Amount (1)	Pay Rate (2)	Life Remaining (in Years)	
< 3 years	\$3,320,000	1.35 %	0.7	\$ 791
>3 and < 6 years	1,210,000	2.00 %	4.6	—
>6 and < 10 years	1,025,000	2.49 %	8.0	—
>10 years	120,000	2.75 %	17.3	—
Total	\$5,675,000	1.71 %	3.1	\$ 791

The net notional amounts included in the tables above represent pay-fixed interest rate swaps, net of any (1) receive-fixed interest rate swaps, and include \$1,525,000 and \$2,655,000 of pay-fixed forward starting interest rate swaps as of September 30, 2018 and December 31, 2017, respectively.

(2) Excluding forward starting pay-fixed interest rate swaps, the weighted average pay rate was 1.66% and 1.36% as of September 30, 2018 and December 31, 2017, respectively.

The majority of the Company's interest rate swap agreements are centrally cleared through the CME. Please refer to (3) Note 1 for information regarding the exchange of variation margin being legally considered as settlement of the derivative as opposed to a pledge of collateral.

The following table summarizes information about the Company's TBA securities as of the dates indicated:

September 30, 2018

TBA Securities:	Notional Amount (1)	Implied Cost Basis (2)	Implied Market Value (3)	Net Carrying Value (4)
Dollar roll positions	\$761,000	\$780,865	\$779,697	\$(1,168 )
Economic hedges	\$—	\$—	\$—	\$—

December 31, 2017

TBA Securities:	Notional Amount (1)	Implied Cost Basis (2)	Implied Market Value (3)	Net Carrying Value (4)
Dollar roll positions	\$795,000	\$829,425	\$830,908	\$1,483
Economic hedges	\$150,000	\$(153,797)	\$(154,066)	\$(269 )

(1) Notional amount represents the par value (or principal balance) of the underlying Agency MBS as if settled as of the end of the period.

(2) Implied cost basis represents the forward price to be paid for the underlying Agency MBS as if settled as of end of the period.

(3) Implied market value represents the estimated fair value of the underlying Agency MBS as if settled as of the end of the period.



Net carrying value is the amount included on the consolidated balance sheets within “derivative assets (liabilities)” (4) and represents the difference between the implied market value and the implied cost basis of the TBA security as of the end of the period.

The tables below summarize changes in the Company’s derivative instruments for the periods indicated:

Type of Derivative Instrument	Notional Amount as of December 31, 2017	Additions	Settlements, Terminations, or Pair-Offs	Notional Amount as of September 30, 2018
Receive-fixed interest rate swaps	\$ 100,000	\$ —	—\$(100,000 )	\$ —
Pay-fixed interest rate swaps	5,775,000	955,000	(2,550,000 )	4,180,000
Eurodollar futures <sup>(1)</sup>	1,950,000	—	(1,950,000 )	—
TBA dollar roll positions	795,000	7,857,000	(7,891,000 )	761,000
TBA economic hedges	150,000	—	(150,000 )	—
Call Options on U.S. Treasury futures	—	100,000	—	100,000
Put Options on U.S. Treasury futures	—	400,000	(300,000 )	100,000

The Eurodollar futures notional amounts represent the total notional of the 3-month contracts all of which expire in (1)2018. The maximum notional outstanding for any future 3-month period did not exceed \$650,000 during the period indicated.

The table below provides detail of the Company’s “gain (loss) on derivative instruments, net” by type of derivative for the periods indicated:

Type of Derivative Instrument	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Receive-fixed interest rate swaps	\$(153 )	\$(99 )	\$(1,658 )	\$746
Pay-fixed interest rate swaps	25,172	(611 )	95,491	(18,799 )
Eurodollar futures	(189 )	—	1,886	—
TBA dollar roll positions	(5,204 )	6,703	(18,256 )	8,419
TBA economic hedges	—	—	293	—
Call Options on U.S. Treasury futures	148	—	148	—
Put Options on U.S. Treasury futures	(275 )	—	616	—
Gain (loss) on derivative instruments, net	\$ 19,499	\$ 5,993	\$ 78,520	\$(9,634)

There is a net unrealized gain of \$240 remaining in AOCI on the Company’s consolidated balance sheet as of September 30, 2018 which represents the activity related to interest rate swap agreements while they were previously designated as cash flow hedges, and this amount will be recognized in the Company’s net income as an adjustment to “interest expense” over the remaining contractual life of the agreements. The Company estimates a credit of \$177 will be reclassified to net income as a reduction of “interest expense” within the next 12 months.

A portion of the Company’s interest rate swaps were entered into under bilateral agreements which contain cross-default provisions with other agreements between the parties. In addition, these bilateral agreements contain financial and operational covenants similar to those contained in the repurchase agreements as described in Note 3. The Company was in compliance with all covenants with respect to bilateral agreements under which interest rate swaps were entered into as of September 30, 2018.

The Company's derivatives are subject to underlying agreements with master netting or similar arrangements, which provide for the right of offset in the event of default or in the event of bankruptcy of either party to the transactions.

The Company reports its derivative assets and liabilities subject to these arrangements on a gross basis. The following tables present information

16

---

regarding those derivative assets and liabilities subject to such arrangements as if the Company had presented them on a net basis as of September 30, 2018 and December 31, 2017:

Offsetting of Assets

	Gross Amount of Recognized Assets	Gross Amount Offset in the Balance Sheet	Net Amount of Assets Presented in the Balance Sheet	Gross Amount Not Offset in the Balance Sheet <sup>(1)</sup>		Net Amount
				Financial Instruments Received as Collateral	Cash Received as Collateral	
September 30, 2018						
Interest rate swaps	\$694	\$ —	—\$ 694	\$—	\$ —	\$ 694
Eurodollar Futures	—	—	—	—	—	—
TBA securities	871	—	871	(346 )	(123 )	402
Options on U.S. Treasury futures	1,047	—	1,047	(1,047 )	—	—
Derivative assets	\$2,612	\$ —	—\$ 2,612	\$(1,393 )	\$ (123 )	\$ 1,096
December 31, 2017						
Interest rate swaps	\$791	\$ —	—\$ 791	\$—	\$ —	\$ 791
Eurodollar Futures	666	—	666	—	(666 )	—
TBA securities	1,483	—	1,483	(180 )	—	1,303
Options on U.S. Treasury futures	—	—	—	—	—	—
Derivative assets	\$2,940	\$ —	—\$ 2,940	\$(180 )	\$ (666 )	\$ 2,094

Offsetting of Liabilities

	Gross Amount of Recognized Liabilities	Gross Amount Offset in the Balance Sheet	Net Amount of Liabilities Presented in the Balance Sheet	Gross Amount Not Offset in the Balance Sheet <sup>(1)</sup>		Net Amount
				Financial Instruments Posted as Collateral	Cash Posted as Collateral	
September 30, 2018						
Interest rate swaps	\$—	\$ —	—\$ —	\$—	\$ —	\$ —
TBA securities	2,039	—	2,039	(346 )	(873 )	820
Derivative liabilities	\$2,039	\$ —	—\$ 2,039	\$(346 )	\$ (873 )	\$ 820
December 31, 2017						
Interest rate swaps	\$—	\$ —	—\$ —	\$—	\$ —	\$ —
TBA securities	269	—	269	(180 )	—	89
Derivative liabilities	\$269	\$ —	—\$ 269	\$(180 )	\$ —	\$ 89

Amounts disclosed for collateral received by or posted to the same counterparty include cash and the fair value of (1)MBS up to and not exceeding the net amount of the asset or liability presented in the balance sheet. The fair value of the total collateral received by or posted to the same counterparty may exceed the amounts presented.

Please see [Note 3](#) for information related to the Company's repurchase agreements which are also subject to underlying agreements with master netting or similar arrangements.





## NOTE 5 – FAIR VALUE OF FINANCIAL INSTRUMENTS

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. ASC Topic 820 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and also requires an entity to consider all aspects of nonperformance risk, including the entity's own credit standing, when measuring fair value of a liability. ASC Topic 820 established a valuation hierarchy of three levels as follows:

Level 1 – Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities as of the measurement date.

Level 2 – Inputs include quoted prices in active markets for similar assets or liabilities; quoted prices in inactive markets for identical or similar assets or liabilities; or inputs either directly observable or indirectly observable through correlation with market data at the measurement date and for the duration of the instrument's anticipated life.

Level 3 – Unobservable inputs are supported by little or no market activity. The unobservable inputs represent management's best estimate of how market participants would price the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

The Company reviews the classification of its financial instruments within the fair value hierarchy on a quarterly basis, and management may conclude that its financial instruments should be reclassified to a different level in the future if a change in type of inputs occurs.

The following table presents the Company's financial instruments that are measured at fair value on a recurring basis by their valuation hierarchy levels as of the dates indicated:

	September 30, 2018			
	Fair Value	Level 1 - Unadjusted Quoted Prices in Active Markets	Level 2 - Observable Inputs	Level 3 - Unobservable Inputs
Assets carried at fair value:				
Investments in securities:				
Mortgage-backed securities	\$3,294,510	\$ —	\$3,288,274	\$ 6,236
U.S. Treasuries	—	—	—	—
Derivative assets:				
Interest rate swaps	694	—	694	—
Eurodollar futures	—	—	—	—
TBA securities	871	—	871	—
Options on U.S. Treasury futures	1,047	1,047	—	—
Total assets carried at fair value	\$3,297,122	\$ 1,047	\$3,289,839	\$ 6,236
Liabilities carried at fair value:				
TBA securities	2,039	—	2,039	—
Total liabilities carried at fair value	\$2,039	\$ —	\$2,039	\$ —

	December 31, 2017			
	Fair Value	Level 1 - Unadjusted Quoted Prices in Active Markets	Level 2 - Observable Inputs	Level 3 - Unobservable Inputs
Assets carried at fair value:				
Investments in securities:				
Mortgage-backed securities	\$3,026,989	\$ —	\$3,019,746	\$ 7,243
U.S. Treasuries	146,530	146,530	—	—
Derivative assets:				
Interest rate swaps	791	—	791	—
Eurodollar futures	666	666	—	—
TBA securities	1,483	—	1,483	—
Total assets carried at fair value	\$3,176,459	\$ 147,196	\$3,022,020	\$ 7,243
Liabilities carried at fair value:				
TBA securities	269	—	269	—
Total liabilities carried at fair value	\$269	\$ —	\$269	\$ —

The fair value of interest rate swaps is measured using the income approach with the primary input being the forward interest rate swap curve, which is considered an observable input, and thus their fair values are considered Level 2 measurements. Eurodollar futures and options on U.S. Treasury futures are valued based on closing exchange prices on these contracts and are classified accordingly as Level 1 measurements. The fair value of TBA securities is estimated using methods similar those used to fair value the Company's Level 2 MBS.



The fair value measurements for a majority of the Company's MBS are considered Level 2 because these securities are substantially similar to securities that either are actively traded or have been recently traded in their respective markets. The Company determines the fair value of its Level 2 securities based on prices received from the Company's primary pricing service as well as other pricing services and brokers. The Company evaluates the third party prices it receives to assess their reasonableness. Although the Company does not adjust third party prices, they may be excluded from use in the determination of a security's fair value if they are significantly different from other observable market data. In valuing a security, the primary pricing service uses either a market approach, which uses observable prices and other relevant information that is generated by market transactions of identical or similar securities, or an income approach, which uses valuation techniques to convert future amounts to a single, discounted present value amount. The Company also reviews the assumptions and inputs utilized in the valuation techniques of its primary pricing service. Examples of these observable inputs and assumptions include market interest rates, credit spreads, and projected prepayment speeds, among other things.

The Company owns certain non-Agency MBS for which there are not sufficiently recent trades of substantially similar securities, and their fair value measurements are thus considered Level 3. The Company determines the fair value of its Level 3 securities by discounting the estimated future cash flows derived from cash flow models using significant inputs which are determined by the Company when market observable inputs are not available. Information utilized in those pricing models include the security's credit rating, coupon rate, estimated prepayment speeds, expected weighted average life, collateral composition, estimated future interest rates, expected credit losses, and credit enhancement as well as certain other relevant information. Significant changes in any of these inputs in isolation may result in a significantly different fair value measurement. Level 3 assets are generally most sensitive to the default rate and severity assumptions.

The activity of the Company's non-Agency MBS measured at fair value on a recurring basis using Level 3 inputs is presented in the following table for the periods indicated:

	Nine Months Ended September 30, 2018	
Balance as of beginning of period	\$	7,243
Unrealized loss included in OCI	(862	)
Principal payments	(1,031	)
Accretion	886	
Balance as of end of period	\$	6,236

The following table presents a summary of the carrying value and estimated fair values of the Company's financial instruments as of the dates indicated:

	September 30, 2018		December 31, 2017	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets:				
Mortgage-backed securities	\$3,294,510	\$3,294,510	\$3,026,989	\$3,026,989
U.S. Treasuries	—	—	146,530	146,530
Mortgage loans held for investment, net <sup>(1)</sup>	12,342	9,165	15,738	12,973
Derivative assets	2,612	2,612	2,940	2,940
Liabilities:				
Repurchase agreements <sup>(2)</sup>	\$2,690,858	\$2,690,858	\$2,565,902	\$2,565,902
Non-recourse collateralized financing <sup>(1)</sup>	3,709	3,742	5,520	5,554
Derivative liabilities	2,039	2,039	269	269

The Company determines the fair value of its mortgage loans held for investment, net and its non-recourse (1) collateralized financing using internally developed cash flow models with inputs similar to those used to estimate the fair value of the Company's Level 3 non-Agency MBS.

(2) The carrying value of repurchase agreements generally approximates fair value due to their short-term maturities.

#### NOTE 6 – SHAREHOLDERS' EQUITY AND SHARE-BASED COMPENSATION

##### Preferred Stock

The Company's articles of incorporation authorize the issuance of up to 50,000,000 shares of preferred stock, par value \$0.01 per share, of which the Company's Board of Directors has designated 8,000,000 shares of 8.50% Series A Preferred Stock and 7,000,000 shares of 7.625% Series B Preferred Stock, (the Series A Preferred Stock and the Series B Preferred Stock collectively, the "Preferred Stock"). The Company had 2,300,000 shares of its Series A Preferred Stock and 3,641,659 shares of its Series B Preferred Stock issued and outstanding as of September 30, 2018 compared to 2,300,000 shares of Series A Preferred Stock and 3,588,680 shares of Series B Preferred Stock as of December 31, 2017.

The Preferred Stock has no maturity and will remain outstanding indefinitely unless redeemed or otherwise repurchased or converted into common stock pursuant to the terms of the Preferred Stock. The Company's Preferred Stock may be redeemed in whole, or in part, at any time and from time to time at the Company's option at a cash redemption price of \$25.00 per share plus any accumulated and unpaid dividends. Because the Preferred Stock is redeemable only at the option of the issuer, it is classified as equity on the Company's consolidated balance sheet. The Series A Preferred Stock pays a cumulative cash dividend equivalent to 8.50% of the \$25.00 liquidation preference per share each year and the Series B Preferred Stock pays a cumulative cash dividend equivalent to 7.625% of the \$25.00 liquidation preference per share each year. The Company paid its regular quarterly dividends on its Preferred Stock for the third quarter on October 15, 2018 to shareholders of record as of October 1, 2018.

##### Common Stock

The Company declared a third quarter common stock dividend of \$0.18 per share that was paid on October 31, 2018 to shareholders of record as of October 3, 2018.

Stock and Incentive Plans. The Company's Board adopted the 2018 Stock and Incentive Plan which was approved by the Company's shareholders on May 15, 2018. The 2018 Plan, which replaced the Company's 2009 Stock and Incentive Plan (the "2009 Plan"), reserves for issuance up to 3,000,000 shares of common stock for eligible employees, non-employee directors, consultants, and advisors to the Company to be granted in the form of stock options,

restricted stock awards, restricted stock units, stock appreciation rights, performance units, and performance cash awards. During the nine months ended September 30,

21

---

2018, 36,924 shares of restricted stock were issued under the 2018 Plan. Awards previously granted under the 2009 Plan will remain outstanding in accordance with their terms, but the Company will not grant any new equity awards under the 2009 Plan.

Total stock-based compensation expense recognized by the Company for the three and nine months ended September 30, 2018 was \$301 and \$930, respectively, compared to \$388 and \$1,567, respectively, for the three and nine months ended September 30, 2017. The following table presents a rollforward of the restricted stock activity for the periods indicated:

	Three Months Ended September 30,			
	2018		2017	
	Shares	Weighted Average Grant Date Fair Value Per Share	Shares	Weighted Average Grant Date Fair Value Per Share
Restricted stock outstanding as of beginning of period	341,713	\$ 6.37	353,103	\$ 7.01
Restricted stock granted	—	—	—	—
Restricted stock vested	—	—	—	—
Restricted stock outstanding as of end of period	341,713	\$ 6.37	353,103	\$ 7.01

  

	Nine Months Ended September 30,			
	2018		2017	
	Shares	Weighted Average Grant Date Fair Value Per Share	Shares	Weighted Average Grant Date Fair Value Per Share
Restricted stock outstanding as of beginning of period	353,103	\$ 7.01	553,396	\$ 7.55
Restricted stock granted	213,157	6.28	138,166	6.76
Restricted stock vested	(224,547)	7.28	(338,459)	7.80
Restricted stock outstanding as of end of period	341,713	\$ 6.37	353,103	\$ 7.01

As of September 30, 2018, the grant date fair value of the Company's remaining nonvested restricted stock is \$1,534 which will be amortized into compensation expense over a weighted average period of 1.8 years.

#### NOTE 7 – SUBSEQUENT EVENTS

Management has evaluated events and circumstances occurring as of and through the date this Quarterly Report on Form 10-Q was filed with the SEC and has determined that there have been no significant events or circumstances that qualify as a "recognized" or "nonrecognized" subsequent event as defined by ASC Topic 855.

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

The following discussion should be read in conjunction with our unaudited financial statements and the accompanying notes included in Part 1, Item 1. "Financial Statements" in this Quarterly Report on Form 10-Q and our audited financial statements and the accompanying notes included in Part II, Item 8 in our Annual Report on Form 10-K for the year ended December 31, 2017. References herein to "Dynex," the "Company," "we," "us," and "our" include Dynex Capital, Inc. and its consolidated subsidiaries, unless the context otherwise requires. In addition to current and historical information, the following discussion and analysis contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements relate to our future business, financial condition or results of operations. For a description of certain factors that may have a significant impact on our future business, financial condition or results of operations, see "Forward-Looking Statements" at the end of this discussion and analysis.

For more information about our business including our operating policies, investment philosophy and strategy, financing and hedging strategies, and other important information, please refer to Part I, Item 1 of our Annual Report on Form 10-K for the year ended December 31, 2017.

### EXECUTIVE OVERVIEW

#### 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"). We finance our investments principally with borrowings under repurchase agreements. Our common stock is traded on the New York Stock Exchange ("NYSE") under the symbol "DX". 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 regular quarterly dividends and also through capital appreciation.

We also 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".

We invest in Agency and non-Agency MBS consisting of 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 have no such guaranty of payment. 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 may also invest in debt securities issued by the United States Department of the Treasury ("the Treasury" and such securities, "U.S. Treasuries").

**RMBS.** The majority of our RMBS are 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 and financing 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 purchases of TBAs 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. We refer to these net long

positions in TBAs as “dollar roll positions” and 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 may also enter into short positions in TBAs as economic hedges. We account for all TBAs (whether dollar roll positions or economic hedges) 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.** The majority of our CMBS investments are fixed-rate Agency-issued securities backed by multifamily housing loans. The remainder of our CMBS portfolio contains non-Agency issued securities backed by multifamily housing as well as other commercial real estate property types such as office building, retail, hospitality, and health care. 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.

**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 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.

**Financing.** 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. These 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. One of our repurchase agreement lenders provides a committed repurchase agreement financing facility to us with an aggregate borrowing capacity of \$400.0 million that expires in May 2019.

**Hedging.** We use derivatives, primarily interest rate swaps, to hedge our exposure to changes in interest rates. Such exposure results from our ownership of investments which are primarily fixed-rate and financed with repurchase agreements which have adjustable rates and significantly shorter maturities than the weighted average life of our investments. Changes in interest rates can impact the market value of our investments and our net interest income, thereby ultimately impacting book value per common share. We frequently adjust our hedging portfolio based on our expectation of future interest rates, including the absolute level of rates and the slope of the yield curve versus market

expectations.

#### Factors that Affect Our Financial Condition and Results of Operations

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) as measures of our financial performance. 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

24

---

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 which are discussed in "Liquidity and Capital Resources" within this Item 2 and in Part I, Item 3, "Quantitative and Qualitative Disclosures About Market Risk" of this Quarterly Report on Form 10-Q as well as in Item 1A, "Risk Factors" of Part I of our Annual Report on Form 10-K for the year ended December 31, 2017. Please see these Items for a detailed discussion of these risks and the potential impact on our results of operations and financial condition.

#### Market Conditions and Recent Activity

Interest rates rose during the third quarter of 2018 approximately 25 basis points across the curve and modestly flattened. The difference in the 2-year U.S. Treasury and the 10-year U.S. Treasury stood at 24 basis points September 30, 2018 versus 33 basis points at June 30, 2018 and 52 basis points at December 31, 2017. A flattening yield curve puts pressure on the net interest spread we earn on our investments, reflecting the generally higher borrowing costs as interest rates rise. As of October 31, 2018, markets are pricing in three more increases in the Federal Funds target rate through 2019.

As we have noted in the past, we anticipate that economic data globally and in the U.S. will continue to be stable for the near term. Underlying fundamentals support continued economic growth, particularly in the U.S. However, interest rates have moved up significantly since the Federal Reserve began to raise the Federal Funds Rate in December 2015, and we believe potential negative side effects are already developing in the global economy and global capital markets. We continue to remain cautious given the fragile global economic environment which is dependent on ever increasing levels of debt and is exposed to a high potential for fiscal or monetary policy mistakes.

Due to these and other macroeconomic challenges facing the U.S. and global markets today, we believe that interest rates cannot move above the current range of the 10-year U.S. Treasury for any meaningful amount of time without negative consequences to the economy.

Overall credit market volatility continued to be muted during the third quarter of 2018 and credit-sensitive assets remain near their highest prices. Spread widening that occurred in the second quarter of 2018 largely reversed itself in the third quarter of 2018.

The chart below shows the highest and lowest rates during the three months ended September 30, 2018 as well as the rates as of September 30, 2018 and June 30, 2018 for the indicated U.S. Treasury securities:

The chart below shows the highest and lowest swap rates during the three months ended September 30, 2018 as well as the swap rates as of September 30, 2018 and June 30, 2018:

## Highlights of the Third Quarter of 2018

Comprehensive income to common shareholders was \$0.7 million for the third quarter of 2018 versus \$3.0 million for the second quarter of 2018. Higher interest rates principally drove the decline in comprehensive income as unrealized losses on MBS increased while gains on related hedges decreased. Net income to common shareholders increased \$9.9 million to \$22.6 million for the third quarter compared to \$12.7 million for the second quarter of 2018 due primarily to lower loss on sales of investments. Net interest income increased \$0.4 million from the second quarter of 2018 to the third quarter of 2018 due to improved effective yields on investments as a result of recent purchases of higher yielding fixed rate MBS and increased prepayment penalty compensation earned on CMBS IO.

Net interest spread was relatively flat, increasing 1 basis point to 1.08% for the third quarter of 2018 compared to 1.07% for the prior quarter. Though we had a larger average balance of higher yielding fixed-rate Agency RMBS and higher prepayment compensation on CMBS IO for the third quarter of 2018 compared to the prior quarter, those benefits were almost entirely offset by higher cost of repurchase agreement financing as a result of increasing short-term interest rates. As shown in the table below, there has been a downward trend in net interest spread for the majority of our investments as a result of increasing short-term borrowing rates:

Quarter Ended	Agency MBS <sup>(1)</sup>			CMBS IO <sup>(2)</sup>			Non-Agency Other <sup>(3)</sup>		
	Yield	Cost <sup>(4)</sup>	Net Yield	Yield	Cost <sup>(4)</sup>	Net Yield	Yield	Cost <sup>(4)</sup>	Net Yield
September 30, 2018	3.12%	2.13%	0.99%	3.98%	2.76%	1.22%	30.31%	—	30.31%
June 30, 2018	2.94%	1.93%	1.01%	3.78%	2.59%	1.19%	30.67%	—	30.67%
March 31, 2018	2.85%	1.60%	1.25%	3.84%	2.33%	1.51%	11.37%	2.47%	8.90%
December 31, 2017	2.77%	1.36%	1.41%	3.82%	2.13%	1.69%	10.21%	2.24%	7.97%
September 30, 2017	2.51%	1.27%	1.24%	3.89%	2.10%	1.79%	9.21%	2.24%	6.97%

(1) Includes Agency RMBS and CMBS.

(2) Includes Agency and non-Agency issued securities.

(3) Includes privately-issued RMBS and CMBS.

(4) 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.

Core net operating income to common shareholders, a non-GAAP measure, increased to \$10.8 million for the third quarter of 2018 from \$10.4 million for the second quarter of 2018 due substantially to an increase in adjusted net interest income of \$0.5 million. Adjusted net interest income, a non-GAAP measure, increased for the third quarter of 2018 compared to the prior quarter from the improved effective yields noted above, and also from a higher average volume of TBA dollar roll transactions that generated an increase in TBA drop income, partially offset by a lower benefit from net periodic interest on interest rate swaps for the third quarter of 2018 compared to the prior quarter.

Adjusted net interest spread for the third quarter of 2018 decreased 10 basis points compared to the second quarter of 2018 primarily because the Company's net receive rate on its interest rate swaps declined 9 basis points, resulting in a lower net periodic interest benefit. In addition, although TBA drop income was \$0.6 million higher during the third quarter of 2018 compared to the second quarter of 2018 as a result of a larger volume of TBA dollar roll transactions, the implied financing rate on these transactions increased approximately 37 basis points from the second quarter of 2018 to the third quarter of 2018. As a result, the net yield from TBA dollar roll transactions declined 32 basis points to 1.61% for the third quarter of 2018 compared to 1.93% for the prior quarter. Please refer to "Non-GAAP Financial Measures" at the end of this section for additional important information.

Total economic return for the third quarter of 2018 was 0% as dividends declared of \$0.18 were offset by the decline in book value of \$(0.18) to \$6.75 as of September 30, 2018 from \$6.93 as of June 30, 2018. Year-to-date we have incurred a total economic loss on book value per common share of (0.7)%. Total economic return consists of the sum of dividends declared and change in book value per common share for the respective period.





## Management Outlook

In prior quarters, we described the investing environment as being driven by global central bank policy. In the U.S., the Federal Reserve has been tightening monetary policy by increasing the targeted U.S. Federal Funds rate and removing quantitative easing (asset purchasing) support. Markets are currently pricing in approximately three more increases in the Fed Funds target rate through 2019. We believe the Federal Reserve will be data dependent, and the future path of short-term rates is largely tied to global economic outcomes. Given the pressures that are building globally as a result of already higher interest rates in the U.S., we believe the Federal Reserve is nearing the end of increasing the targeted Federal Funds rate. 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 Agency RMBS spreads will provide leveraged returns on investment capital in the low teens, as they were at September 30, 2018. Part of the return opportunity in Agency RMBS stems from market concerns over the risk that the Federal Reserve accelerates its balance sheet reduction of these securities. We believe this risk is very low and view Agency RMBS as an attractive investment opportunity relative to other asset classes. We are also concerned about excess U.S. Treasury supply as that could cause interest rates to move higher; however, this would create an investment opportunity for us as we expect to see MBS reprice to a more appropriate risk/reward balance. Our goal is to manage through the transition to higher returns, seeking to preserve capital while providing shareholders with an adequate return in the interim.

Given the fragile economic environment as noted above, in the near term we may rapidly change our outlook for Federal Reserve policy, interest rates and/or credit spreads which could necessitate changes to our investment strategy, duration, overall risk profile, leverage target, or hedging strategy.

## Non-GAAP Financial Measures

In addition to the Company's operating results presented in accordance with GAAP, the information presented within Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Quarterly Report on Form 10-Q 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. Reconciliations of core net operating income to common shareholders, adjusted interest expense, and adjusted net interest income to the related GAAP financial measures are provided below and within "Results of Operations".

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 net periodic interest benefit/cost, drop income on TBA dollar roll positions, other operating income (expense), 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 net periodic interest benefit/cost from its interest rate swaps, which are 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 net periodic interest benefit/cost 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, such as Eurodollar futures. 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.

(\$ in thousands, except per share amounts)	Three Months Ended	
	September 30, 2018	June 30, 2018
GAAP net income to common shareholders	\$22,630	\$12,710
Less:		
Change in fair value of derivative instruments, net <sup>(1)</sup>	(13,460 )	(14,715 )
Loss on sale of investments, net	1,726	12,444
De-designated cash flow hedge accretion <sup>(2)</sup>	(66 )	(48 )
Fair value adjustments, net	(12 )	(27 )
Core net operating income to common shareholders	\$10,818	\$10,364
Weighted average common shares outstanding	57,727	56,295
Core net operating income per common share	\$0.19	\$0.18

(1) Amount represents net realized and unrealized gains and losses on derivatives and excludes net periodic interest benefits related to these instruments.

(2) Amount recorded as a portion of "interest expense" in accordance with GAAP 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.

(\$ in thousands)	Three Months Ended			
	September 30, 2018		June 30, 2018	
	Amount	Rate	Amount	Rate
GAAP interest expense/cost of funds	\$14,751	2.25 %	\$14,175	2.06 %
Add: net periodic interest benefit <sup>(1)</sup>	(1,777 )	(0.28)%	(2,333 )	(0.35)%
Less: de-designated cash flow hedge accretion <sup>(2)</sup>	66	0.01 %	48	0.01 %
Adjusted interest expense/adjusted cost of funds	\$13,040	1.98 %	\$11,890	1.72 %

(1) Amount represents net periodic interest benefit of effective interest rate swaps outstanding during the period and excludes realized and unrealized gains and losses from changes in fair value of derivatives.

(2) Amount recorded as a portion of "interest expense" in accordance with GAAP 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.

(\$ in thousands)	Three Months Ended			
	September 30, 2018		June 30, 2018	
	Amount	Rate	Amount	Rate
Net interest income	\$12,174	1.08 %	\$11,747	1.07 %
Add: TBA drop income	4,262	0.06 %	3,619	0.10 %
Add: net periodic interest benefit <sup>(1)</sup>	1,777	0.28 %	2,333	0.35 %
Less: de-designated cash flow hedge accretion <sup>(2)</sup>	(66 )	(0.01)%	(48 )	(0.01)%
Adjusted net interest income	\$18,147	1.41 %	\$17,651	1.51 %

(1) Amount represents net periodic interest benefit of effective interest rate swaps outstanding during the period and excludes realized and unrealized gains and losses from changes in fair value of derivatives.

(2) Amount recorded as a portion of "interest expense" in accordance with GAAP 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.

## 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. Our critical accounting policies are discussed in Part II, Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the year ended December 31, 2017 under "Critical Accounting Policies". There have been no significant changes in our critical accounting policies during the three and six months ended September 30, 2018.

## FINANCIAL CONDITION

Our investment portfolio is comprised mostly of fixed-rate investments. As of September 30, 2018, approximately 62% 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 table provides a summary of the amortized cost and fair value of our investment portfolio including TBA dollar roll positions used for investment purposes as of the dates indicated:

(\$ in thousands)	September 30, 2018		December 31, 2017	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Agency RMBS, fixed-rate	\$1,780,027	\$1,738,084	\$903,270	\$898,678
TBAs, fixed-rate <sup>(1)</sup>	780,865	779,697	829,425	830,908
Agency RMBS, adjustable rate	36,339	37,068	289,304	285,583
Agency CMBS, fixed-rate	997,058	948,296	1,134,409	1,124,351
CMBS IO <sup>(2)</sup>	562,327	564,826	683,833	692,522
Non-Agency other <sup>(3)</sup>	4,833	6,236	23,536	25,855
U.S. Treasuries	—	—	148,267	146,530
Mortgage loans held for investment, net <sup>(4)</sup>	12,342	9,165	15,738	12,973
Total investment portfolio including TBA dollar roll positions	\$4,173,791	\$4,083,372	\$4,027,782	\$4,017,400

Consists of long positions in TBAs used for investment purposes at their implied cost basis and implied market (1) 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) Includes Agency and non-Agency issued securities.

(3) Includes non-Agency CMBS and RMBS.



(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 nine months ended September 30, 2018:

(\$ in thousands)	Agency RMBS		Agency CMBS	CMBS IO (3)	Non-Agency Other (4)	Total
	30-Year Fixed Rate (1) (2)	Adjustable Rate				
Balance as of December 31, 2017	\$1,729,586	\$285,583	\$1,124,351	\$692,522	\$25,855	\$3,857,897
Purchases	896,265	—	51,862	2,814	—	950,941
Principal payments	(64,712 )	(26,213 )	(26,680 )	—	(19,635 )	(137,240 )
Sales	—	(225,622 )	(160,767 )	(19,087 )	—	(405,476 )
(Amortization) accretion	(3,356 )	(1,130 )	(1,766 )	(105,233 )	932	(110,553 )
Change in fair value	(40,002 )	4,450	(38,704 )	(6,190 )	(916 )	(81,362 )
Balance as of September 30, 2018	\$2,517,781	\$37,068	\$948,296	\$564,826	\$6,236	\$4,074,207

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

Includes long positions in TBAs used for investment purposes at their implied market value as if settled and

(2) 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) Includes Agency and non-Agency issued securities.

(4) Includes non-Agency CMBS and RMBS.

## 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:

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

September 30, 2018							
Coupon	Par	Amortized Cost/Implied Cost Basis <sup>(1)(3)</sup>	Fair Value <sup>(2)(3)</sup>	Weighted Average Original Loan Balance <sup>(4)</sup>	Weighted Average Loan Age (in months) <sup>(4)</sup>	3 Month CPR <sup>(4)(5)</sup>	Duration <sup>(6)</sup>
(\$ in thousands)							
30-year fixed-rate:							
3.0%	\$228,116	\$229,734	\$218,671	\$234,112	23	8.3 %	6.32
4.0%	1,339,668	1,386,905	1,356,169	264,330	9	4.5 %	4.81
4.5%	158,111	163,388	163,244	309,714	2	2.5 %	3.21
TBA 4.0%	211,000	214,365	213,060	n/a	n/a	n/a	4.50
TBA 4.5%	550,000	566,500	566,637	n/a	n/a	n/a	4.25
Total 30-year fixed-rate	\$2,486,895	\$2,560,892	\$2,517,781	\$264,494	10	4.8 %	4.70
Adjustable-rate:							
4.1% <sup>(7)</sup>	\$35,379	\$36,339	\$37,068	\$208,515	128	18.1 %	0.52
Total Agency RMBS (including TBA dollar roll positions)	\$2,522,274	\$2,597,231	\$2,554,849	\$263,369	12	5.0 %	4.64

December 31, 2017							
Coupon	Par	Amortized Cost/Implied Cost Basis <sup>(1)(3)</sup>	Fair Value <sup>(2)(3)</sup>	Weighted Average Original Loan Balance <sup>(4)</sup>	Weighted Average Loan Age (in months) <sup>(4)</sup>	3 Month CPR <sup>(4)(5)</sup>	Duration <sup>(6)</sup>
(\$ 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% <sup>(7)</sup>	\$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 \$(1.2) million as of September 30, 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

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. Because non-Agency CMBS are not guaranteed, our entire investment is exposed to credit losses from the underlying loans collateralizing the CMBS. The amortized cost of our non-Agency CMBS as of September 30, 2018 declined to \$3.9 million compared to \$22.5 million as of December 31, 2017 due to significant prepayment activity during the first quarter of 2018. The non-Agency CMBS remaining as of September 30, 2018 are comprised of securities collateralized by loans we originated prior to 2000.

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:

(\$ in thousands)	September 30, 2018			December 31, 2017		
	Par Value	Amortized Cost	Months to Estimated Maturity <sup>(1)</sup>	Par Value	Amortized Cost	Months to Estimated Maturity <sup>(1)</sup>
Year of Origination:						
2008 and prior	\$25,865	\$23,418	34	\$34,065	\$31,026	41
2009 to 2012	81,762	83,637	24	106,619	109,234	27
2013 to 2014	13,578	13,865	76	20,237	20,600	82
2015	301,746	303,877	101	468,296	469,657	103
2016	238,716	240,246	101	239,139	240,831	110
2017	280,945	284,078	109	282,112	285,527	118
2018	51,681	51,861	143	—	—	—
	\$994,293	\$1,000,982	97	\$1,150,468	\$1,156,875	99

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

## CMBS IO

As of September 30, 2018, our CMBS IO investments comprised approximately 14% 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 lead 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.

33

---

The following table presents our CMBS IO investments as of September 30, 2018 by year of origination:

(\$ in thousands)	September 30, 2018			December 31, 2017		
	Amortized Cost	Fair Value	Remaining WAL <sup>(1)</sup>	Amortized Cost	Fair Value	Remaining WAL <sup>(1)</sup>
Year of Origination:						
2010	\$4,217	\$4,240	9	\$6,421	\$6,554	13
2011	18,638	19,322	14	25,652	26,720	18
2012	43,402	43,614	20	71,615	72,913	22
2013	77,948	77,890	24	103,730	104,568	28
2014	143,016	143,639	31	171,285	173,043	34
2015	149,935	151,017	36	170,663	172,974	40
2016	75,116	75,148	43	82,698	83,444	47
2017	47,504	47,455	49	51,769	52,306	53
2018	2,551	2,501	73	—	—	—
	\$562,327	\$564,826	33	\$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.

There have been no material changes to the characteristics or geographic distribution of collateral underlying our CMBS IO securities since December 31, 2017.

#### 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 Quarterly Report on Form 10-Q for more information.

Interest rate derivatives. As of September 30, 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 nine months ended September 30, 2018, we added interest rate swaps with a combined notional balance of \$1.0 billion at a weighted average net pay-fixed rate of 2.86% in order to increase our protection from rising short-term interest rates. We had interest rate swaps with a notional balance of \$2.3 billion and a weighted average pay-fixed rate of 1.29% mature during the nine months ended September 30, 2018. During that same period, we realized a gain of \$2.1 million from terminated interest rate swaps with a notional balance of \$0.4 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.

As of September 30, 2018, we held options on U.S. Treasury futures with an aggregate notional balance of \$200.0 million and a fair value of \$1.0 million, for which we paid a premium of \$1.1 million. We entered the options to enhance returns if interest rates decline while limiting our downside to the premium paid if interest rates increase. During the nine months ended September 30, 2018, we realized a gain of \$0.8 million from terminated options on U.S. Treasury futures with a notional balance of \$300.0 million.

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 September 30, 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. The following table presents the amount pledged and leverage against the fair value of our non-Agency MBS investments by credit rating as of September 30, 2018 and December 31, 2017:

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

(\$ in thousands)	September 30, 2018			December 31, 2017		
	Fair Value	Amount Pledged	Related Borrowings	Fair Value	Amount Pledged	Related Borrowings
<b>Non-Agency CMBS:</b>						
A	—	—	—	\$18,212	\$18,212	\$ 15,508
Below A/Not Rated	—	—	—	6,552	—	—
	\$—	\$—	\$ —	\$24,764	\$18,212	\$ 15,508
<b>Non-Agency CMBS IO:</b>						
AAA	\$209,400	\$209,395	\$ 177,712	\$259,155	\$259,151	\$ 218,995
AA	36,740	36,239	30,644	42,486	39,342	35,531
A	681	681	591	735	735	641
Below A/Not Rated	8,775	8,775	7,573	9,840	12,343	8,527
	\$255,596	\$255,090	\$ 216,520	\$312,216	\$311,571	\$ 263,694

Please refer to Note 3 of the Notes to the Unaudited Consolidated Financial Statements contained within this Quarterly Report on Form 10-Q 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.

#### Accumulated Other Comprehensive Loss

We recorded other comprehensive loss of \$(77.1) million for the nine months ended September 30, 2018 related primarily to declines in fair value of our available-for-sale debt securities as a result of increasing interest rates. The following table includes detail of the accumulated gain (loss) position and change in fair value by type of debt security as of and for the periods indicated:

(\$ in thousands)	Nine Months Ended			
	As of December 31, 2017	September 30, 2018 Unrealized Gain (Loss)	September 30, 2018 Realized Gain (Loss) <sup>(1)</sup>	As of September 30, 2018
Fixed-rate Agency RMBS	\$ (4,592 )	\$ (37,351 )	\$—	\$ (41,943 )
Adjustable-rate Agency RMBS	(3,721 )	12,235	\$(7,785 )	729
Agency CMBS	(10,058 )	(34,933 )	(3,771 )	(48,762 )
CMBS IO <sup>(2)</sup>	8,689	(6,368 )	178	2,499
Non-Agency other <sup>(3)</sup>	2,319	(916 )	—	1,403
U.S. Treasuries	(1,737 )	8,304	(6,567 )	—
De-designated cash flow hedges	403	—	(162 )	241
<b>Total</b>	<b>\$ (8,697 )</b>	<b>\$ (59,029 )</b>	<b>\$ (18,107 )</b>	<b>\$ (85,833 )</b>

(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.

#### 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 Quarterly Report on Form 10-Q for additional important information about these

measures.

Net Interest Income For the Three Months Ended September 30, 2018 Compared to the Three Months Ended September 30, 2017

36

---

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

Net interest income and net interest spread declined for the three months ended September 30, 2018 compared to the same period in 2017 due to higher repurchase agreement borrowing costs as a result of significant increases in short-term interest rates. Repurchase agreement borrowing costs have increased as a result of increases in market borrowing rates such as LIBOR that are significantly influenced by changes in the targeted federal funds rate established by the Federal Reserve. The following tables present certain information about our interest-earning assets and interest-bearing liabilities and their performance for the three months ended September 30, 2018 and September 30, 2017:

(\$ in thousands)	Three Months Ended September 30, 2018				2017			
	Interest Income/Expense (1)(2)	Average Balance (1)(2)	Effective Yield/ Cost of Funds (3)(4)		Interest Income/Expense (1)(2)	Average Balance (1)(2)	Effective Yield/ Cost of Funds (3)(4)	
<b>Interest-earning assets:</b>								
Agency RMBS-fixed rate	\$ 11,561	\$ 1,384,926	3.34 %		\$ 1,390	\$ 186,721	2.98 %	
Agency CMBS-fixed rate	7,362	1,002,661	2.81 %		9,213	1,316,364	2.73 %	
Agency RMBS-adjustable rate	283	37,634	3.12 %		3,159	668,845	1.95 %	
CMBS IO <sup>(5)</sup>	6,646	581,770	3.98 %		8,050	734,282	3.89 %	
Non-Agency other <sup>(6)</sup>	427	4,869	30.31 %		959	37,456	9.21 %	
U.S. Treasuries	45	6,302	2.83 %		—	—	— %	
Other investments <sup>(7)</sup>	601	13,226	4.25 %		332	16,927	3.92 %	
Total:	\$ 26,925	\$ 3,031,388	3.33 %		\$ 23,103	\$ 2,960,595	2.95 %	
<b>Interest-bearing liabilities:</b>								
Repurchase agreements	\$ 14,780	\$ 2,564,863	2.25 %		\$ 9,910	\$ 2,616,250	1.48 %	
Non-recourse collateralized financing	37	4,260	3.01 %		27	5,817	1.97 %	
De-designated cash flow hedge accretion <sup>(8)</sup>	(66 )	n/a	(0.01 )%		(48 )	n/a	(0.01 )%	
Total:	\$ 14,751	\$ 2,569,123	2.25 %		\$ 9,889	\$ 2,622,067	1.48 %	
Net interest income/net interest spread	\$ 12,174		1.08 %		\$ 13,214		1.47 %	

(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.

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) Includes Agency and non-Agency issued securities.

(6) Includes privately-issued RMBS and CMBS.

(7) Interest income for other investments consists of \$139 from mortgage loans held for investment, net and \$462 from cash and cash equivalents for the three months ended September 30, 2018 compared to \$172 and \$160 for the three months ended September 30, 2017, respectively. Average balances and yields shown for other investments includes amortized cost of mortgage loans held for investment and excludes cash.

(8)

Amount recorded as a portion of "interest expense" in accordance with GAAP 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.



Interest income increased \$3.8 million for the three months ended September 30, 2018 compared to the same period in 2017 due to the shift in our portfolio to 30-year fixed-rate Agency RMBS which have higher coupons and lower premium amortization than the adjustable-rate Agency RMBS held in our portfolio during the same period in 2017. The benefit of a higher average balance of higher yielding assets was partially offset by lower prepayment penalty compensation and lower discount accretion on our CMBS and CMBS IO for the three months ended September 30, 2018 compared to the same period in 2017.

Interest expense increased \$4.9 million for the three months ended September 30, 2018 compared to the same period in 2017 due to higher borrowing rates on our repurchase agreements. Our borrowing rates are based largely on short-term market rates such as one-month LIBOR which averaged 2.11% for the three months ended September 30, 2018 compared to 1.23% for the same period in 2017.

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:

(\$ in thousands)	Three Months Ended September 30, 2018 Compared to September 30, 2017			Total Change in Interest Income/Expense
	Increase (Decrease) Due to Change In			
	Rate	Volume	Prepayment Adjustments (1)	
<b>Interest-earning assets:</b>				
Agency RMBS-fixed rate	\$1,251	\$8,920	\$ —	\$ 10,171
Agency CMBS-fixed rate	151	(2,184 )	183	(1,850 )
Agency RMBS-adjustable rate	112	(3,099 )	111	(2,876 )
CMBS IO (2)	83	(1,422 )	(66 )	(1,405 )
Non-Agency other (3)	246	(726 )	(52 )	(532 )
U.S. Treasuries	—	45	—	45
Other investments (4)	15	263	(9 )	269
Total increase (decrease) in interest income	\$1,858	\$1,797	\$ 167	\$ 3,822
<b>Interest-bearing liabilities:</b>				
Repurchase agreements	\$5,046	\$(194 )	\$ —	\$ 4,852
Non-recourse collateralized financing, net of other (5)	17	(7 )	—	10
Total increase (decrease) in interest expense	5,063	(201 )	—	4,862
Total net (decrease) increase in net interest income	\$(3,205)	\$1,998	\$ 167	\$ (1,040 )

Prepayment adjustments represent effective interest amortization adjustments related to changes in actual and (1) 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 \$301 thousand in other interest income from cash and cash equivalents is included as a change in volume.

(5) Includes decrease of \$18 thousand in de-designated cash flow hedge accretion as a change in rate.

The increase of \$1.9 million in interest income due to rate is primarily related to our sales of lower yielding hybrid Agency RMBS and the purchase of higher yielding fixed-rate Agency RMBS which resulted in the increase in the average effective yield on our investment portfolio to 3.33% for the three months ended September 30, 2018 compared to 2.95% for the same period in 2017. The average effective yield for Agency CMBS and CMBS IO were also both up modestly primarily due to sales and pay downs of lower yielding assets within those groups as well as a \$0.2 million increase in prepayment compensation on Agency CMBS for the three months ended September 30, 2018 compared to the same period in 2017.

Adjusted Net Interest Income For the Three Months Ended September 30, 2018 Compared to the Three Months Ended September 30, 2017

Drop income from TBA dollar roll positions and net periodic interest benefit (cost) of interest rate swaps effective during the period are included in "gain on derivatives instruments, net" on the Company's consolidated statements of comprehensive income. Drop income is the difference in price between the near settling TBA contract and the price for the same contract with a later settlement date. Management believes 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. Management also views net periodic interest benefit (cost) of effective interest rate swaps used to hedge interest rate risk as an additional benefit (cost) of using repurchase agreements to finance its investments. As such, 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 related financings. Please read the section "Non-GAAP Financial Measures" for additional important information about this non-GAAP financial measure.

The following table reconciles adjusted net interest income to GAAP net interest income for the periods indicated:

(\$ in thousands)	Three Months Ended			
	September 30, 2018		September 30, 2017	
	Amount	Rate	Amount	Rate
Net interest income	\$12,174	1.08 %	\$13,214	1.47 %
Add: TBA drop income <sup>(1)</sup>	4,262	0.06 %	3,902	0.15 %
Add: net periodic interest benefit (cost) <sup>(2)</sup>	1,777	0.28 %	(1,131 )	(0.17)%
De-designated cash flow hedge accretion <sup>(3)</sup>	(66 )	(0.01)%	(48 )	(0.01)%
Adjusted net interest income	\$18,147	1.41 %	\$15,937	1.44 %

1) TBA drop income is calculated by multiplying the notional amount of the TBA dollar roll positions by the difference in price between two TBA securities with the same terms but different settlement dates.

(2) Amount represents net periodic interest benefit (cost) of effective interest rate swaps outstanding during the period and excludes realized and unrealized gains and losses from changes in fair value of derivatives.

(3) Amount recorded as a portion of "interest expense" in accordance with GAAP 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.

Adjusted net interest income increased \$2.2 million for the three months ended September 30, 2018 compared to the same period in 2017 primarily because of higher TBA drop income in the third quarter of 2018 as well as a net periodic interest benefit from interest rate swaps during the third quarter of 2018 which partially offset the increase in interest expense from our repurchase agreements. The floating rate we receive on the majority of our pay-fixed interest rate swaps is based on 3-month LIBOR which averaged approximately 2.34% for the three months ended September 30, 2018 compared to 1.31% for the same period in 2017. Please refer to "Gain (Loss) on Derivative Instruments, Net" for additional information on our interest rate swaps.

The following table summarizes information related to our drop income from TBA dollar roll transactions for the periods indicated:

Three Months Ended		Three Months Ended	
September 30,		September 30, 2018	
		Compared to Three	
		Months Ended	
		September 30, 2017	
		Due to Change	
2018	2017	Total	In
		Change	

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

(\$ in thousands)	Amount	Average Yield/Cost	Amount	Average Yield/Cost	Rate	Volume
TBA implied interest income <sup>(1)</sup>	\$9,708	3.66 %	\$6,150	3.02 %	\$3,558	\$1,708 \$1,850
TBA implied interest expense <sup>(2)</sup>	5,446	2.05 %	2,248	1.10 %	3,198	2,522 676
TBA drop income/net yield <sup>(3)</sup>	\$4,262	1.61 %	\$3,902	1.92 %	\$360	\$(814 ) \$1,174

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

Average funding cost for TBA dollar roll positions is determined using the “price drop” between the near settling (2)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.

#### Net Interest Income For the Nine Months Ended September 30, 2018 Compared to the Nine Months Ended September 30, 2017

Net interest income and net interest spread declined for the nine months ended September 30, 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 nine months ended September 30, 2018. The following tables present certain information about our interest-earning assets and interest-bearing liabilities and their performance for the nine months ended September 30, 2018 and September 30, 2017:

(\$ in thousands)	Nine Months Ended September 30, 2018			2017		
	Interest Income/Expense (1)(2)	Average Balance (1)(2)	Effective Yield/ Cost of Funds (3)(4)	Interest Income/Expense (1)(2)	Average Balance (1)(2)	Effective Yield/ Cost of Funds (3)(4)
<b>Interest-earning assets:</b>						
Agency RMBS-fixed rate	\$27,853	\$1,142,907	3.25 %	\$1,390	\$62,924	2.95 %
Agency CMBS-fixed rate	22,257	1,031,979	2.83 %	26,373	1,254,723	2.76 %
Agency RMBS-adjustable rate	3,205	190,854	2.23 %	11,710	934,524	1.73 %
CMBS IO <sup>(5)</sup>	19,886	627,537	4.11 %	24,678	749,343	4.23 %
Non-Agency other <sup>(6)</sup>	1,495	9,459	20.10 %	5,361	70,923	9.17 %
U.S. Treasuries	2,012	109,816	2.45 %	—	—	— %
Other investments <sup>(7)</sup>	1,329	14,407	4.11 %	866	17,876	3.94 %
<b>Total:</b>	<b>\$78,037</b>	<b>\$3,126,959</b>	<b>3.25 %</b>	<b>\$70,378</b>	<b>\$3,090,313</b>	<b>2.97 %</b>
<b>Interest-bearing liabilities:</b>						
Repurchase agreements	\$40,575	\$2,641,929	2.03 %	\$26,269	\$2,736,834	1.27 %
Non-recourse collateralized financing	108	4,879	2.82 %	73	6,058	1.63 %
De-designated cash flow hedge accretion <sup>(8)</sup>	(162)	n/a	(0.01) %	(220)	n/a	(0.01) %
<b>Total:</b>	<b>\$40,521</b>	<b>\$2,646,808</b>	<b>2.02 %</b>	<b>\$26,122</b>	<b>\$2,742,892</b>	<b>1.26 %</b>
<b>Net interest income/net interest spread</b>	<b>\$37,516</b>		<b>1.23 %</b>	<b>\$44,256</b>		<b>1.71 %</b>

(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.

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 (3) 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) Includes Agency and non-Agency issued securities.

(6) Includes privately-issued RMBS and CMBS.

Interest income for other investments consists of \$444 thousand from mortgage loans held for investment, net and  
(7) \$885 thousand from cash and cash equivalents for the nine months ended September 30, 2018 compared to \$533  
and \$333 for the

40

---

nine months ended September 30, 2017, respectively. Average balances and yields shown for other investments includes amortized cost of mortgage loans held for investment and excludes cash.

Amount recorded as a portion of "interest expense" in accordance with GAAP related to the accretion of the (8) balance remaining in accumulated other comprehensive loss as a result of the Company's discontinuation of cash flow hedge accounting effective June 30, 2013.

Interest income increased \$7.7 million for the nine months ended September 30, 2018 compared to the same period in 2017 due to the shift in our portfolio to 30-year fixed-rate Agency RMBS which have higher average effective yields than the adjustable-rate Agency RMBS held in our portfolio during the same period in 2017. The benefit of the higher average balance of higher yielding assets was partially offset by the lower prepayment penalty compensation and lower discount accretion on our CMBS and CMBS IO for the nine months ended September 30, 2018 compared to the same period in 2017.

Interest expense increased \$14.4 million for the nine months ended September 30, 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 1.91% during the nine months ended September 30, 2018 compared to an average of 1.04% for the same period in 2017.

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:

	Nine Months Ended September 30, 2018 Compared to September 30, 2017			
	Increase (Decrease) Due to Change In			Total Change in Interest Income/Expense
(\$ in thousands)	Rate	Volume	Prepayment Adjustments (1)	
<b>Interest-earning assets:</b>				
Agency RMBS-fixed rate	\$2,606	\$23,857	\$ —	\$ 26,463
Agency CMBS-fixed rate	388	(4,623 )	120	(4,115 )
Agency RMBS-adjustable rate	409	(10,727 )	1,813	(8,505 )
CMBS IO (2)	(2 )	(3,429 )	(1,361 )	(4,792 )
Non-Agency other (3)	724	(2,930 )	(1,660 )	(3,866 )
Treasuries	—	2,012	—	2,012
Other investments (4)	17	462	(17 )	462
Total increase (decrease) in interest income	\$4,142	\$4,622	\$ (1,105 )	\$ 7,659
<b>Interest-bearing liabilities:</b>				
Repurchase agreements	\$15,290	\$(926 )	\$ —	\$ 14,364
Non-recourse collateralized financing, net of other (5)	40	(5 )	—	35
Total increase (decrease) in interest expense	15,330	(931 )	—	14,399
Total net change in net interest income	\$(11,188)	\$5,553	\$ (1,105 )	\$ (6,740 )

Prepayment adjustments represent effective interest amortization adjustments related to changes in actual and (1) 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 \$551 thousand in other interest income from cash and cash equivalents is included as a change in volume.
- (5) Includes decrease of \$58 thousand in de-designated cash flow hedge accretion as a change in rate.

The increase of \$4.1 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 September 30, 2017, which resulted in the average effective yield increasing for the remaining securities in our portfolio for the nine months ended September 30, 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 September 30,



2017. The average effective yield for CMBS IO declined 12 basis points, which was primarily due to lower prepayment penalty compensation during the nine months ended September 30, 2018 compared to the same period in 2017.

#### Adjusted Net Interest Income For the Nine Months Ended September 30, 2018 Compared to Nine Months Ended September 30, 2017

As discussed earlier, 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. The following table reconciles adjusted net interest income to GAAP net interest income for the periods indicated:

(\$ in thousands)	Nine Months Ended September 30,			
	2018		2017	
	Amount	Rate	Amount	Rate
Net interest income	\$37,516	1.23 %	\$44,256	1.71 %
Add: TBA drop income <sup>(1)</sup>	11,614	0.05 %	5,253	0.04 %
Add: net periodic interest benefit (cost) <sup>(2)</sup>	3,890	0.20 %	(3,099 )	(0.15) %
De-designated cash flow hedge accretion <sup>(3)</sup>	162	0.01 %	(220 )	(0.01) %
Adjusted net interest income	\$53,182	1.49 %	\$46,190	1.59 %

(1) TBA drop income is calculated by multiplying the notional amount of the TBA dollar roll positions by the difference in price between two TBA securities with the same terms but different settlement dates.

(2) Amount represents net periodic interest benefit (cost) of effective interest rate swaps outstanding during the period and excludes realized and unrealized gains and losses from changes in fair value of derivatives.

(3) Amount recorded as a portion of "interest expense" in accordance with GAAP 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.

Adjusted net interest income increased \$7.0 million for the nine months ended September 30, 2018 compared to the same period in 2017 primarily because of higher TBA drop income as well as a net periodic interest benefit from interest rate swaps which partially offset the increase in interest expense from our repurchase agreements during the nine months ended September 30, 2018 compared to the same period in 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 2.20% for the nine months ended September 30, 2018 compared to 1.20% for the same period in 2017.

The following table summarizes information related to our drop income from TBA dollar roll transactions for the periods indicated:

(\$ in thousands)	Nine Months Ended September 30,				Nine Months Ended September 30, 2018 Compared to Nine Months Ended September 30, 2017		
	2018		2017		Total Change	Rate	Volume
	Amount	Average Yield/Cost	Amount	Average Yield/Cost			
TBA implied interest income <sup>(1)</sup>	\$23,483	3.51 %	\$8,077	2.98 %	\$15,406	\$3,502	\$11,904
TBA implied interest expense <sup>(2)</sup>	11,869	1.77 %	2,824	1.04 %	9,045	4,883	4,162
TBA drop income/net yield <sup>(3)</sup>	\$11,614	1.74 %	\$5,253	1.94 %	\$6,361	\$(1,381)	\$7,742

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

- 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
- (2) 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.

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:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Interest rate derivatives:				
Interest rate swaps:				
Net periodic interest costs	\$1,777	\$(1,131)	\$3,890	\$(3,099)
Change in fair value (1)	2,242	421	89,944	(14,954)
Total interest rate swap gains (losses), net	2,019	(710)	93,834	(18,053)
Eurodollar futures:				
Change in fair value (1)	(189)	—	1,886	—
TBA short positions (economic hedges):	—	—	—	—

Change  
in  
fair  
value  
(2)

—	293	—	
---	-----	---	--

Total  
interest  
rate  
swaps  
gains  
(losses),  
net

24,830	(710 )	96,013	(18,053 )
--------	--------	--------	-----------

TBA  
dollar  
roll  
positions:  
TBA  
futures

4,062	3,902	11,614	5,253
-------	-------	--------	-------

Change  
in  
fair  
value  
(2)

(9,466 )	2,801	(29,870 )	3,166
----------	-------	-----------	-------

Total  
TBA  
dollar  
roll  
(losses)  
gains,  
net

(5,204 )	6,703	(18,256 )	8,419
----------	-------	-----------	-------

Other  
derivatives:  
Options  
on  
US  
Treasury  
futures

(127 )	—	763	—
--------	---	-----	---

Total  
gain  
(loss)  
on  
derivative  
instruments,  
net

\$19,499	\$5,993	\$78,520	\$(9,634)
----------	---------	----------	-----------

(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.

Gain on derivative instruments, net for the three months ended September 30, 2018 included \$2.6 million of realized gains on terminated interest rate swaps with a notional balance of \$250.0 million, \$2.0 million of realized losses on TBA dollar roll positions, and \$0.8 million of realized gains resulting from \$650.0 million of Eurodollar futures that matured during the third quarter of 2018. The increase in fair value of our interest rate swaps was the result of higher interest rates along the entire curve. The decline in fair value of TBA dollar roll positions of \$(9.5) million was driven primarily by the increase in interest rates during the third quarter.

Gain on derivative instruments, net for the nine months ended September 30, 2018 included \$2.1 million of realized gains on terminated interest rate swaps with a notional balance of \$350 million, \$15.6 million of realized losses on TBA dollar roll positions, and \$2.6 million of realized gains resulting from \$2.0 billion of Eurodollar futures that matured during the nine months ended September 30, 2018. The decline in fair value of TBAs of \$(29.9) million was driven primarily by the increase in interest rates during the same period.

The following table provides details on the effective interest rate swaps outstanding during the periods indicated:

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

(\$ in thousands)	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2018	2017	2018	2017	
Average repurchase agreement borrowings outstanding	\$2,564,863	\$2,616,250	\$2,641,929	\$2,736,834	
Average net TBAs outstanding - at cost <sup>(1)</sup>	982,665	745,270	856,531	353,060	
Average borrowings and net TBAs outstanding	3,547,528	3,361,520	3,498,460	3,089,894	
Average notional amount of interest rate swaps outstanding (excluding forward starting swaps)	2,502,609	3,007,609	2,830,824	2,176,300	
Ratio of average interest rate swaps to average borrowings and net TBAs outstanding <sup>(1)</sup>	0.7	0.9	0.8	0.7	
Average interest rate swap net pay-fixed rate (excluding forward starting swaps) <sup>(2)</sup>	2.09	% 1.43	% 1.84	% 1.35	%
Average interest rate swap net receive-floating rate <sup>(2)</sup>	2.32	% 1.26	% 2.01	% 1.15	%
Average interest rate swap net pay/(receive) rate	(0.23	)% 0.17	% (0.17	)% 0.20	%

<sup>(1)</sup> 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.

<sup>(2)</sup> Net rates include receive-fixed (pay-floating) interest rate swaps.

As mentioned in “Financial Condition” of Part I, Item 2 of this Quarterly Report on Form 10-Q, 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.

We may also periodically enter into short positions in TBAs to hedge the impact of adverse changes in interest rates on the fair value of our fixed-rate Agency RMBS. Unlike long positions in TBAs in which we execute dollar roll transactions, we do not simultaneously enter into an identical TBA short position with a later settlement date when we pair off initial short positions. Therefore, short positions in TBAs used as economic hedges do not generate drop income (loss). We did not have any short positions in TBAs used as economic hedges as of September 30, 2018.

#### 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:

(\$ in thousands)	Three Months Ended September 30,			
	2018		2017	
	Amortized cost basis sold	Loss on sale of investments, net	Amortized cost basis sold	Loss on sale of investments, net
Agency RMBS	\$—	\$ —	\$398,662	\$ (5,160 )
Agency CMBS	49,957	(1,720 )	13,484	(51 )
Agency CMBS IO	10,444	127	—	—
U.S. Treasuries	57,976	(133 )	—	—
	\$118,377	\$ (1,726 )	\$412,146	\$ (5,211 )

(\$ in thousands)	Nine Months Ended September 30,			
	2018		2017	
	Amortized cost basis sold	(Loss) gain on sale of investments, net	Amortized cost basis sold	(Loss) gain on sale of investments, net
Agency RMBS	\$225,622	\$ (7,785 )	\$728,952	\$ (12,392 )
Agency CMBS	160,766	(3,771 )	206,470	523
Agency CMBS IO	10,444	127	—	—
Non-Agency CMBS IO	8,644	51	—	—
Non-Agency CMBS	—	—	34,506	1,199
Non-Agency RMBS	—	—	16,365	42
U.S. Treasuries	225,369	(6,567 )	—	—
	\$630,845	\$ (17,945 )	\$986,293	\$ (10,628 )

### General and Administrative Expenses

General and administrative expenses increased to \$(4.0) million for the three months ended September 30, 2018 compared to \$(3.6) million for the three months ended September 30, 2017. Other general and administrative expenses increased \$0.7 million compared to the third quarter of 2017 due primarily to an increase in expenses related to the litigation discussed in Part II, Item 1 “Legal Proceedings”. Compensation and benefits expense declined \$0.4 million due to primarily to lower stock-based compensation and incentive compensation expenses.

General and administrative expenses decreased \$0.4 million for the nine months ended nine months ended compared to the same period in 2017. Compensation and benefits expense declined \$0.9 million primarily due to lower stock-based compensation expense. Partially offsetting that decline was a \$0.5 million increase in legal expenses primarily related to the litigation discussed in Part II, Item 1 “Legal Proceedings” during the nine months ended September 30, 2018 compared to the same period in 2017.

### LIQUIDITY AND CAPITAL RESOURCES

Our primary sources of liquidity include borrowings under repurchase arrangements and monthly principal and interest payments we receive on our investments. Additional sources may also include proceeds from the sale of investments, equity offerings, and payments received from counterparties from interest rate swap agreements. We use our liquidity to purchase investments and to pay our operating expenses and dividends on our common and preferred stock. We also use our liquidity to post initial and variation margins on our repurchase agreements and derivative

transactions, including TBA contracts, when required under the terms of the related agreements. We may also use liquidity to repurchase shares of our stock periodically.

Our liquid assets fluctuate based on our investment activities, our financing and capital raising activities, and changes in the fair value of our investments and derivative instruments. We seek to maintain sufficient liquidity to support our operations and to meet our anticipated liquidity demands, including potential margin calls from lenders (as discussed further below). We measure, manage, and forecast our liquidity on a daily basis. Our most liquid assets include unrestricted cash and cash equivalents, U.S.



Treasuries and unencumbered Agency RMBS, CMBS, and CMBS IO. As of September 30, 2018, our most liquid assets were \$286.1 million compared to \$283.9 million as of December 31, 2017.

We perform sensitivity analysis on our liquidity based on changes in the fair value of our investments due to, among other things, changes in the absolute level of interest rates and the shape of the yield curve, credit spreads, lender haircuts, and prepayment speeds as well as changes in the fair value of our derivative instruments due to changes in the absolute level of interest rates and the shape of the yield curve. In performing this analysis we will also consider the current state of the fixed income markets and the repurchase agreement markets in order to determine if market forces such as supply-demand imbalances or structural changes to these markets could change the liquidity of MBS or the availability of financing. The objective of our analysis is to assess the adequacy of our liquidity to withstand potential adverse events. We may change our leverage targets based on market conditions and our perceptions of the liquidity of our investments.

We closely monitor our debt-to-invested equity ratio (which is the ratio of debt financing to invested equity for any investment) as part of our liquidity management process as well as our overall enterprise level debt-to-equity ratio. We also monitor the ratio of our available liquidity to outstanding repurchase agreement borrowings, which fluctuates due to changes in the fair value of collateral we have pledged to our lenders. Including our TBA dollar roll positions at cost (if settled), which was \$780.9 million as of September 30, 2018, our leverage was 6.7 times shareholders' equity. It is possible under certain market conditions that it may be uneconomical for us to roll our TBA dollar roll positions into future months, which may result in us having to take physical delivery of the underlying securities. Because under those circumstances we would have to fund our total purchase commitment with cash or other financing sources, which may impact our liquidity position, management includes our TBA dollar roll positions at cost (if settled) in evaluating the Company's leverage.

The following table presents information regarding the balances of our repurchase agreement borrowings and our TBA dollar roll positions for the periods indicated:

(\$ in thousands)	Repurchase Agreements			TBA Dollar Roll Positions <sup>(1)</sup>	
	Balance Outstanding As of Quarter End	Average Balance Outstanding For the Quarter Ended	Maximum Balance Outstanding During the Quarter Ended	Balance Outstanding As of Quarter End	Average Balance Outstanding For the Quarter Ended
September 30, 2018	\$2,690,858	\$2,564,863	\$2,701,797	\$780,865	\$982,665
June 30, 2018	2,514,984	2,716,097	2,844,225	782,408	722,005
March 31, 2018	2,613,892	2,645,714	2,716,729	844,941	863,615
December 31, 2017	2,565,902	2,557,573	2,677,894	829,425	928,329
September 30, 2017	2,519,230	2,616,250	2,801,418	683,813	745,270

Balance outstanding as of quarter end and average balance outstanding for the quarter ended includes TBA dollar (1) roll positions as reported at cost (as if settled). Does not include short TBA positions used to hedge interest rate risk exposure from fixed-rate Agency RMBS in applicable periods.

Depending on our liquidity levels, investment opportunities, the condition of the credit markets, and other factors, we may from time to time consider the issuance of debt, equity, or other securities. We may also sell investments in order to provide additional liquidity for our operations. While we will attempt to avoid dilutive or otherwise costly issuances, depending on market conditions and in order to manage our liquidity, we could be forced to issue equity or debt securities which may be dilutive to our capital base or our profitability.

On June 29, 2018, the Company entered into a new equity distribution agreement pursuant to which we may offer and sell up to 10,000,000 shares of our common stock from time to time through sales agents in ATM offerings. We issued 1.4 million shares of common stock pursuant to this new equity distribution agreement during the three months ended September 30, 2018 for net cash proceeds of \$13.4 million at a discount of approximately 6.2% to book value of \$6.75 as of September 30, 2018. During the quarter ended September 30, 2018, we issued 32,660 shares of Series B Preferred Stock under our preferred stock ATM program at a discount of approximately 2.5% to its liquidation value of \$25.00 per share. Cash proceeds were \$0.8 million, net of 1.5% broker commissions and other fees.

## Repurchase Agreements

Our repurchase agreement borrowings are generally renewable at the discretion of our lenders without guaranteed roll-over terms. Given the short-term and uncommitted nature of most of our repurchase agreement financing, we attempt to maintain unused capacity under our existing repurchase agreement credit lines with multiple counterparties which helps protect us in the event of a counterparty's failure to renew existing repurchase agreements either with favorable terms or at all. As of September 30, 2018, we had repurchase agreement borrowings outstanding with 17 of our 35 available repurchase agreement counterparties at a weighted average borrowing rate of 2.36% compared to 1.67% as of December 31, 2017. Our repurchase agreement borrowings generally carry a rate of interest based on a spread to an index such as LIBOR.

For our repurchase agreement borrowings, we are required to post and maintain margin to the lender (i.e., collateral in excess of the repurchase agreement financing) in order to support the amount of the financing. This excess collateral is often referred to as a "haircut" (and which we also refer to as equity at risk) and is intended to provide the lender some protection against fluctuations in fair value of the collateral and/or the failure by us to repay the borrowing at maturity. The majority of the collateral pledged to our repurchase agreement counterparties is MBS, the fair value of which fluctuates depending on market conditions. If the fair value of the collateral falls below the haircut required by the lender, the lender has the right to demand additional margin, or collateral, to increase the haircut back to the initial amount. These demands are typically referred to as "margin calls". Declines in the value of investments occur for any number of reasons including but not limited to changes in interest rates, changes in ratings on an investment, changes in actual or perceived liquidity of the investment, or changes in overall market risk perceptions. Additionally, values in Agency RMBS will also decline from the payment delay feature of those securities. Agency RMBS have a payment delay feature whereby Fannie Mae and Freddie Mac announce principal payments on Agency RMBS but do not remit the actual principal payments and interest for 20 days in the case of Fannie Mae and 40 days in the case of Freddie Mac. Because these securities are financed with repurchase agreements, the repurchase agreement lender generally makes a margin call for an amount equal to the product of their advance rate on the repurchase agreement and the announced principal payments on the Agency RMBS. A margin call made by a lender reduces our liquidity until we receive the principal payments and interest 20 to 40 days later.

If we fail to meet any margin call, our lenders also have the right to terminate the repurchase agreement and sell any collateral pledged. Therefore, we attempt to maintain cash and other liquid securities in sufficient amounts to manage our exposure to margin calls by lenders. The lender also has the right to change the required haircut at maturity of the repurchase agreement (if the term is renewed) which would require us to post additional collateral to the lender. The following table presents the weighted average minimum haircut contractually required by our counterparties for MBS pledged as collateral for our repurchase agreement borrowings as of the dates indicated:

	September 30, 2018		June 30, 2018		March 31, 2018		December 31, 2017		September 30, 2017	
Agency CMBS and RMBS	4.8	%	4.9	%	4.8	%	4.9	%	5.0	%
Non-Agency CMBS and RMBS	—	%	—	%	—	%	15.0	%	15.0	%
CMBS IO	13.3	%	13.3	%	13.7	%	14.6	%	15.0	%

The counterparties with whom we have the greatest amounts of equity at risk may vary significantly during any given period due to the short-term and generally uncommitted nature of the repurchase agreement borrowings. Equity at risk represents the potential loss to the Company if the counterparty is unable or unwilling to return collateral securing the repurchase agreement borrowing at its maturity. Please refer to [Note 3](#) for information regarding counterparties with whom we have the greatest amount of equity at risk as of September 30, 2018.

The following table discloses our repurchase agreement amounts outstanding and the value of the related collateral pledged by geographic region of our counterparties as of the dates indicated:

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

	September 30, 2018		December 31, 2017	
	Amount	Market Value of	Amount	Market Value of
(\$ in thousands)	Outstanding	Collateral Pledged	Outstanding	Collateral Pledged
North America	\$1,849,184	\$1,994,027	\$1,551,758	\$1,700,582
Asia	457,221	479,730	489,376	515,593
Europe	384,453	404,229	524,768	548,924
	\$2,690,858	\$2,877,986	\$2,565,902	\$2,765,099

47

---

Certain of our repurchase agreement counterparties require us to comply with various operating and financial covenants. The financial covenants include, among other things, requirements that we maintain minimum shareholders' equity (usually a set minimum, or a percentage of the highest amount of shareholders' equity since the date of the agreement), limits on maximum decline in shareholders' equity (expressed as a percentage decline in any given period), and limits on maximum leverage (as a multiple of shareholders' equity). Operating requirements include, among other things, requirements to maintain our status as a REIT and to maintain our listing on the NYSE. Violations of one or more of these covenants could result in the lender declaring an event of default which would result in the termination of the repurchase agreement and immediate acceleration of amounts due thereunder. In addition, some of the agreements contain cross default features, whereby default with one lender simultaneously causes default under agreements with other lenders. Violations could also restrict us from paying dividends or engaging in other transactions that are necessary for us to maintain our REIT status.

We monitor and evaluate on an ongoing basis the impact these customary financial covenants may have on our operating and financing flexibility. Currently, we do not believe we are subject to any covenants that materially restrict our financing flexibility.

#### Derivative Instruments

We are party to certain types of financial instruments that are accounted for as derivative instruments including interest rate swaps, Eurodollar futures and long and short positions in TBA securities. Certain of these derivative instruments may require us to post initial margin at inception and daily variation margin based on subsequent changes in their fair value. The collateral posted as margin by us is typically in the form of cash or Agency MBS. In addition, counterparties may have to post variation margin to us. Generally, as interest rates decline, we will be required to post collateral with counterparties on our interest rate derivatives, and vice versa as interest rates increase. As of September 30, 2018, we had cash of \$58.3 million posted as collateral under these agreements.

As of September 30, 2018, approximately \$160 million of the Company's interest rate swaps were entered into under bilateral agreements which contain cross-default provisions with other agreements between the parties. In addition, these bilateral agreements contain financial and operational covenants similar to those contained in our repurchase agreements, as described above. Currently, we do not believe we are subject to any covenants that materially restrict our hedging flexibility.

Our TBA contracts are subject to master securities forward transaction agreements published by the Securities Industry and Financial Markets Association as well as supplemental terms and conditions with each counterparty. Under the terms of these agreements, we may be required to pledge collateral to, or have the right to receive collateral from, our counterparties when initiated or in the event the fair value of our TBA contracts declines. Declines in the fair value of TBA contracts are generally related to such factors as rising interest rates, increases in expected prepayment speeds, or widening spreads. Our TBA contracts generally provide that valuations for our TBA contracts and any pledged collateral are to be obtained from a generally recognized source agreed to by both parties. However, in certain circumstances, our counterparties have the sole discretion to determine the value of the TBA contract and any pledged collateral. In such instances, our counterparties are required to act in good faith in making determinations of value. In the event of a margin call, we must generally provide additional collateral on the same business day.

#### Dividends

As a REIT, we are required to distribute to our shareholders amounts equal to at least 90% of our REIT taxable income for each taxable year after consideration of our tax NOL carryforwards. We generally fund our dividend distributions through our cash flows from operations. If we make dividend distributions in excess of our operating cash flows during the period, whether for purposes of meeting our REIT distribution requirements or other strategic

reasons, those distributions are generally funded either through our existing cash balances or through the return of principal from our investments (either through repayment or sale).

We have a net operating tax loss ("NOL") carryforward that we could use to offset our REIT taxable income distribution requirement. This NOL carryforward had an estimated balance of \$89.8 million as of September 30, 2018. We also have deferred tax hedge losses on terminated derivative instruments, which will be recognized over the original periods being hedged by those terminated derivatives. These losses have already been recognized in our GAAP earnings but will reduce taxable income over the next ten years as noted in the following table:

48

---

	Tax Hedge
(\$ in thousands)	Loss
	Deduction
2018	\$ 19,149
2019	17,187
2020	5,134
2021 - 2028	2,865
	\$ 44,335

If any of the deferred tax hedge losses for the years noted in the table above result in dividend distributions to our shareholders in excess of REIT taxable income, the excess dividends distributed will be considered a return of capital to the shareholder. Approximately 79% of our common stock dividends declared during the nine months ended September 30, 2018 will represent a return of capital to shareholders and not a distribution of REIT taxable income, principally as a result of the amount of the tax hedge loss deduction.

### Contractual Obligations

The following table summarizes our contractual obligations by payment due date as of September 30, 2018:

(\$ in thousands)	Payments due by period				
	Total	< 1 year	1-3 years	3-5 years	> 5 years
Contractual Obligations:					
Repurchase agreements <sup>(1)</sup>	\$2,754,448	\$2,754,448	\$—	\$—	\$—
Non-recourse collateralized financing <sup>(2)</sup>	3,758	1,155	1,501	803	299
Operating lease obligations	329	109	220	—	—
Total	\$2,758,535	\$2,755,712	\$1,721	\$ 803	\$ 299

(1) Includes estimated interest payments calculated using interest rates in effect as of September 30, 2018.

(2) Amounts shown are for principal only and exclude interest obligations as those amounts are not significant. Non-recourse collateralized financing represents securitization financing that is payable solely from loans and securities pledged as collateral. Payments due by period were estimated based on the principal repayments forecasted for the underlying loans and securities, substantially all of which is used to repay the associated financing outstanding.

### Other Matters

As of September 30, 2018, we do not believe that any off-balance sheet arrangements exist that are reasonably likely to have a material effect on our current or future financial condition, results of operations, or liquidity other than as discussed above. In addition, we do not have any material commitments for capital expenditures and have not obtained any commitments for funds to fulfill any capital obligations.

### RECENT ACCOUNTING PRONOUNCEMENTS

There were no accounting pronouncements issued during the nine months ended September 30, 2018 that are expected to have a material impact on the Company's financial condition or results of operations.

### FORWARD-LOOKING STATEMENTS

Certain written statements in this Quarterly Report on Form 10-Q that are not historical facts constitute "forward-looking statements" within the meaning of Section 27A of the 1933 Act and Section 21E of the Exchange Act. Statements in this report addressing expectations, assumptions, beliefs, projections, future plans and strategies, future events, developments that we expect or anticipate will occur in the future, and future operating results are forward-looking statements. Forward-looking statements are based upon management's beliefs, assumptions, and

expectations as of the date of this report regarding future events and operating performance, taking into account all information currently available to us, and are applicable only as of the date of this report. Forward-looking statements generally can be identified by use of words such as “believe”, “expect”, “anticipate”, “estimate”, “plan” “may”, “will”, “intend”, “should”, “could” or similar expressions. We caution readers not to place undue reliance on our forward-looking statements, which are not historical facts and may be based on projections, assumptions, expectations, and anticipated events that do not materialize. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statement whether as a result of new information, future events, or otherwise.



Forward-looking statements in this Quarterly Report on Form 10-Q may include, but are not limited to statements about:

- Our business and investment strategy including our ability to generate acceptable risk-adjusted returns and our target investment allocations, and our views on the future performance of MBS and other investments;
- Our views on conditions in the investment, credit, and derivatives markets;
- Our views on the effect of actual or proposed actions of the U.S. Federal Reserve, the FOMC, or other central banks with respect to monetary policy (including the targeted Federal Funds Rate), and the potential impact of these actions on interest rates, inflation or unemployment;
- The effect of regulatory initiatives of the Federal Reserve (including the FOMC), other financial regulators, and other central banks;
- Our financing strategy including our target leverage ratios, our use of TBA dollar roll transactions, and anticipated trends in financing costs, and our hedging strategy including changes to the derivative instruments to which we are a party, and changes to government regulation of hedging instruments and our use of these instruments;
- Our investment portfolio composition and target investments;
- Our investment portfolio performance, including the fair value, yields, and forecasted prepayment speeds of our investments;
- Our liquidity and ability to access financing, and the anticipated availability and cost of financing;
- Our stock repurchase activity and the impact of stock repurchases;
- Our use of and restrictions on using our tax NOL carryforward;
- The status of pending litigation;
- The competitive environment in the future, including competition for investments and the availability of financing;
- Estimates of future interest expenses, including related to the Company's repurchase agreements and derivative instruments;
- The status and effect of legislative reforms and regulatory rule-making or review processes, and the status of reform efforts and other business developments in the repurchase agreement financing market;
- Market, industry and economic trends, and how these trends and related economic data may impact the behavior of market participants and financial regulators; and
- Market interest rates and market spreads.

Forward-looking statements are inherently subject to risks, uncertainties and other factors that could cause our actual results to differ materially from historical results or from any results expressed or implied by such forward-looking statements. Not all of these risks and other factors are known to us. New risks and uncertainties arise over time, and it is not possible to predict those events or how they may affect us. The projections, assumptions, expectations or beliefs upon which the forward-looking statements are based can also change as a result of these risks or other factors. If such a risk or other factor materializes in future periods, our business, financial condition, liquidity and results of operations may vary materially from those expressed or implied in our forward-looking statements.

While it is not possible to identify all factors that may cause actual results to differ from historical results or from any results expressed or implied by forward-looking statements, or that may cause our projections, assumptions, expectations or beliefs to change, some of those factors include the following:

- the risks and uncertainties referenced in this Quarterly Report on Form 10-Q, particularly those set forth under and incorporated by reference into Part II, Item 1A, "Risk Factors";
- our ability to find suitable reinvestment opportunities;
- changes in domestic economic conditions;
- changes in interest rates and interest rate spreads, including the repricing of interest-earning assets and interest-bearing liabilities;
- our investment portfolio performance particularly as it relates to cash flow, prepayment rates and credit performance;



the impact on markets and asset prices from the Federal Reserve's balance sheet normalization process through the reduction in its holdings of Agency RMBS and U.S. Treasuries;

actual or anticipated changes in Federal Reserve monetary policy or the monetary policy of other central banks;

adverse reactions in U.S. financial markets related to actions of foreign central banks or the economic performance of foreign economies including in particular China, Japan, the European Union, and the United Kingdom;

uncertainty concerning the long-term fiscal health and stability of the United States;

the cost and availability of financing, including the future availability of financing due to changes to regulation of, and capital requirements imposed upon, financial institutions;

the cost and availability of new equity capital;

changes in our use of leverage;

changes to our investment strategy, operating policies, dividend policy or asset allocations;

the quality of performance of third-party servicer providers of our loans and loans underlying our securities;

the level of defaults by borrowers on loans we have securitized;

changes in our industry;

increased competition;

changes in government regulations affecting our business;

changes or volatility in the repurchase agreement financing markets and other credit markets;

changes to the market for interest rate swaps and other derivative instruments, including changes to margin requirements on derivative instruments;

uncertainty regarding continued government support of the U.S. financial system and U.S. housing and real estate markets; or to reform the U.S. housing finance system including the resolution of the conservatorship of Fannie Mae and Freddie Mac;

the composition of the Board of Governors of the Federal Reserve System;

ownership shifts under Section 382 that further limit the use of our tax NOL carryforward;

systems failures or cybersecurity incidents; and

exposure to current and future claims and litigation.

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

Market risk is the exposure to losses resulting from changes in market factors. Our business strategy exposes us to a variety of market risks, including interest rate, spread, prepayment, reinvestment, credit, and liquidity risks. These risks can and do cause fluctuations in our comprehensive income and book value as discussed below.

#### Interest Rate Risk

Investing in interest-rate sensitive investments such as MBS and TBA securities subjects us to interest rate risk. Interest rate risk results from investing in securities that have a fixed coupon or when the coupon may not immediately adjust for changes in interest rates. Interest rate risk also results from the mismatch between the duration of our assets versus the duration of our liabilities and hedges.

The measures of an instrument's price sensitivity to interest rate fluctuations are its duration and convexity. Duration measures the percentage change in projected market value of our investments and derivative instruments given a change in interest rates. The duration of RMBS and TBA securities tend to increase when interest rates rise and decrease when interest rates fall, which is commonly referred to as negative convexity. This occurs because prepayments of the mortgage loans underlying the RMBS tend to decline when interest rates rise (which extends the life of the security) and increase when interest rates fall (which shortens the life of the security). The fair value of TBA securities react similarly to RMBS to changes in interest rates as they are based on an underlying non-specified pool of fixed-rate RMBS securities. CMBS and CMBS IO, however, generally have little convexity because the mortgage loans underlying the securities contain some form of prepayment protection provision (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties) which create an economic disincentive for the loans to prepay.

We attempt to manage our exposure to changes in interest rates that results from the duration mismatch between our assets and liabilities by entering into interest rate swaps and other instruments to hedge this risk. We manage interest rate risk within tolerances set by our Board of Directors. Our portfolio duration changes based on the composition of our investment portfolio and our hedge positions as well as market factors. We calculate our portfolio duration based on modeled projected cash flows, and such calculated duration can be an imprecise measure of actual interest rate risk. In the case of Agency RMBS and TBA securities, the primary input to the calculated duration is the anticipated prepayment speed of the underlying mortgage loans, which is sensitive to future interest rates and borrowers' behavior. Estimates of prepayment speeds can vary significantly by investor for the same security and therefore estimates of security and portfolio duration can vary significantly.

During a period of rising interest rates (particularly short term rates in a flattening yield curve environment), normally our borrowing costs will increase faster than our asset yields, negatively impacting our net interest income. The amount of the impact will depend on the composition of our portfolio, our hedging strategy, the effectiveness of our hedging instruments as well as the magnitude and the duration of the increase in interest rates.

As of September 30, 2018, we had a positive net duration gap in our investment portfolio. This indicates that our liabilities mature or reset sooner than our investments, and we have not fully hedged this difference. Therefore, increases in interest rates, particularly rapid increases, will negatively impact the market value of our investments, thereby reducing our book value. The table below shows the projected sensitivity of our net interest income (excluding TBA drop income) and net periodic interest costs on our interest rate swaps; the projected sensitivity of the market value of our investments and derivative instruments (including TBA securities); and the percentage change in shareholders' equity based on an instantaneous parallel shift in market interest rates as of the dates indicated.

Changes in types of our investments, the returns earned on these investments, future interest rates, credit spreads, the shape of the yield curve, the availability of financing, and/or the mix of our investments and financings including

derivative instruments may cause actual results to differ significantly from the modeled results. There can be no assurance that assumed events used for the model below will occur, or that other events will not occur, that will affect the outcomes; therefore, the tables below and all related disclosures constitute forward-looking statements.

Edgar Filing: DYNEX CAPITAL INC - Form 10-Q

	September 30, 2018			December 31, 2017		
	Percentage Change in			Percentage Change in		
Parallel Shift in Interest Rates	Market Value of Investments (1)	Shareholders' Equity	Net Interest Income and Net Periodic Interest Costs (2)	Market Value of Investments (1)	Shareholders' Equity	Net Interest Income and Net Periodic Interest Costs (2)
			%			%
+100	(1.8)%	(11.0 )%	4.5 %	(1.7)%	(10.0 )%	(8.1 )%
+50	(0.7)%	(4.5 )%	2.7 %	(0.7)%	(4.0 )%	(3.2 )%
-50	0.4 %	2.5 %	(5.9 )%	0.3 %	1.8 %	0.7 %
-100	0.3 %	1.9 %	(16.2)%	0.3 %	1.6 %	2.3 %

(1) Includes changes in market value of our investments and derivative instruments, including TBA securities, but excludes changes in market value of our financings because they are not carried at fair value on our balance sheet. The projections for market value do not assume any change in credit spreads.

(2) Includes changes in net interest income as well as net periodic interest costs on our interest rate swaps recorded in “gain (loss) on derivatives instruments, net”. TBA drop income is not included in the sensitivity analysis for net interest income and net periodic interest costs.

We entered into additional interest rate swaps to hedge the interest rate risk resulting from the implied financing cost inherent in our TBA dollar roll positions; however, the projected sensitivity of TBA drop income (implied interest income less implied financing costs) are not included in the net interest income sensitivity analysis. Because we held a higher projected average notional balance of effective interest rate swaps for the 12-month projection as of September 30, 2018 compared to the 12-month projection as of December 31, 2017, a parallel increase in interest rates is projected to increase our net interest income and net periodic benefit/cost (and decrease if interest rates decline) for the 12-month projection as of September 30, 2018 compared to the 12-month projection as of December 31, 2017. Management also considers changes in the shape of the interest rate curves in assessing and managing portfolio interest rate risk. Often interest rates do not move in a parallel fashion from quarter to quarter. The table below shows the percentage change in projected market value of our investment portfolio net of derivative instruments for instantaneous changes in the shape of the U.S. Treasury (“UST”) curve (with similar changes to the interest rate swap curves) as of the dates indicated:

Basis Point Change in		September 30, 2018			December 31, 2017		
		Percentage Change in			Percentage Change in		
2-year UST	10-year UST	Market Value of Investments (1)	Shareholders' Equity	Market Value of Investments (1)	Shareholders' Equity	Market Value of Investments (1)	Shareholders' Equity
				%		%	
+25	+50	(0.6)%	(3.4 )%	(0.5)%	(3.0 )%	(0.5)%	(3.0 )%
+25	+0	(0.2)%	(1.0 )%	(0.2)%	(0.9 )%	(0.2)%	(0.9 )%
+50	+25	(0.5)%	(3.0 )%	(0.5)%	(2.8 )%	(0.5)%	(2.8 )%
+50	+100	(1.5)%	(8.9 )%	(1.3)%	(7.7 )%	(1.3)%	(7.7 )%
-10	-50	0.2 %	1.3 %	0.1 %	0.8 %	0.1 %	0.8 %

(1) Includes changes in market value of our investments and derivative instruments, including TBA securities, but excludes changes in market value of our financings because they are not carried at fair value on our balance sheet. The projections for market value do not assume any change in credit spreads.



## Spread Risk

Spread risk is the risk of loss from an increase in the market spread between the yield on an investment versus its benchmark index. Changes in market spreads represent the market's valuation of the perceived riskiness of an asset relative to risk-free rates, and widening spreads reduce the market value of our investments as market participants require additional yield to hold riskier assets. Market spreads could change based on macroeconomic or systemic factors as well as the 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 or FOMC monetary policy. Likewise, most of our investments are fixed-rate or reset in rate over a period of time, and as interest rates rise, we would expect the market value of these investments to decrease.

Fluctuations in spreads typically vary based on the type of investment. Sensitivity to changes in market spreads is derived from models that are dependent on various assumptions, and actual changes in market value in response to changes in market spreads could differ materially from the projected sensitivity if actual conditions differ from these assumptions.

The table below is an estimate of the percentage change in projected market value of our investments (including TBA securities) given the indicated change in market spreads as of the dates indicated:

Basis Point Change in Market Spreads	Percentage Change in Projected Market Value of Investments	
	September 30, 2018	December 31, 2017
	+50	(3.0)%
+25	(1.7)%	(1.1)%
-25	1.6%	1.6%
-50	3.2%	3.2%

## Prepayment and Reinvestment Risk

Prepayment risk is the risk of an early, unscheduled return of principal on an investment. We are subject to prepayment risk from premiums paid on investments, which are amortized as a reduction in interest income using the effective yield method under GAAP. Principal prepayments on our investments are influenced by changes in market interest rates and a variety of economic, geographic, government policy, and other factors beyond our control.

Loans underlying our CMBS and CMBS IO securities typically have some form of prepayment protection provisions (such as prepayment lock-outs) or prepayment compensation provisions (such as yield maintenance or prepayment penalties). Yield maintenance and prepayment penalty requirements are intended to create an economic disincentive for the loans to prepay; however, the amount of the prepayment penalty required to be paid may decline over time, and as loans age, interest rates decline, or market values of collateral supporting the loans increase, prepayment penalties may lessen as an economic disincentive to the borrower. Generally, our experience has been that prepayment lock-out and yield maintenance provisions result in stable prepayment performance from period to period. There are no prepayment protections, however, if the loan defaults and is partially or wholly repaid earlier as a result of loss mitigation actions taken by the underlying loan servicer. Historically, we have experienced low default rates on loans underlying CMBS and CMBS IO.



Because CMBS IO consist of rights to interest on the underlying commercial mortgage loan pools and do not have rights to principal payments on the underlying loans, prepayment risk on these securities would be particularly acute without these prepayment protection provisions. CMBS IO prepayment protection and compensation provisions vary by issuer of the security (i.e. Freddie Mac, Fannie Mae, Ginnie Mae, or non-Agency). The majority of our Agency CMBS IO are issued by Freddie Mac and these securities generally have initial prepayment lock-outs followed by a defeasance period which on average extends to within six months of the stated maturities of the underlying loans. Non-Agency CMBS IO generally have prepayment protection in the form of prepayment lock-outs and defeasance provisions.

Prepayments on the loans underlying our RMBS generally accelerate in a declining interest rate environment, as the loans age, and, with respect to ARMS, as the loans near their respective interest rate reset dates, particularly the initial reset date,

or if expectations are that interest rates will rise in the future. Our prepayment models anticipate an acceleration of prepayments in these events. To the extent the actual prepayments exceed our modeled prepayments, or, with respect to adjustable-rate RMBS, if we change our future prepayment expectations, we will record adjustments to our premium amortization which may negatively impact our net interest income. In addition, changes in market expectations of prepayments could impact the fair value of our RMBS.

We seek to manage our prepayment risk on our MBS by diversifying our investments, seeking investments which we believe will have superior prepayment performance, and investing in securities which have some sort of prepayment prohibition or yield maintenance (as is the case with CMBS and CMBS IO). With respect to RMBS, when we invest in RMBS at a premium to the security's par value, we tend to favor securities in which we believe the underlying borrowers have some disincentive to refinance as a result of the size of each loan's principal balance, credit characteristics of the borrower, or geographic location of the property, among other factors.

We are also subject to reinvestment risk as a result of the prepayment, repayment and sales of our investments. In order to maintain our investment portfolio size and our earnings, we need to reinvest capital received from these events into new interest-earning assets or TBA securities. If we are unable to find suitable reinvestment opportunities or if yields on assets in which we reinvest are lower than yields on existing assets, our results and cash flows could be negatively impacted. In addition, 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 even when attractive reinvestment opportunities are available, or we may decide to reinvest in assets with lower yield but greater liquidity. If we retain capital or pay dividends to return capital to shareholders rather than reinvest capital, or if we invest capital in lower yielding assets for liquidity reasons, the size of our investment portfolio and the amount of income generated by our investment portfolio will likely decline.

#### Credit Risk

Credit risk is the risk that we will not receive all contractual amounts due on investments that we own due to default by the borrower or due to a deficiency in proceeds from the liquidation of the collateral securing the obligation. Agency RMBS and Agency CMBS have credit risk to the extent that Fannie Mae or Freddie Mac fails to remit payments on the MBS for which they have issued a guaranty of payment. Given the improved financial performance and conservatorship of these entities and the continued support of the U.S. government, we believe this risk is low. Since Agency CMBS IO represent the right to excess interest and not principal on the underlying loans, these securities are exposed to the loss of investment basis in the event a loan collateralizing the security liquidates without paying yield maintenance or prepayment penalty, which typically occurs when an involuntarily liquidating loan repays all or a portion of its related principal balance.

We are exposed to credit risk on our non-Agency securities and we attempt to mitigate our credit risk through asset selection and by purchasing higher quality non-Agency MBS. Our non-Agency MBS are typically investment grade rated securities which we believe will have strong credit performance. We do not currently seek to purchase heavily discounted, credit sensitive MBS. The majority of our non-Agency securities are CMBS IO and the return we earn on these securities is dependent on the credit performance of the underlying commercial loans. In particular, since investments in CMBS IO pay interest from the underlying commercial mortgage loan pools, returns generally are more negatively impacted by liquidations of loans in the underlying loan pool. Please refer to "Financial Condition-Repurchase Agreements" within Part I, Item 2 of this Quarterly Report on Form 10-Q for information regarding the credit ratings on our non-Agency MBS.

#### Liquidity Risk

We have liquidity risk principally from the use of recourse repurchase agreements to finance our ownership of securities. In general, our repurchase agreements provide a source of uncommitted short-term financing for

longer-term assets, thereby creating a mismatch between the maturities of the asset and the associated financing. Our repurchase agreements are renewable at the discretion of our lenders and do not contain guaranteed roll-over terms. If we fail to repay the lender at maturity, the lender has the right to immediately sell the collateral and pursue us for any shortfall if the sales proceeds are inadequate to cover the repurchase agreement financing. In addition, declines in the market value of our investments pledged as collateral for repurchase agreement borrowings may result in counterparties initiating margin calls for additional collateral.

Our use of TBA long positions as a means of investing in and financing Agency RMBS also exposes us to liquidity risk in the event that we are unable to roll or terminate our TBA contracts prior to their settlement date. If we are unable to roll or terminate our TBA long positions, we could be required to take physical delivery of the underlying securities and settle our obligations for cash, which could negatively impact our liquidity position or force us to sell assets under adverse conditions if financing is not available to us on acceptable terms.

For further information, including how we attempt to mitigate liquidity risk and monitor our liquidity position, please refer to “Liquidity and Capital Resources” in Part I, Item 2 of this Quarterly Report on Form 10-Q.

#### ITEM 4. CONTROLS AND PROCEDURES

Disclosure controls and procedures.

Our management evaluated, with the participation of our Principal Executive Officer and Principal Financial Officer, the effectiveness of our disclosure controls and procedures, as defined in Exchange Act Rule 13a-15(e), as of the end of the period covered by this report. Based on that evaluation, our Principal Executive Officer and Principal Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2018 to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Principal Executive Officer and Principal Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting.

Our management is also responsible for establishing and maintaining adequate internal control over financial reporting as defined in Exchange Act Rule 13a-15(f). There were no changes in our internal control over financial reporting during the three months ended September 30, 2018 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

There have been no material developments during the three months ended September 30, 2018 with respect to the litigation against the Company and DCI Commercial, Inc. (“DCI”), as co-defendants, discussed in the Company’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2018 and in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017. The garnishment action related to DCI, which is also discussed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017, is ongoing, but there have been no material developments with respect to this garnishment action during the nine months ended September 30, 2018.

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

### ITEM 1A. RISK FACTORS

Risks and uncertainties identified in our forward-looking statements contained in this Quarterly Report on Form 10-Q together with those previously disclosed in the Annual Report on Form 10-K for the year ended December 31, 2017 or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations and cash flows. See “Forward-Looking Statements” contained in Part I, Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” within this Quarterly Report on Form 10-Q as well as Part I, Item 1A, “Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2017.

### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

#### Issuer Purchases of Equity Securities

The Company has been authorized by its Board of Directors to repurchase up to \$40 million of its outstanding shares of common stock through December 31, 2018. 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. During the three months ended September 30, 2018, the Company did not repurchase any shares of common stock under this repurchase authorization, and the Company did not withhold any shares of common stock to satisfy tax withholding obligations arising upon the vesting of restricted shares.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

### ITEM 4. MINE SAFETY DISCLOSURES

None.

### ITEM 5. OTHER INFORMATION

None.



ITEM 6. EXHIBITS

Exhibit No.	Description
3.1	<u>Restated Articles of Incorporation, effective June 2, 2014 (incorporated herein by reference to Exhibit 3.1 to Dynex's Registration Statement on Form S-8 filed September 17, 2014).</u>
3.2	<u>Amended and Restated Bylaws, effective as of March 12, 2018 (incorporated herein by reference to Exhibit 3.2 to Dynex's Quarterly Report on Form 10-Q for the quarter ended March 31, 2018).</u>
10.24.1	<u>Amendment No. 1 to Guarantee Agreement by Dynex Capital, Inc. in favor of Wells Fargo Bank, National Association, dated September 13, 2018 (filed herewith).</u>
10.29.1	<u>Amendment No. 1, dated September 4, 2018, to Equity Distribution Agreement by and among Dynex Capital, Inc., Ladenburg Thalmann &amp; Co. Inc., and JonesTrading Institutional Services LLC (incorporated herein by reference to Exhibit 10.29.1 to Dynex's Current Report on Form 8-K filed September 4, 2018).</u>
12.1	<u>Statement Regarding Computation of Ratio of Earnings to Fixed Charges and Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividends (filed herewith).</u>
31.1	<u>Certification of principal executive officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).</u>
31.2	<u>Certification of principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).</u>
32.1	<u>Certification of principal executive officer and principal financial officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).</u>
101	The following materials from Dynex Capital, Inc.'s Quarterly Report on Form 10-Q for the three months ended September 30, 2018, formatted in XBRL (Extensible Business Reporting Language), filed herewith: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Comprehensive Income (Loss), (iii) Consolidated Statement of Shareholders' Equity, (iv) Consolidated Statements of Cash Flows, and (v) Notes to Unaudited Consolidated Financial Statements.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DYNEX CAPITAL, INC.

Date: November 6, 2018 /s/ Byron L. Boston  
Byron L. Boston  
Chief Executive Officer, President,  
Co-Chief Investment Officer, and Director  
(Principal Executive Officer)

Date: November 6, 2018 /s/ Stephen J. Benedetti  
Stephen J. Benedetti  
Executive Vice President, Chief Financial Officer and Chief Operating Officer  
(Principal Financial Officer)