

Section 1: 10-K (10-K)

[Table of Contents](#)

UNITED STATES SECURITIES AND EXCHANGE COMMISSION WASHINGTON, D.C. 20549		
FORM 10-K		
☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2019 OR ☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO COMMISSION FILE NUMBER 001-13709		
ANWORTH MORTGAGE ASSET CORPORATION (Exact Name of Registrant as Specified in Its Charter)		
MARYLAND (State or Other Jurisdiction of incorporation or organization) 1299 OCEAN AVENUE, 2ND FLOOR SANTA MONICA, CALIFORNIA (Address of Principal Executive Offices)	52-2059785 (I.R.S. Employer Identification No.) 90401 (Zip Code)	Registrant’s telephone number, including area code: (310) 255-4493 Securities registered pursuant to Section 12(b) of the Act:
Title of Each Class	Trading Symbol(s)	Name of Each Exchange on Which Registered
Common Stock, \$0.01 Par Value	ANH	New York Stock Exchange
Series A Cumulative Preferred Stock, \$0.01 Par Value	ANHPRA	New York Stock Exchange
Series B Cumulative Convertible Preferred Stock, \$0.01 Par Value	ANHPRB	New York Stock Exchange
Series C Cumulative Redeemable Preferred Stock, \$0.01 Par Value	ANHPRC	New York Stock Exchange
Securities registered pursuant to Section 12(g) of the Act: NONE		
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ☐ No ☒		
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒		
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 Act). Yes ☐ No ☒

The aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant, computed by reference to the closing price of such stock on the New York Stock Exchange, as of June 30, 2019 was approximately \$367,467,902.

As of March 4, 2020, the registrant had 98,915,645 shares of common stock issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of this Form 10-K incorporates by reference certain portions of the registrant’s proxy statement for its 2020 annual meeting of stockholders to be filed with the Commission not later than 120 days after the end of the fiscal year covered by this report.

[Table of Contents](#)

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

FORM 10-K ANNUAL REPORT

FISCAL YEAR ENDED DECEMBER 31, 2019

TABLE OF CONTENTS

<u>Item</u>		Page
	<u>PART I</u>	
<u>1.</u>	<u>Business</u>	1
<u>1A.</u>	<u>Risk Factors</u>	33
<u>1B.</u>	<u>Unresolved Staff Comments</u>	67
<u>2.</u>	<u>Properties</u>	67
<u>3.</u>	<u>Legal Proceedings</u>	67
<u>4.</u>	<u>Mine Safety Disclosures</u>	67
	<u>PART II</u>	
<u>5.</u>	<u>Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	67
<u>6.</u>	<u>Selected Financial Data</u>	71
<u>7.</u>	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	72
<u>7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	92
<u>8.</u>	<u>Financial Statements and Supplementary Data</u>	97
<u>9.</u>	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	97
<u>9A.</u>	<u>Controls and Procedures</u>	97
<u>9B.</u>	<u>Other Information</u>	99
	<u>PART III</u>	
<u>10.</u>	<u>Directors, Executive Officers and Corporate Governance</u>	100
<u>11.</u>	<u>Executive Compensation</u>	100
<u>12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	100
<u>13.</u>	<u>Certain Relationships and Related Transactions, and Director Independence</u>	100
<u>14.</u>	<u>Principal Accountant Fees and Services</u>	100
	<u>PART IV</u>	
<u>15.</u>	<u>Exhibits and Financial Statement Schedules</u>	101
	<u>Signatures</u>	105

PART I

Item 1. BUSINESS

Overview

Our Company

We were incorporated in Maryland on October 20, 1997 and commenced operations on March 17, 1998. Our principal business is to invest in, finance and manage a leveraged portfolio of residential mortgage-backed securities, or MBS, and residential mortgage loans, which presently includes the following types of investments:

- *Agency mortgage-backed securities*, or Agency MBS, which include residential mortgage pass-through certificates and collateralized mortgage obligations, or CMOs, which are securities representing interests in pools of mortgage loans secured by residential property in which the principal and interest payments are guaranteed by a government-sponsored enterprise, or GSE, such as the Federal National Mortgage Association, or Fannie Mae, or the Federal Home Loan Mortgage Corporation, or Freddie Mac.
- *Non-agency mortgage-backed securities*, or Non-Agency MBS, which are securities issued by companies that are not guaranteed by federally sponsored enterprises and that are secured primarily by first-lien residential mortgage loans.
- *Residential mortgage loans*. We acquire non-Qualified Mortgage, or Non-QM, residential mortgage loans (which are described further on page 79) from independent loan originators with the intent of holding these loans for securitization. These loans are financed by a warehouse line of credit until securitization. We also hold residential mortgage loans through consolidated securitization trusts. We finance these loans through asset-backed securities, or ABS, issued by the consolidated securitization trusts. The ABS, which are held by unaffiliated third parties, are non-recourse financing. The difference in the amount of the loans in the trusts and the amount of the ABS represents our retained net interest in the securitization trusts.

Our principal business objective is to generate net income for distribution to our stockholders primarily based upon the spread between the interest income on our mortgage assets and our borrowing costs to finance our acquisition of those assets.

We have elected to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended, or the Code. As long as we retain our REIT status, we generally will not be subject to federal or state income taxes to the extent that we distribute our taxable net income to our stockholders, and we routinely distribute to our stockholders substantially all of the taxable net income generated from our operations. In order to qualify as a REIT, we must meet various ongoing requirements under the tax law, including requirements relating to the composition of our assets, the nature of our gross income, minimum distribution requirements and requirements relating to the ownership of our stock.

Our Manager

We are externally managed and advised by Anworth Management, LLC, or our Manager. Our Manager is supervised and directed by our board of directors, or our Board. Our day-to-day operations are being conducted by our Manager through the authority delegated to it under the Management Agreement between us and our Manager (which we refer to as the “Management Agreement”) and pursuant to the policies established by our Board.

Our Manager will also perform such other services and activities relating to our assets and operations as described in the Management Agreement. In exchange for services provided, our Manager receives a management fee paid monthly in arrears in an amount equal to one-twelfth of 1.20% of our Equity (as defined in the Management Agreement).

Special Note Regarding Forward-Looking Statements

This Annual Report on Form 10-K contains, or incorporates by reference, not only historical information but also forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, or the Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act, that are subject to the safe harbors created by such sections. Forward-looking statements involve numerous risks and uncertainties. Our actual results may differ from our beliefs, expectations, estimates, and projections and, consequently, you should not rely on these forward-looking statements as predictions of future events. Forward-looking statements are not historical in nature and can be identified by words such as “anticipate,” “estimate,” “will,” “should,” “expect,” “believe,” “assume,” “intend,” “seek,” “plan,” “target,” “goals,” “future,” “likely,” “may,” and similar expressions or their negative forms, or by reference to strategy, plans, or intentions. These forward-looking statements are subject to risks and

uncertainties including, among other things, those described in this Annual Report on Form 10-K under the caption “Risk Factors.” Other risks, uncertainties, and factors that could cause our actual results to differ materially and adversely from those projected are described below and may be described from time to time in reports we file with the U.S. Securities and Exchange Commission, or the SEC, including our Current Reports on Form 8-K. Forward-looking statements speak only as of the date they are made and we undertake no obligation to update or revise any such forward-looking statements, whether as a result of new information, future events, or otherwise.

Statements regarding the following subjects, among others, that may affect our actual results may be forward-looking: risks associated with investing in mortgage-backed securities, or MBS, and other mortgage-related assets; changes in interest rates and the market value of our target investments; changes in prepayment rates of the mortgage loans securing our mortgage-related investments; changes in the yield curve; the credit performance of our Non-Agency MBS, residential mortgage loans held-for-securitization, and residential mortgage loans held-for-investment through consolidated securitization trusts; the concentration of the credit risks we are exposed to; the state of the credit markets and other general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the availability of our target investments for purchase at attractive prices; the availability of financing for our target investments, including the availability of repurchase agreement financing and warehouse lines of credit; declines in home prices; increases in payment delinquencies and defaults on the mortgages comprising and underlying our target investments; changes in liquidity in the market for MBS, the re-pricing of credit risk in the capital markets, inaccurate ratings of securities by rating agencies, rating agency downgrades of securities, and changes in the supply of mortgage-related assets available-for-sale; changes in the values of the MBS and other mortgage-related investments in our portfolio and the impact of adjustments reflecting those changes on our financial statements; our ability to generate the amount of cash flow we expect from our target investments; changes in our investment and financial strategies and the new risks that those changes may expose us to; changes in the competitive environment within our industry; changes that may affect our Manager’s ability to attract and retain personnel; our ability to successfully diversify our business into new investments and manage the new risks they may expose us to; our ability to manage various operational and regulatory risks associated with our business; our ability to establish, adjust and maintain appropriate hedges for the risks to our portfolio; legislative and regulatory actions affecting the mortgage and derivatives industries or our business; implementation of or changes in government regulations or programs affecting our business; changes due to the consequences of actions by the U.S. government and other foreign governments to address various financial and economic issues and our ability to respond to and comply with such actions and changes; our ability to maintain our qualification as a REIT for federal income tax purposes; our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended; limitations imposed on our business due to our REIT status as exempt from registration under the Investment Company Act of 1940, as amended; and our ability to manage our growth. All forward-looking statements speak only as of the date they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we do not intend to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

As used in this Annual Report on Form 10-K, “Company,” “we,” “us,” “our” and “Anworth” refer to Anworth Mortgage Asset Corporation.

Our Investment Strategy

Our investment objective is to provide attractive risk-adjusted total returns to our stockholders over the long-term primarily through dividends and secondarily through capital appreciation. Our strategy is to invest in residential MBS (both Agency MBS and Non-Agency MBS), residential mortgage loans, and residential rental properties.

We seek to acquire assets that will produce competitive returns after considering the amount and nature of the investment’s anticipated returns, our ability to pledge the investment to secure collateralized borrowings and the costs associated with financing, managing and reserving for these investments.

Financing Strategy

Our primary financing source for our Agency MBS and Non-Agency MBS portfolios is repurchase agreements.

We have acquired residential mortgage loans that are being held-for-securitization. These loans are financed by a warehouse line of credit, which is a short-term revolving credit facility extended by the financial institution for loans that are being held pending securitization.

We also invest in the subordinate classes of newly-formed securitization trusts, which allows us to consolidate all of the loans of these trusts. These residential mortgage loans are financed through ABS issued by the securitization trusts. The ABS which are held by unaffiliated third parties are non-recourse financing. The difference in the amount of the loans and the amount of the ABS represents our retained net interest in the loans held in the securitization trusts.

We employ short-term borrowing to attempt to increase potential returns to our stockholders. Pursuant to our Capital and Leverage Policy, we seek to strike a balance between the under-utilization of leverage, which reduces potential returns to stockholders, and the over-utilization of leverage, which could reduce our ability to meet our obligations during adverse market conditions.

The amount of leverage we deploy for particular investments in our target investments depends upon an assessment of a variety of factors, which may include: the anticipated liquidity and price volatility of our assets; the gap between the duration of our assets and liabilities, including hedges; the availability and cost of financing our assets; our opinion of the credit worthiness of financing counterparties; the health of the U.S. economy and residential mortgage and housing markets; our outlook for the level, slope and volatility of interest rates; the credit quality of the loans we acquire and the loans underlying our MBS; and our outlook for asset spreads relative to the London Interbank Offered Rate, or LIBOR, curve.

Repurchase agreements are financings pursuant to which one party, the seller or borrower, sells assets to the repurchase agreement counterparty, the buyer or lender, for an agreed price with the obligation to repurchase the assets from the buyer at a future date and at a price higher than the original purchase price. The amount of financing available under a repurchase agreement is limited to a specified percentage of the estimated market value of the assets. The difference between the sale price and repurchase price is the interest expense of financing under a repurchase agreement. Under repurchase agreement financing arrangements, if the value of the collateral decreases, the buyer could require the seller to provide additional cash or other collateral to re-establish the ratio of value of the collateral to the amount of borrowing. In the current financing climate, lenders using repurchase agreements generally advance approximately 95% of the market value of the Agency MBS financed (meaning a 5% haircut) and 65% to 80% of the market value of the

Non-Agency MBS financed (meaning a 20% to 35% haircut). A significant decrease in advance rate or an increase in the haircut could result in our having to sell securities in order to meet additional margin requirements by the lender. We expect to mitigate our risk of margin calls under repurchase agreements by deploying a prudent amount of leverage.

In order to reduce our exposure to counterparty-related risk, we generally seek to diversify our exposure by entering into repurchase agreements with multiple counterparties. At December 31, 2019, we had approximately \$3.66 billion of outstanding balances under repurchase agreements with 18 different counterparties, with a maximum net exposure (the difference between the amount loaned to us and the value of the assets pledged by us as collateral) to any single lender of approximately \$50.5 million, or approximately 9.1% of our equity.

[Table of Contents](#)

Growth Strategy

It is our long-term objective to grow our earnings and our dividends per common share by increasing our paid-in capital and book value per share.

Our Target Investments

Our investment portfolio is focused on two different strategies that embody our hybrid investment approach. The target investments that fall under these strategies are:

Agency MBS

This strategy includes investing in Agency MBS and the related derivative transactions. The performance of this strategy is most affected by changes in interest rates, prepayments and mortgage spreads relative to U.S. Treasury securities. These assets have minimal exposure to the underlying credit of the investments. Agency MBS are collateralized by fixed-rate mortgage loans, adjustable-rate mortgage loans, hybrid mortgage loans, and any derivatives thereof, including:

- mortgage pass-through certificates issued by a GSE such as Fannie Mae and Freddie Mac; and
- “to-be-announced” forward contracts, or TBAs, which are pools of mortgages with specific investment terms to be issued by government-sponsored enterprises at a future date.

Mortgage Credit Investments

These assets include investing in Non-Agency MBS, residential mortgage loans and related derivative transactions. Examples of Non-Agency MBS include MBS collateralized by prime mortgage loans, Alt-A mortgage loans and subprime mortgage loans, which may have fixed-rate, adjustable-rate or hybrid-rate terms.

Non-Agency MBS

Non-Agency MBS includes both senior and mezzanine MBS. Senior MBS refers to Non-Agency MBS that represent the senior-most tranches – that is, tranches which have the highest priority claim to cash flows from the related collateral pool within the MBS structure. Mezzanine MBS refers to subordinated tranches within the collateral pool. The Non-Agency MBS we purchase may include investment grade and non-investment grade classes including non-rated securities.

We believe the performance of our Non-Agency MBS and residential mortgage loans are most affected by changes in credit performance of the underlying collateral. These assets also have interest rate and mortgage spread exposure, but we believe this exposure is not viewed to be the main driver of performance.

Residential Mortgage Loans Held-for-Securitization

Residential mortgage loans held for securitization are held at our wholly-owned subsidiary, Anworth Mortgage Loans, Inc. (incorporated August 2017), with the intent to sponsor our own securitizations. The residential mortgage loans held-for-securitization are financed by a warehouse line of credit.

Residential Mortgage Loans Held-for-Investment Through Consolidated Securitization Trusts

We invest in residential mortgage loans held-for-investment through consolidated securitization trusts. We finance our residential mortgage loans through ABS issued by the consolidated securitization trusts. The ABS which are held by unaffiliated third parties are non-recourse financing. The difference in the amount of the loans and the amount of the ABS represents our retained net interest in the loans held in the securitization trusts.

Residential Real Estate

These assets consist primarily of single-family residential properties which, after renovation, we lease to tenants. Our focus is on properties that produce high occupancy and attractive rental rates and generate long-term property appreciation.

Our Operating Policies and Programs

We have established the following four primary operating policies to implement our business strategies:

- our Asset Acquisition Policy;
- our Capital and Leverage Policy;
- our Credit Risk Management Policy; and
- our Asset/Liability Management Policy.

Asset Acquisition Policy

Our Asset Acquisition Policy provides guidelines for acquiring investments and contemplates that we will acquire a portfolio of investments that can be grouped into specific categories. Each category and our respective investment guidelines are as follows:

- *Category I* — At least 60% of our total assets will generally be high-quality MBS, unsecuritized prime residential mortgage loans, and short-term investments. MBS in this category will be rated within one of the three highest rating categories (A- rated or better) by at least one nationally recognized statistical rating organization or, if not rated, will be obligations guaranteed by a GSE, such as Fannie Mae or Freddie Mac. Also included in Category I are the portion of mortgage loans that have been deposited into a trust and have received a rating within one of the three highest rating categories by at least one nationally recognized statistical rating organization.
- *Category II* — At least 90% of our total assets will generally consist of Category I investments plus other mortgage-related assets. Included in this category are mortgage securities not rated within one of the three highest rating categories by at least one nationally recognized statistical rating organization, mortgage derivative securities, mortgage servicing rights, unsecuritized non-prime residential mortgage loans, shares of other REITs or mortgage-related companies and the portion of real estate mortgage loans that have been deposited into a trust and have not received a rating within one of the three highest rating categories by at least one nationally recognized statistical rating organization.
- *Category III* — Assets not meeting any of the above criteria will be less than 10% of our total assets. Included in this category is the ownership of real estate.

Capital and Leverage Policy

We employ a leverage strategy to increase our investment assets by borrowing against existing mortgage-related assets and using the proceeds to acquire additional mortgage-related assets. Our borrowings may vary from time to time depending on market conditions and other factors deemed relevant by our management and our Board. We believe that this will leave an adequate capital base to protect against interest rate environments in which our borrowing costs might exceed our interest income from mortgage-related assets. At December 31, 2019, our leverage on capital (including common stockholders’ equity, all preferred stock, and junior subordinated notes) was 6.2x.

Our mortgage-related assets are financed primarily at short-term borrowing rates through repurchase agreements. We also employ borrowings under a warehouse line of credit that we established with an institutional lender.

Credit Risk Management Policy

Subject to the constraints of our Asset Acquisition Policy, we are allowed to own both investment grade and non-investment grade Non-Agency MBS and other mortgage-related assets. Prior to purchase, we review credit risk and other risks of loss associated with each of our potential investments. To lessen our overall credit risk, we may diversify our portfolio of mortgage-related assets relative to geographic, insurer, industry and certain other types of concentrations. With respect to loans acquired for securitization, we employ an independent due diligence firm to ensure that the loans are in accordance with our established credit lending guidelines and policies.

If there is a decline in the credit quality of any of our Non-Agency MBS holdings or in our loans, we may, after evaluation, maintain or increase our holdings or liquidate all or a portion of the position. We are not required to sell a security when it is moved to a lower Category in our Asset Acquisition Policy.

Asset/Liability Management Policy

Interest Rate Risk Management. To the extent consistent with our election to qualify as a REIT, we follow an interest rate risk management program intended to protect our portfolio of mortgage-related assets and related debt against the effects of major interest rate changes. Specifically, our interest rate management program is formulated with the intent to offset, to some extent, the potential adverse effects resulting from rate adjustment limitations on our mortgage-related assets and the differences between interest rate adjustment indices and interest rate adjustment periods of our adjustable-rate mortgage-related assets and related borrowings.

Our interest rate risk management program encompasses a number of procedures including the following:

- monitoring and adjusting, if necessary, the interest rate sensitivity of our mortgage-related assets compared with the interest rate sensitivities of our borrowings;
- attempting to structure our borrowing agreements relating to adjustable-rate mortgage-related assets to have a range of different maturities and interest rate adjustment periods (although substantially all will be less than one year); and
- actively managing, on an aggregate basis, the interest rate indices and interest rate adjustment periods of our mortgage-related assets compared to the interest rate indices and adjustment periods of our borrowings.

We expect to be able to adjust the average maturity/adjustment period of our borrowings on an ongoing basis by changing the mix of maturities and interest rate adjustment periods as borrowings come due or are renewed. Through the use of these procedures, we attempt to reduce the risk of differences between interest rate adjustment periods of our adjustable-rate mortgage-related assets and our related borrowings.

Depending on market conditions and the cost of the transactions, we may conduct certain hedging activities in connection with the management of our portfolio. To the extent consistent with our election to qualify as a REIT, we may adopt a hedging strategy intended to lessen the effects of interest rate changes and to enable us to earn net interest income in periods of generally rising, as well as declining or static, interest rates. Specifically, hedging programs are formulated with the intent to offset some of the potential adverse effects of changes in interest rate levels relative to the interest rates on the mortgage-related assets held in our investment portfolio and differences between the interest rate adjustment indices and periods of our mortgage-related assets and our borrowings. We monitor carefully, and may have to limit, our hedging activity to assure that we do not realize excessive hedging income or hold hedges having excess value in relation to our mortgage-related assets, which could result in our disqualification as a REIT or, in the case of excess hedging income, if the excess is due to reasonable cause and not willful neglect, the payment of a penalty tax for failure to satisfy certain REIT income tests under the Code. In addition, hedging activity involves transaction costs that increase dramatically as the period covered by hedging protection increases and that may increase during periods of fluctuating interest rates.

[Table of Contents](#)

Prepayment Risk Management. We also seek to lessen the effects of prepayment of mortgage loans underlying our investments at a faster or slower rate than anticipated. We accomplish this by structuring a diversified portfolio with a variety of prepayment characteristics, investing in mortgage-related assets whose underlying loans have attractive prepayment characteristics, and purchasing mortgage-related assets at a premium or at a discount.

We believe that we have developed cost-effective asset/liability management policies to mitigate prepayment risks. However, no strategy can completely insulate us from prepayment risks. Further, as noted above, certain of the federal income tax requirements that we must satisfy to qualify as a REIT limit our ability to fully hedge our prepayment risks. Therefore, we could be prevented from effectively hedging our prepayment risks.

Our Investment Portfolio

Agency MBS

Residential Mortgage Pass-Through Certificates. We principally invest in pass-through certificates, which are securities representing interests in “pools” of mortgage loans secured by residential real property in which payments of both interest and principal on the securities are generally made monthly to holders of the security, in effect “passing through” monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer/guarantor and servicers of the securities. In general, mortgage pass-through certificates distribute cash flows from underlying collateral on a pro rata basis among certificate holders. The payment of principal and interest on these securities is guaranteed by Ginnie Mae or a GSE such as Fannie Mae or Freddie Mac.

Early repayment of principal on some MBS, arising from prepayments of principal due to sale of the underlying property, refinancing or foreclosure, net of fees and costs which may be incurred, may expose us to a lower rate of return upon reinvestment of principal. This is generally referred to as “prepayment risk.” Additionally, if a security subject to prepayment has been purchased at a premium, the unamortized value of the premium would be lost in the event of prepayment.

Like other fixed-income securities, when interest rates rise, the value of a mortgage-backed security generally will decline. When interest rates are declining, however, the value of MBS with prepayment features may not increase as much as other fixed-income securities. The rate of prepayments on underlying mortgages will affect the price and volatility of MBS and may have the effect of shortening or extending the effective maturity of the security beyond what was anticipated at the time of purchase. When interest rates rise, our holdings of MBS may experience reduced returns if the owners of the underlying mortgages pay off their mortgages later than anticipated. This is generally referred to as “extension risk.”

Payment of principal and interest on some mortgage pass-through securities, though not the market value of the securities themselves, may be guaranteed by the full faith and credit of the federal government, including securities backed by Ginnie Mae, or by agencies or instrumentalities of the federal government, or by GSEs such as Fannie Mae and Freddie Mac. MBS created by non-governmental issuers, including commercial banks, savings and loan institutions, private mortgage insurance companies, mortgage bankers and other secondary market issuers, may be supported by various forms of insurance or guarantees including individual loan, title, pool and hazard insurance and letters of credit which may be issued by governmental entities, private insurers or the mortgage poolers.

General Information About Agency MBS

The Agency MBS that we acquire provide funds for mortgage loans made to residential homeowners. These securities generally represent interests in pools of mortgage loans made by mortgage bankers, commercial banks, savings and loan institutions and other mortgage lenders. These pools of mortgage loans are assembled for sale to investors, such as us, by various government-related or private organizations.

Agency MBS differ from other forms of traditional debt securities, which normally provide for periodic payments of interest in fixed amounts with principal payments at maturity or on specified call dates. Instead, Agency MBS provide for a monthly payment, which may consist of both interest and principal. In effect, these payments are a “pass-through”

[Table of Contents](#)

of the monthly interest and scheduled and unscheduled principal payments (referred to as “prepayments”) made by the individual borrower on the mortgage loans, net of any fees paid to the issuer, servicer, or guarantor of the securities.

The investment characteristics of Agency MBS differ from those of traditional fixed-income securities. Major differences include the payment of interest and principal on the securities on a more frequent schedule (as described above) and the possibility that principal may be prepaid, without penalty, at par at any time due to prepayments on the underlying mortgage loans. These differences can result in significantly greater price and yield volatility than is the case with traditional fixed-income securities.

Various factors affect the rate at which mortgage prepayments occur, including changes in the level of and directional trends in housing prices, interest rates, general economic conditions, defaults on the underlying mortgages, the age of the mortgage loan, the size of the loan, the loan-to-value ratio of the mortgage, the location of the property, and social and demographic conditions. Additionally, changes to GSE underwriting practices or other governmental programs could also significantly impact prepayment rates or expectations. Also, the pace at which the loans underlying our securities become seriously delinquent or are modified, and the timing of GSE repurchases of loans from our securities, can materially impact the rate of prepayments. Generally, prepayments on Agency MBS increase during periods of falling mortgage interest rates and decrease during periods of rising mortgage interest rates; however, this may not always be the case. We may reinvest principal repayments at a yield that is higher or lower than the yield on the repaid investment, thus affecting our net interest income by altering the average yield on our assets.

Payments of principal and interest on Agency MBS, although not the market value of the securities themselves, are guaranteed either by the full faith and credit of the United States, such as those issued by Ginnie Mae, or by a GSE, such as those issued by Fannie Mae or Freddie Mac.

Agency MBS are collateralized by pools of fixed-rate mortgage loans, or FRMs, adjustable-rate mortgage loans, or ARMs, and hybrid ARMs. Hybrid ARMs are mortgage loans that have interest rates that are fixed for an initial period (typically ranging from one to ten years) and, thereafter, reset at regular intervals, subject to interest rate caps. Our allocation of investments among securities collateralized by FRMs, ARMs, or hybrid ARMs depends upon our Manager’s assessment of the relative value of the securities, which is based upon numerous factors including, but not limited to, expected future prepayment trends, supply and demand, costs of financing, costs of hedging, expected future interest rate volatility, and the overall shape of the U.S. Treasury and interest rate swap yield curves.

The types of residential pass-through certificates in which we invest, or which may comprise the CMOs in which we may invest, are described below.

Freddie Mac and Fannie Mae

We invest in Agency MBS issued by Fannie Mae and Freddie Mac, which are stockholder-owned corporations chartered by Congress with a public mission to provide liquidity, stability and affordability to the U.S. housing market. Fannie Mae and Freddie Mac are currently regulated by the Federal Housing Finance Agency, or the FHFA, the U.S. Department of Housing and Urban Development, the SEC, and the U.S. Department of the Treasury, or the U.S. Treasury, and are currently operating under the conservatorship of the FHFA. The U.S. Treasury has agreed to support the continuing operations of Fannie Mae and Freddie Mac with any necessary capital contributions while in conservatorship. However, the U.S. Government does not guarantee the securities, or other obligations, of Fannie Mae or Freddie Mac.

Fannie Mae and Freddie Mac operate in the secondary mortgage market. They purchase residential mortgage loans and mortgage-related securities from primary mortgage market institutions, such as commercial banks, savings and loan associations, mortgage banking companies, seller/servicers, securities dealers and other investors. Through the mortgage securitization process, they package the purchased mortgage loans into guaranteed MBS for sale to investors, such as us, in the form of pass-through certificates and guarantee the payment of principal and interest on the securities or, on the underlying loans held within the securitization trust, in exchange for guarantee fees. The underlying loans must meet certain underwriting standards established by Fannie Mae and Freddie Mac (referred to as “conforming loans”) and may be fixed- or adjustable-rate loans with original terms to maturity of up to 40 years.

[Table of Contents](#)

TBA Agency MBS

We also enter into TBA Agency MBS as either a means of investing in and financing Agency MBS or as a means of disposing of or reducing our exposure to agency securities. Pursuant to TBA contracts, we agree to purchase or sell, for future delivery, Agency MBS with certain principal and interest terms and certain types of collateral, but the particular Agency MBS to be delivered are not identified until shortly before the TBA settlement date. We also may choose, prior to settlement, to move the settlement of these MBS out to a later date by entering into an offsetting short or long position (referred to as a “pair off”), net settling the paired off positions for cash, and simultaneously purchasing a similar TBA contract for a later settlement date. This transaction is commonly referred to as a “dollar roll.” The Agency MBS purchased or sold for a forward settlement date are typically priced at a discount to agency securities for settlement in the current month. This difference (or discount) is referred to as the “price drop.” The price drop represents compensation to us for foregoing net interest margin (interest income less repurchase agreement financing cost). TBA Agency MBS are accounted for as derivative instruments since they do not meet the exemption allowed for a “regular way” security trade under ASC 815, as either the TBA contracts do not settle in the shortest period of time possible or we cannot assess that it is probable at inception that we will take physical delivery of the security or that we will not settle on a net basis.

Mortgage Credit Investments

Non-Agency MBS

Non-Agency MBS are securities backed by residential mortgages for which the payment of principal and interest is not guaranteed by a GSE or government agency. Instead, a private institution such as a commercial bank will package residential mortgage loans and securitize them through the issuance of MBS. Non-Agency MBS are often referred to as “private label MBS.” Non-Agency MBS may benefit from credit enhancement derived from structural elements, such as subordination, overcollateralization or insurance, and they may also be bought at significant discounts. Non-Agency MBS can carry a significantly higher level of credit exposure relative to the credit exposure of Agency MBS. We may also purchase highly-rated instruments that benefit from credit enhancement or non-investment grade instruments that absorb credit risk. We focus primarily on Non-Agency MBS where the underlying mortgages are secured by residential properties within the United States. Non-Agency MBS also include securitized non-performing loans where resolution of the loans may come from loan modifications, short sales, or foreclosures. While there is a high expectation of losses on these loans, the bonds benefit from credit enhancement and over-collateralization.

Non-Agency MBS are backed by residential mortgages that can be comprised of prime mortgage or non-prime mortgage loans, which are described below:

Prime mortgage loans. Prime mortgage loans are residential mortgage loans that generally conform to the underwriting guidelines of a U.S. Government agency or a GSE but that do not carry any credit guarantee from either a U.S. Government agency or a GSE. Jumbo prime mortgage loans are prime mortgage loans that conform to such underwriting guidelines except as to loan size.

Non-prime mortgage loans. Non-prime mortgage loans are residential mortgage loans that do not meet all of the underwriting guidelines of a U.S. Government agency or a GSE. Consequently, these loans may carry higher credit risk than prime mortgage loans. Non-prime mortgage loans may allow borrowers to qualify for a mortgage loan with reduced or alternative forms of documentation. This category includes loans commonly referred to as alternative A- paper, or Alt-A, or as subprime. Alt-A mortgage loans are considered riskier than prime mortgage loans but less risky than subprime mortgage loans. They are typically characterized by borrowers with less than full documentation, lower credit scores and higher loan-to-value ratios and include a higher percentage of investment properties. Subprime mortgage loans are considered to be of the lowest credit quality. These loans may also include option-ARM loans, which contain a feature providing the borrower the option, within certain constraints, to make lesser payments than otherwise required by the stated interest rate for a number of years, leading to negative amortization and increased loan balances.

[Table of Contents](#)

Residential Mortgage Loans Held-for-Securitization

We acquire and accumulate mortgage loans through our wholly-owned subsidiary, Anworth Mortgage Loans, Inc., as part of our investment strategy until a sufficient quantity has been accumulated for securitization. We anticipate that any mortgage loans that we would acquire and do not securitize will not constitute more than 40% of our total mortgage-related assets at any time. Despite our intentions, however, we may not be successful in securitizing these mortgage loans. As part of our due diligence process, we review and validate all appraisals.

Mortgage loans and other mortgage-related assets may be purchased from various suppliers of mortgage-related assets throughout the United States including savings and loans associations, banks, mortgage bankers and other mortgage lenders.

Residential Mortgage Loans Held-for-Investment Through Consolidated Securitization Trusts

We invest in residential mortgage loans held-for-investment through consolidated securitization trusts. We finance residential mortgage loans through ABS issued by the consolidated securitization trusts. The ABS which are held by unaffiliated third parties are non-recourse financing. The difference in the amount of the loans and the amount of the ABS represents our retained net interest in the loans held in the securitization trusts.

Other Mortgage-Related Investments

Mortgage Derivative Securities. We may acquire mortgage derivative securities in an amount not to exceed 10% of our total assets. Mortgage derivative securities provide for the holder to receive interest-only, principal-only or interest and principal in amounts that are disproportionate to those payable on the underlying mortgage loans. Payments on mortgage derivative securities are highly sensitive to the rate of prepayments on the underlying mortgage loans. In the event of faster or slower than anticipated prepayments on these mortgage loans, the rates of return on interests in mortgage derivative securities, representing the right to receive interest-only or a disproportionately large amount of interest or interest-only derivatives, would be likely to decline or increase, respectively. Conversely, the rates of return on mortgage derivative securities, representing the right to receive principal-only or a disproportionate amount of principal or principal-only derivatives, would be likely to increase or decrease in the event of faster or slower prepayments, respectively. We may invest in inverse floaters, a class of CMOs with a coupon rate that resets in the opposite direction from the market rate of interest to which it is indexed. Any rise in the index rate, which can be caused by an increase in interest rates, causes a drop in

the coupon rate of an inverse floater, while any drop in the index rate causes an increase in the coupon of an inverse floater. An inverse floater may behave like a leveraged security since its interest rate usually varies by a magnitude much greater than the magnitude of the index rate of interest. The leverage-like characteristics inherent in inverse floaters result in a greater volatility of their market prices.

We may also invest in other mortgage derivative securities, including other types that may be developed in the future.

Subordinated Interests. We may acquire subordinated interests, which are classes of MBS that are junior to other classes of the same series of MBS in the right to receive payments from the underlying mortgage loans. The subordination may be for all payment failures on the mortgage loans securing or underlying such series of mortgage securities. The subordination will not be limited to those resulting from particular types of risks, including those resulting from war, earthquake or flood, or the bankruptcy of a borrower. The subordination may be for the entire amount of the series of mortgage-related securities or may be limited in amount.

Other Mortgage-Related Assets

Other Investments. We may acquire other investments that include equity and debt securities issued by other primarily mortgage-related finance companies, interests in mortgage-related collateralized bond obligations, other subordinated interests in pools of mortgage-related assets, commercial mortgage loans and securities and residential mortgage loans other than high-credit quality mortgage loans. Although we expect that our other investments will be limited to less than 10% of total assets, we have no limit on how much of our stockholders’ equity will be allocated to

[Table of Contents](#)

other investments. There may be periods in which other investments represent a large portion of our stockholders’ equity.

Residential Real Estate

These assets consist of residential properties which we lease to tenants. Our focus is on properties in those areas that produce high occupancy and rental rates and generate long-term property appreciation.

Corporate Governance

We strive to maintain an ethical workplace in which the highest standards of professional conduct are practiced.

- Our Board is composed of a majority of independent directors. Our Audit, Compensation, and Nominating and Corporate Governance Committees are comprised exclusively of independent directors.
- In order to foster the highest standards of ethics and conduct in all of our business relationships, we have adopted a Code of Ethics and Business Conduct and Corporate Governance Guidelines, which cover a wide range of business practices and procedures that apply to all of our directors and officers and the officers and employees of our Manager. In addition, we have implemented a Whistle-Blower Hotline and procedures by which any officer or employee may raise, on a confidential basis, concerns regarding any questionable or unethical accounting, internal accounting controls or auditing matters with our Audit Committee.
- We have an Insider Trading Policy, which is incorporated into our Code of Ethics and Business Conduct, which prohibits any of our directors and officers and the officers and employees of our Manager from buying or selling our securities on the basis of material non-public information and prohibits communicating material non-public information about our Company to others.
- We have a formal internal audit function, through the current use of an independent CPA firm, to further the effective functioning of our internal controls and procedures. Our internal auditors report directly to our Audit Committee and the internal audit function is intended to provide management and our Audit Committee with an effective tool to identify and address areas of financial or operational concerns and to ensure that appropriate controls and procedures are in place. We have implemented Section 404 of the Sarbanes-Oxley Act of 2002, as amended, which requires an evaluation of internal control over financial reporting in association with our consolidated financial statements as of December 31, 2019 (see Item 9A, “Controls and Procedures,” included in this Annual Report on Form 10-K).

Competition

When we invest in MBS and other mortgage-related assets, we compete with a variety of institutional investors including other REITs, insurance companies, mutual funds, pension funds, investment banking firms, banks and other financial institutions that invest in the same or similar types of assets. Many of these investors have greater financial resources and access to lower costs of capital than we do.

Employees

Effective December 31, 2011, in accordance with the Management Agreement, all of our employees at the Company were terminated and were employed by our Manager.

Company Information

We were incorporated in Maryland on October 20, 1997 and commenced our operations on March 17, 1998. Our principal executive offices are located at 1299 Ocean Avenue, 2nd Floor, Santa Monica, California, 90401. Our telephone number is (310) 255-4493 and our fax number is (310) 434-0100.

[Table of Contents](#)

Filings with the SEC

We file annual, quarterly, and special reports, proxy statements, and other information with the SEC. Our SEC filings are available to the public from the SEC’s website at *http://sec.gov*. This site contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC.

Information on our Company Website

The Company maintains a website, *http://www.anworth.com*. We make our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, available, free of charge, on our website as soon as reasonably practicable after we file or furnish these reports with the SEC. In addition, we post the following information on our website (we do not intend to and does not hereby incorporate by reference the information on our website as a part of this Annual Report on Form 10-K):

- our corporate code of conduct, which qualifies as a “code of ethics” as defined by Item 406 of Regulation S-K of the Exchange Act;
- our corporate governance guidelines; and
- charters for our Audit Committee, Nominating and Corporate Governance Committee, and Compensation Committee.

All of the above information is also available in print upon request to our Corporate Secretary at the address listed under the heading “Company Information” above.

CERTAIN FEDERAL INCOME TAX CONSIDERATIONS

The following discussion summarizes particular U.S. federal income tax considerations regarding our qualification and taxation as a REIT and particular U.S. federal income tax consequences resulting from the acquisition, ownership and disposition of our capital stock. This discussion is based on current law and assumes that we have qualified at all times throughout our existence, and will continue to qualify, as a REIT for U.S. federal income tax purposes. The tax law upon which this discussion is based could be changed and any such change could have a retroactive effect. The following discussion is not exhaustive of all possible tax considerations. This summary neither gives a detailed discussion of any state, local or foreign tax considerations nor discusses all of the aspects of U.S. federal income taxation that may be relevant to you in light of your particular circumstances or to particular types of stockholders which are subject to special tax rules, such as insurance companies, tax-exempt entities, financial institutions or broker-dealers, foreign corporations or partnerships and persons who are not citizens or residents of the U.S., stockholders that hold our stock as a hedge, part of a straddle, conversion transaction or other arrangement involving more than one position, or stockholders whose functional currency is not the U.S. dollar. This discussion assumes that you will hold our capital stock as a “capital asset” under the Code, which generally is property held for investment.

We urge you to consult with your own tax advisor regarding the specific consequences to you of the acquisition, ownership and disposition of stock in an entity electing to be taxed as a REIT, including the federal, state, local, foreign and other tax considerations of such acquisition, ownership, and disposition, and the potential changes in applicable tax laws.

General

Our qualification and taxation as a REIT depends upon our ability to meet, on an ongoing basis, various requirements imposed under the Code as discussed below, which relate to the nature of our gross income, the composition of our assets, distribution levels, and diversity of stock ownership. Accordingly, the actual results of our operations for any particular taxable year may not satisfy these requirements.

[Table of Contents](#)

We have made an election to be taxed as a REIT under the Code commencing with our taxable year ended December 31, 1998. We currently expect to continue operating in a manner that will permit us to maintain our qualification as a REIT. All qualification requirements for maintaining our REIT status, however, may not have been, or might not continue to be, met.

So long as we qualify for taxation as a REIT, we generally will be permitted a deduction for dividends that we pay to our stockholders. As a result, we generally will not be required to pay federal corporate income taxes on our net income that is distributed to our stockholders on a current basis. This treatment substantially eliminates the “double taxation” that ordinarily results from investment in a corporation. Double taxation means taxation once at the corporate level when income is earned and once again at the stockholder level when this income is distributed. We will be required to pay federal income tax, however, as follows:

- we will be required to pay tax at regular corporate rates on any undistributed “real estate investment trust taxable income,” including undistributed net capital gains;
- we may be required to pay the “alternative minimum tax” on our items of tax preference; and
- if we have (a) net income from the sale or other disposition of “foreclosure property” which is held primarily for sale to customers in the ordinary course of business, or (b) other non-qualifying income from foreclosure property, we will be required to pay tax at the highest corporate rate on this income. Foreclosure property is generally defined as property acquired through foreclosure or after a default on a loan secured by the property or on a lease of the property.

To the extent that distributions exceed current and accumulated earnings and profits, they will constitute a return of capital, rather than dividend or capital gain income, and will reduce the stockholder’s tax basis in the stock with respect to which the distributions are paid and, to the extent that they exceed such basis, will be taxed in the same manner as gain from the sale of that stock. For purposes of determining whether distributions are out of current or accumulated earnings and profits, our earnings and profits will be allocated first to our preferred stock (rather than to our common stock) with the result that distributions with respect to our preferred stock are more likely to be treated as dividends than as return of capital or a distribution in excess of basis. Calculations of corporate earnings and profits are complex and it is possible that distributions expected to be a return of capital may subsequently be determined to be taxable distributions of earnings and profits.

Currently, dividends paid by regular C corporations to stockholders other than corporations are generally taxed at the rate applicable to long-term capital gains, which is currently a maximum of 20%, subject to certain limitations. Because we are a REIT, however, our dividends, including dividends paid on our stock, including shares of our preferred stock, generally will continue to be taxed at regular ordinary income tax rates, except in limited circumstances, including dividend distributions allocable to distributions we have received from a taxable REIT subsidiary or other taxable corporation; provided, however, that all such distributions, other than distributions which are taxable as capital gain dividends or traceable to distributions from a taxable REIT subsidiary, as are received by a pass-through entity or an individual, became eligible for a 20% deduction from gross income starting in 2018 under the tax laws. This eligibility for a 20% deduction will expire in 2025.

We will be required to pay a 100% tax on any net income from prohibited transactions. Prohibited transactions are, in general, sales or other taxable dispositions of property other than foreclosure property held primarily for sale to customers in the ordinary course of business. While the Code contains certain safe harbor provisions to avoid the application of this 100% tax, outside of the safe harbor, the determination of whether property is held as inventory or primarily for sale to customers in the ordinary course of a trade or business depends on all the facts and circumstances surrounding the particular transaction. No assurance can be given that any particular property in which we hold a direct or indirect interest will not be treated as property held for sale to customers, or that we can comply with certain safe harbor provisions of the Code that would prevent such treatment. The 100% tax will not apply to gains from the sale of property that is held through a taxable REIT subsidiary or other taxable corporation, although such income will be taxed to the corporation at regular corporate tax rates.

If we fail to satisfy the 75% gross income test or the 95% gross income test discussed below but nonetheless maintain our qualification as a REIT because certain other requirements are met, we will be subject to a tax equal to the greater of (i) the amount by which 75% of our gross income exceeds the amount qualifying under the 75% gross income test described below, and (ii) the amount by which 95% of our gross income exceeds the amount qualifying under the 95% gross income test described below, multiplied by a fraction intended to reflect our profitability.

In the event a more than de minimis failure of any of the asset tests occurs in a taxable year, as long as the failure was due to reasonable cause and not willful neglect and we dispose of the assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure, we may pay a tax equal to the greater of \$50 thousand or 35% of the net income from the non-qualifying assets during the period in which we failed to satisfy any of the asset tests in lieu of having our qualification as a REIT terminated.

In the event of a failure to satisfy one or more requirements for REIT qualification occurring in a taxable year, other than the gross income tests and the asset tests, as long as such failure was due to reasonable cause and not to willful neglect, we will be required to pay a penalty of \$50 thousand for each such failure in order to maintain our REIT qualification.

We will be required to pay a nondeductible 4% excise tax on the excess of the required distribution over the amounts actually distributed if we fail to distribute during each calendar year at least the sum of:

- 85% of our real estate investment trust ordinary income for the year;
- 95% of our real estate investment trust capital gain net income for the year; and
- any undistributed taxable income from prior periods.

This distribution requirement is in addition to, and different from, the distribution requirements discussed below in the section entitled “Annual Distribution Requirements.”

We may elect to retain and pay income tax on our net long-term capital gain. In that case, if we so elect, a U.S. stockholder would be taxed on its proportionate share of our undistributed long-term capital gain (to the extent that we make a timely designation of such gain to the stockholder) and would receive a credit or refund of its proportionate share of the tax we paid. The basis of the stockholder’s shares is increased by the amount of the undistributed long-term capital gain (less the amount of capital gains tax paid by the REIT) includable by the stockholder.

If we own a residual interest in a real estate mortgage investment conduit (which we refer to as a “REMIC”), we will be taxable at the highest corporate rate on the portion of any excess inclusion income that we derive from the REMIC residual interests equal to the percentage of our stock that is held by “disqualified” organizations. Although the law is unclear, similar rules may apply if we own an equity interest in a taxable mortgage pool. To the extent that we own a REMIC residual interest or an interest in a taxable mortgage pool through a taxable REIT subsidiary, we will not be subject to this tax, although our taxable REIT subsidiary will be subject to corporate income tax on all of its income, including any income derived from a residual interest in a REMIC or an interest in a taxable mortgage pool. A “disqualified organization” includes:

- the United States of America;
- any state or political subdivision of the United States of America;
- any foreign government;
- any international organization;
- any agency or instrumentality of any of the foregoing;

[Table of Contents](#)

- any other tax-exempt organization other than a farmers’ cooperative described in Section 521 of the Code that is exempt both from income taxation and from taxation under the unrelated business taxable income provisions of the Code; and
- any rural electrical or telephone cooperative.

If we acquire any asset from a corporation which is or has been taxed as a C corporation under the Code in a transaction in which the basis of the asset in our hands is determined by reference to the basis of the asset in the hands of the C corporation and we subsequently recognize gain on the disposition of the asset during the five-year period beginning on the date on which we acquired the asset, then we will be required to pay tax at the highest regular corporate tax rate on this gain to the extent of the excess of:

- the fair market value of the asset, over
- our adjusted basis in the asset,
- in each case determined as of the date on which we acquired the asset.

We may be subject to a 100% excise tax on certain transactions with any taxable REIT subsidiaries (defined below) to the extent that such transactions are not conducted on a basis that is consistent with arm’s length terms.

In addition, notwithstanding our REIT status, we may also have to pay certain state and local income taxes, because not all states and localities treat REITs in the same manner as they are treated for federal income tax purposes.

Requirements for Qualification as a REIT

The Code defines a REIT as a corporation, trust or association:

1. that is managed by one or more trustees or directors;
2. that issues transferable shares or transferable certificates to evidence beneficial ownership;
3. that would be taxable as a domestic corporation but for Code Sections 856 through 859;
4. that is not a financial institution or an insurance company within the meaning of the Code;

- 5. that is beneficially owned by 100 or more persons;
- 6. not more than 50% in value of the outstanding stock of which is owned, actually or constructively, by five or fewer individuals, including specified entities, at all times during the last half of each taxable year;
- 7. that meets other tests, described below, regarding the nature of its income and assets and the amount of its distributions; and
- 8. that elects to be a REIT or has made such election for a previous taxable year and satisfies all relevant filing and other administrative requirements established by the Internal Revenue Service, or the IRS, that must be met in order to elect and retain REIT status.

The Code provides that all of the first four conditions stated above must be met during the entire taxable year and that the fifth condition must be met during at least 335 days of a taxable year of twelve months, or during a proportionate part of a taxable year of less than twelve months. The fifth and sixth conditions do not apply until after the first taxable year for which an election is made to be taxed as a REIT.

For purposes of the sixth condition, certain specified types of trusts and tax-exempt entities are treated as individuals, except that a “look-through” exception generally applies with respect to pension funds.

Stock Ownership Tests

As noted above, our stock must be beneficially held by at least 100 persons (which we refer to as the “100 Stockholder Rule”), and no more than 50% of the value of our stock may be owned, directly or indirectly, by five or fewer individuals at any time during the last half of the taxable year (which we refer to as the “5/50 Rule”). We are required to solicit information from certain of our record stockholders to verify actual stock ownership levels and our charter provides for restrictions regarding the transfer of our stock in order to aid in meeting the stock ownership requirements. If we were to fail either of the stock ownership tests, we would generally be disqualified from our REIT status. However, if we comply with regulatory rules pursuant to which we are required to send annual letters to holders of our stock requesting information regarding the actual ownership of our stock, and we do not know, or exercising reasonable diligence would not have known, whether we failed to meet the 5/50 Rule, then we will be treated as having met the 5/50 Rule.

Income Tests

We must satisfy two gross income requirements annually to maintain our qualification as a REIT:

- We must derive, directly or indirectly, at least 75% of our gross income, excluding gross income from prohibited transactions, from specified real estate sources, including rental income, interest on obligations (including certain MBS) that are secured by mortgages on real property or on interests in real property, gain from the disposition of “qualified real estate assets” (i.e., interests in real property, mortgages secured by real property or interests in real property, and certain other assets), income from certain types of temporary investments, amounts, such as commitment fees, received in consideration for entering into an agreement to make a loan secured by real property, and income derived from a REMIC in proportion to the real estate assets held by the REMIC, unless at least 95% of the REMIC’s assets are real estate assets (in which case, all of the income derived from the REMIC) (which we refer to as the “75% gross income test”); and
- We must derive at least 95% of our gross income, excluding gross income from prohibited transactions, from (a) the sources of income that satisfy the 75% gross income test, (b) dividends, interest and gain from the sale or disposition of stock or securities, or (c) any combination of the foregoing (which we refer to as the “95% gross income test”).

Gross income from servicing loans for third parties is not qualifying income for purposes of either gross income test. Any gross income from our sale of property held primarily for sale to customers in the ordinary course of business is excluded from both the numerator and the denominator in both income tests (but is subject to a 100% tax as a prohibited transaction unless certain safe harbor provisions are satisfied). Income and gain from certain transactions that we enter into to hedge indebtedness incurred or to be incurred to acquire or carry real estate assets, and that are clearly and timely identified as such, are excluded from both the numerator and denominator for purposes of both gross income tests.

For purposes of the 75% and 95% gross income tests, a REIT is deemed to have earned a proportionate share of the income earned by any partnership, or any limited liability company treated as a partnership for federal income tax purposes, in which it owns an interest, which share is determined by reference to the REIT’s capital interest in such entity, and is deemed to have earned all of the income earned by any qualified REIT subsidiary (in general, a 100%-owned corporate subsidiary of a REIT) or any other entity that is disregarded as separated from the parent REIT for U.S. federal income tax purposes. Interest earned by a REIT ordinarily does not qualify as income meeting the 75% or 95% gross income tests if the determination of all or some of the amount of interest depends on the income or profits of any person. Interest will not be disqualified from meeting such tests, however, solely by reason of being based on a fixed percentage or percentages of receipts or sales.

The following paragraphs discuss in more detail the specific application of the gross income tests to us.

Interest. The term “interest,” as defined for purposes of both gross income tests, generally excludes any amount that is based in whole or in part on the income or profits of any person. However, interest generally includes the following:

- an amount that is based on a fixed percentage or percentages of receipts or sales; and
- an amount that is based on the income or profits of a debtor as long as the debtor derives substantially all of its income from the real property securing the debt from leasing substantially all of its interest in the property and only to the extent that the amounts received by the debtor would be qualifying “rents from real property” if received directly by a REIT.

If a loan contains a provision that entitles a REIT to a percentage of the borrower’s gain upon the sale of the real property securing the loan or a percentage of the appreciation in the property’s value as of a specific date, income attributable to that loan provision will generally be treated as gain from the sale of the property securing the loan, which normally constitutes qualifying income for purposes of both gross income tests.

Interest on debt secured by a mortgage on real property or on interests in real property, including, for this purpose, discount points, prepayment penalties, loan assumption fees and late payment charges that are not compensation for services, generally is qualifying income for purposes of the 75% gross income test. However, if the highest principal amount of a loan outstanding during a taxable year exceeds the fair market value of the real property securing the loan as of the date the REIT agreed to originate or acquire the loan, a portion of the interest income from such loan will not be qualifying income for purposes of the 75% gross income test but will be qualifying income for purposes of the 95% gross income test. The portion of the interest income that will not be qualifying income for purposes of the 75% gross income test will be equal to the portion of the principal amount of the loan that is not secured by real property—that is, the amount by which the loan exceeds the value of the real estate that is security for the loan. For purposes of these rules, ancillary personal property that secures a mortgage loan and has a value not in excess of 15% of the total value of the collateral (i.e., of the real property together with the personal property) is treated as real property.

The interest, original issue discount and market discount income that we receive from our mortgage loans and certain MBS (including Agency MBS and interests in REMICs) generally will be qualifying income for purposes of both gross income tests. However, as discussed above, if the fair market value of the real estate securing any of our loans is less than the principal amount of the loan, a portion of the income from that loan will be qualifying income for purposes of the 95% gross income test but not the 75% gross income test.

Fee Income. We may receive various fees in connection with originating mortgage loans. The fees will be qualifying income for purposes of both the 75% and 95% income tests if they are received in consideration for entering into an agreement to make a loan secured by real property and the fees are not determined based on the borrower’s income or profits. Therefore, commitment fees will generally be qualifying income for purposes of the income tests. Other fees, such as fees received for servicing loans for third parties, are not qualifying income for purposes of either income test.

Dividends. Our share of any dividends received from any corporation (including any of our taxable REIT subsidiaries, but excluding any REIT) in which we own an equity interest will qualify for purposes of the 95% gross income test but not for purposes of the 75% gross income test. Our share of any dividends received from any other REIT in which we own an equity interest will be qualifying income for purposes of both gross income tests.

Rents from Real Property. Rents that we receive with respect to real property will qualify as “rents from real property” in satisfying the gross income requirements for a REIT described above provided that the following conditions

are met:

- First, the amount of rent must not be based, in whole or in part, on the income or profits of any person. However, an amount received or accrued generally will not be excluded from rents from real property solely by reason of being based on fixed percentages of receipts or sales.
- Second, rents we receive from a “related party tenant” will not qualify as rents from real property in satisfying the gross income tests unless the tenant is a taxable REIT subsidiary, at least 90% of the property is leased to unrelated tenants and the rent paid by the taxable REIT subsidiary is substantially comparable to the rent paid by the unrelated tenants for comparable space. A tenant is a related party tenant if the REIT, or an actual or constructive owner of 10% or more of the REIT, actually or constructively owns 10% or more of the tenant.
- Third, if rent attributable to personal property leased in connection with a lease of real property is greater than 15% of the total rent received under the lease, then the portion of rent attributable to the personal property will not qualify as rents from real property.
- Fourth, we generally must not operate or manage our real property or furnish or render services to our tenants, other than through an “independent contractor” who is adequately compensated and from whom we do not derive revenue. However, we may provide services directly to tenants if the services are “usually or customarily rendered” in connection with the rental of space for occupancy only and are not considered to be provided for the tenants’ convenience. In addition, we may provide a minimal amount of “non-customary” services to the tenants of a property, other than through an independent contractor, as long as our income from the services does not exceed 1% of our income from the related property. Furthermore, we may own up to 100% of the stock of a taxable REIT subsidiary, which may provide customary and non-customary services to tenants without tainting our rental income from the related properties.

Hedging Transactions. From time to time, we may enter into hedging transactions with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swap agreements, caps and floors, options to purchase these items and futures and forward contracts. Income and gain from certain “hedging transactions” will be excluded from gross income for purposes of both the 95% gross income test and the 75% gross income test. A “hedging transaction” includes any transaction entered into in the normal course of our trade or business primarily to manage the risk of interest rate, changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, to acquire or carry real estate assets. We will be required to clearly identify any such hedging transaction before the close of the day on which it was acquired, originated or entered into, and to meet certain other requirements. To the extent that any of our hedging transactions do not meet these requirements, or if we hedge for other purposes, or to the extent that a portion of our mortgage loans is not secured by “real estate assets” (as described below under “Asset Tests”), or in other situations, the income from those transactions could be treated as income that does not qualify for purposes of one or both of the gross income tests. We intend to structure any hedging transactions in a manner that does not jeopardize our status as a REIT.

Prohibited Transactions. As discussed above, a REIT will incur a 100% tax on the net income derived from any sale or other disposition of property other than foreclosure property that the REIT holds primarily for sale to customers in the ordinary course of a trade or business. We believe that our assets generally will not be held primarily for sale to customers and that sales of our assets will not be considered to be in the ordinary course of our business. Whether a REIT holds an asset “primarily for sale to customers in the ordinary course of a trade or business” depends, however, on the facts and circumstances in effect from time to time, including those related to a particular asset. When practicable, we will attempt to comply with the terms of safe-harbor provisions in the federal income tax laws prescribing when an asset sale will not be characterized as a prohibited transaction or otherwise structure our sale transactions so as to minimize this risk.

Foreclosure Property. We will be subject to tax at the maximum corporate rate on any income from foreclosure property other than income that otherwise would be qualifying income for purposes of the 75% gross income test, less expenses directly connected with the production of that income. However, gross income from foreclosure property will

[Table of Contents](#)

qualify under the 75% and 95% gross income tests. Foreclosure property is any real property, including interests in real property, and any personal property incident to such real property:

- that is acquired by a REIT as the result of the REIT having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law, after there was a default or default was imminent on a lease of such property or on indebtedness that such property secured;
- for which the related loan or lease was acquired by the REIT at a time when the default was not imminent or anticipated; and
- for which the REIT makes a proper election to treat the property as foreclosure property.

Permitted foreclosure property income also includes foreign currency gain that is attributable to otherwise permitted income from foreclosure property. Such foreign currency gain also is included as foreclosure property income for purposes of any tax on such income.

However, a REIT will not be considered to have foreclosed on a property where the REIT takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor. Property generally ceases to be foreclosure property at the end of the third taxable year following the taxable year in which the REIT acquired the property or longer if an extension is granted by the Secretary of the Treasury. This grace period terminates and foreclosure property ceases to be foreclosure property on the first day:

- on which a lease is entered into for the property that, by its terms, will give rise to income that does not qualify for purposes of the 75% gross income test or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after such day that will give rise to income that does not qualify for purposes of the 75% gross income test;
- on which any construction takes place on the property, other than completion of a building or any other improvement, where more than 10% of the construction was completed before default became imminent; or
- which is more than 90 days after the day on which the REIT acquired the property and the property is used in a trade or business which is conducted by the REIT other than through an independent contractor from whom the REIT itself does not derive or receive any income.

Failure to Satisfy Gross Income Tests. If we fail to satisfy one or both of the gross income tests for any taxable year, we nevertheless may qualify as a REIT for that year if we qualify for relief under certain provisions of the federal income tax laws. Those relief provisions will be available if:

- our failure to meet those tests is due to reasonable cause and not to willful neglect, and
- following such failure for any taxable year, a schedule of the sources of our income is filed in accordance with regulations prescribed by the Secretary of the Treasury.

We cannot predict, however, whether in all circumstances we would qualify for the relief provisions. In addition, as discussed above, even if the relief provisions apply, we would incur a tax equal to the amount that our gross income fails to satisfy the 75% gross income test or the 95% gross income test, as applicable, multiplied by a fraction intended to reflect our profitability.

Foreign Investment and Exchange Gains

A REIT must be a U.S. domestic entity, but it is permitted to hold foreign real estate or other foreign-based assets, provided that the 75% and 95% income tests and other requirements for REIT qualification are met. A REIT that holds foreign real estate or other foreign-based assets may have foreign currency exchange gain under the foreign currency transaction tax rules. Foreign currency exchange gain originally was not explicitly included in the statutory definitions of

qualifying income for purposes of the 75% and 95% income tests until a statutory change, although the IRS issued guidance that allowed foreign currency gain to be treated as qualified income in certain circumstances. The statutory change excludes certain foreign currency gain from the computation of qualifying income for purposes of the 75% income test or the 95% income test, respectively. The exclusion is solely for purposes of the computations under these tests.

The statutory change defines two new categories of income for purposes of the exclusion rules: “real estate foreign exchange gain” and “passive foreign exchange gain.” Real estate foreign exchange gain is excluded from gross income for purposes of both the 75% and the 95% income tests. Passive foreign exchange gain is excluded for purposes of the 95% income test but is included in gross income and treated as non-qualifying income, to the extent that it is not real estate foreign exchange gain, for purposes of the 75% income test.

Real estate foreign exchange gain is foreign currency gain which is attributable to: (i) any item of income qualifying for the numerator for the 75% income test; (ii) the acquisition or ownership of obligations secured by mortgages on real property or interests in real property; or (iii) becoming or being the obligor under obligations secured by mortgages on real property or interests in real property. Real estate foreign exchange gain also includes certain foreign currency gains attributable to certain “qualified business units” of the REIT.

Passive foreign exchange gain includes all real estate foreign exchange and, in addition, includes foreign currency gain which is attributable to: (i) any item of income or gain included in the numerator for the 95% income test, (ii) acquisition or ownership of obligations other than described in the preceding paragraph; (iii) becoming the obligor under obligations other than described in the preceding paragraph; and (iv) any other foreign currency gain to be determined by the IRS.

Notwithstanding the foregoing rules, except in the case of certain income excluded under the hedging rules, foreign currency exchange gain derived from engaging in dealing, or substantial and regular trading, in certain securities constitutes gross income that does not qualify under either the 75% or 95% income test.

Asset Tests

To qualify as a REIT, we also must satisfy the following asset tests at the end of each quarter of each taxable year:

First, at least 75% of the value of our total assets must consist of:

- cash or cash items, including certain receivables;
- government securities;
- interests in real property, including leaseholds and options to acquire real property and leaseholds;
- interests in mortgage loans secured by real property (together with ancillary personal property that does not exceed 15% of the total collateral value), including, in general, our Agency MBS and almost all of our Non-Agency MBS;
- stock in other REITs;
- debt instruments issued by publicly offered REITs;
- investments in stock or debt instruments during the one-year period following our receipt of new capital that we raise through equity offerings or public offerings of debt with at least a five-year term; and
- regular or residual interests in a REMIC. However, if less than 95% of the assets of a REMIC consist of assets that are qualifying real estate-related assets under the federal income tax laws, determined as if we held such assets, we will be treated as holding directly our proportionate share of the assets of such REMIC.

The term “cash” for purposes of the REIT asset qualification rules is defined to include foreign currency if the REIT or its “qualified business unit” uses such foreign currency as its functional currency, but only to the extent such foreign currency is held for use in the normal course of the activities of the REIT or the “qualified business unit” giving rise to income in the numerator for the 75% or 95% income tests, or directly related to acquiring or holding assets qualifying for the numerator in the 75% assets test, and is not held in connection with a trade or business of trading or dealing in certain securities.

Second, not more than 25% of the value of our total assets may be represented by securities (other than those included in the preceding category).

Third, not more than 20% of the value of our total assets may be represented by securities of one or more taxable REIT subsidiaries.

Fourth, except with respect to a taxable REIT subsidiary and securities that qualify for purposes of the 75% test described above, (a) not more than 5% of the value of our total assets may be represented by securities of any one issuer, (b) we may not hold securities possessing more than 10% of the total voting power of the outstanding securities of any one issuer and (c) we may not hold securities having a value of more than 10% of the total value of the outstanding securities of any one issuer.

For purposes of the second and third asset tests, the term “securities” does not include stock in another REIT, equity or debt securities of a qualified REIT subsidiary or taxable REIT subsidiary, mortgage loans that constitute real estate assets, or equity interests in a partnership.

For purposes of the 10% value test, the term “securities” does not include:

- “Straight debt” securities, which is defined as a written unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the debt is not convertible, directly or indirectly, into stock, and (ii) the interest rate and interest payment dates are not contingent on profits, the borrower’s discretion, or similar factors. “Straight debt” securities do not include any securities issued by a partnership or a corporation in which we or any controlled taxable REIT subsidiary (i.e., a taxable REIT subsidiary in which we own directly or indirectly more than 50% of the voting power or value of the stock) hold non-“straight debt” securities that have aggregate value of more than 1% of the issuer’s outstanding securities. However, “straight debt” securities include debt subject to the following contingencies:
 - a contingency relating to the time of payment of interest or principal, as long as either (i) there is no change to the effective yield of the debt obligation other than a change to the annual yield that does not exceed the greater of 0.25% or 5% of the annual yield, or (ii) neither the aggregate issue price nor the aggregate face amount of the issuer’s debt obligations held by us exceeds \$1 million and no more than 12 months of unaccrued interest on the debt obligations can be required to be prepaid; and
 - a contingency relating to the time or amount of payment upon a default or prepayment of a debt obligation, as long as the contingency is consistent with customary commercial practice.
- Any loan to an individual or an estate.
- Any “section 467 rental agreement” other than an agreement with a related party tenant.
- Any obligation to pay “rents from real property.”
- Certain securities issued by governmental entities.
- Any security issued by a REIT.

- Any debt instrument of an entity treated as a partnership for federal income tax purposes to the extent of our interest as a partner in the partnership.
- Any debt instrument of an entity treated as a partnership for federal income tax purposes not described in the preceding bullet points if at least 75% of the partnership’s gross income, excluding income from prohibited transaction, is qualifying income for purposes of the 75% gross income test described above in “Income Tests.”

The asset tests described above are based on our gross assets. For federal income tax purposes, we will be treated as owning both the loans we hold directly and, in general, any loans that we would securitize through non-REMIC debt securitizations. Although we will have a partially offsetting obligation with respect to the securities issued pursuant to securitizations, these offsetting obligations will generally not reduce the gross assets we are considered to own for purposes of the asset tests.

We believe that a substantial majority of the mortgage loans and MBS that we will own will be qualifying assets for purposes of the 75% asset test. However, certain of our investments, such as certain non-agency MBS that are not interests in REMICs, and certain derivative positions in MBS such as interests in “to be announced” Agency MBS and dollar roll transactions, may not qualify for purposes of the asset tests. Moreover, for purposes of these rules, if the outstanding principal balance of a mortgage loan exceeds the fair market value of the real property securing the loan (together with that of any ancillary personal property which serves as collateral), a portion of such loan likely will not be a qualifying real estate asset under the federal income tax laws.

Revenue Procedures 2011-16 and 2014-51 discuss the modification of a mortgage loan (or an interest therein) that is held by a REIT in which the modification was occasioned by either a default on the loan or a modification that satisfies both of the following conditions: (a) based on all the facts and circumstances, the REIT or servicer of the loan (the “pre-modified loan”) reasonably believes that there is a significant risk of default of the pre-modified loan upon maturity of the loan or at an earlier date, and (b) based on all the facts and circumstances, the REIT or servicer reasonably believes that the modified loan presents a substantially reduced risk of default, as compared with the pre-modified loan. Revenue Procedures 2011-16 and 2014-51 provide that a REIT may treat a modification of a mortgage loan described therein as not being a new commitment to make or purchase a loan for purposes of apportioning interest on that loan between interest with respect to real property or other interest. The modification will also not be treated as a prohibited transaction. Further, with respect to the REIT asset test, the IRS will not challenge the REIT’s treatment of a loan as being in part a “real estate asset” if the REIT treats the loan as being a real estate asset in an amount equal to the lesser of (a) the value of the loan as determined under Treasury Regulations Section 1.856-3(a), or (b) the loan value of the real property securing the loan as determined under Treasury Regulations Section 1.856-5(c) and Revenue Procedures 2011-16 and 2014-51.

We will monitor the status of our assets for purposes of the various asset tests and will seek to manage our investment portfolio to comply at all times with such tests. There can be no assurance, however, that we will be successful in this effort. In this regard, to determine our compliance with these requirements, we will need to estimate the value of the real estate securing our mortgage loans at various times. Although we will seek to be prudent in making these estimates, there can be no assurances that the IRS might not disagree with these determinations and assert that a lower value is applicable. If we fail to satisfy the asset tests at the end of a calendar quarter, we will not lose our REIT status if:

- we satisfied the asset tests at the end of the preceding calendar quarter; and
- the discrepancy between the value of our assets and the asset test requirements arose from changes in the market values of our assets and was not wholly or partly caused by the acquisition of one or more non-qualifying assets, or solely by a change in the foreign currency exchange rate used to value a foreign asset.

If we did not satisfy the condition described in the second item, above, we still could avoid disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which it arose.

In the event that, at the end of any calendar quarter, we violate the asset tests described above, we will not lose our REIT status if (i) the failure is de minimis (up to the lesser of 1% of our assets or \$10 million) and (ii) we dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure. In the event of a more than de minimis failure of any of the asset tests, as long as the failure was due to reasonable cause and not to willful neglect, we will not lose our REIT status if (i) we dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure and (ii) pay a tax equal to the greater of \$50 thousand or 35% of the net income from the non-qualifying assets during the period in which we failed to satisfy the asset tests.

We currently believe that the securities and other assets that we expect to hold will satisfy the foregoing asset test requirements. However, no independent appraisals will be obtained to support our conclusions as to the value of our assets and securities, or in many cases, the real estate collateral for the mortgage loans that we hold. Moreover, the values of some assets may not be susceptible to a precise determination. As a result, there can be no assurance that the IRS will not contend that our ownership of securities and other assets violates one or more of the asset tests applicable to REITs.

Annual Distribution Requirements

Each taxable year, we must distribute dividends, other than capital gain dividends and deemed distributions of retained capital gain, to our stockholders in an aggregate amount at least equal to:

- the sum of:
 - 90% of our “REIT taxable income,” computed without regard to the dividends paid deduction and our net capital gain or loss, and
 - 90% of our after-tax net income, if any, from foreclosure property, minus
- the sum of certain items of excess non-cash income.

We must pay such distributions in the taxable year to which they relate or in the following taxable year if we declare the distribution before we timely file our federal income tax return for the year and pay the distribution on or before the first regular dividend payment date after such declaration. In addition, dividends declared in October, November or December payable to stockholders of record in such month are deemed received by stockholders on December 31 and to have been paid on December 31 if actually paid in January of the following year. See below under “Distributions Generally.”

We will pay the federal income tax on taxable income, including net capital gain, that we do not distribute to stockholders. Furthermore, if we fail to distribute during a calendar year, or by the end of January following the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of:

- 85% of our REIT ordinary income for such year,
- 95% of our REIT capital gain income for such year, and

- any undistributed taxable income from prior periods,

we will incur a 4% nondeductible excise tax on the excess of such required distribution over the amounts we actually distribute. We may elect to retain and pay income tax on the net long-term capital gain we receive in a taxable year (see the section entitled “Taxation of Taxable U.S. Stockholders”). If we so elect, we will be treated as having distributed any such retained amount for purposes of the 4% nondeductible excise tax described above. We intend to make timely distributions sufficient to satisfy the annual distribution requirements and to not incur corporate income tax and the 4% nondeductible excise tax.

It is possible that, from time to time, we may experience timing differences between the actual receipt of income and actual payment of deductible expenses and the inclusion of that income and deduction of such expenses in arriving at our REIT taxable income. Possible examples of those timing differences include the following:

- Because we may deduct capital losses only to the extent of our capital gains, we may have taxable income that exceeds our economic income.
- We will recognize taxable income in advance of the related cash flow if any of our mortgage loans or MBS are deemed to have original issue discount. We generally must accrue original issue discount based on a constant yield method that takes into account projected prepayments but that defers taking into account credit losses until they are actually incurred.
- We may recognize taxable market discount income when we receive the proceeds from the disposition of, or principal payments on, loans that have a stated redemption price at maturity that is greater than our tax basis in those loans, although such proceeds often will be used to make non-deductible principal payments on related borrowings.
- We may recognize taxable income without receiving a corresponding cash distribution if we foreclose on or make a significant modification to a loan to the extent that the fair market value of the underlying property or the principal amount of the modified loan, as applicable, exceeds our basis in the original loan.
- We may recognize phantom taxable income from any residual interests in REMICs or from retained ownership interests in mortgage loans that are used in certain securitization structures.

Although several types of non-cash income are excluded in determining the annual distribution requirement, we will incur corporate income tax and the 4% nondeductible excise tax with respect to those non-cash income items if we do not distribute those items on a current basis. As a result of the foregoing, we may have less cash than is necessary to distribute all of our taxable income and thereby avoid corporate income tax and the excise tax imposed on certain undistributed income. In such a situation, we may need to borrow funds or issue additional common stock or preferred stock.

Under certain circumstances, we may be able to correct a failure to meet the distribution requirement for a year by paying “deficiency dividends” to our stockholders in a later year. We may include such deficiency dividends in our deduction for dividends paid for the earlier year. Although we may be able to avoid income tax on amounts distributed as deficiency dividends, we will be required to pay interest to the IRS based upon the amount of any deduction we take for deficiency dividends.

Recordkeeping Requirements

We must maintain certain records in order to qualify as a REIT. In addition, to avoid a monetary penalty, we must request, on an annual basis, information from our stockholders designed to disclose the actual ownership of our outstanding stock. We intend to comply with these requirements.

Failure to Qualify

If we fail to satisfy one or more requirements for REIT qualification, other than the gross income tests and the asset tests, we could avoid disqualification if our failure is due to reasonable cause and not to willful neglect and we pay a penalty of \$50 thousand for each such failure. In addition, there are relief provisions for a failure of the gross income tests and asset tests as described in “Income Tests” and “Asset Tests.”

If we fail to qualify as a REIT in any taxable year and no relief provision applies, we would be subject to federal income tax and any applicable alternative minimum tax on our taxable income at regular corporate rates. In calculating our taxable income in a year in which we fail to qualify as a REIT, we would not be able to deduct amounts distributed

to our stockholders. In fact, we would not be required to distribute any amounts to stockholders in that year. In such event, to the extent of our current and accumulated earnings and profits, all distributions to stockholders would be taxable as ordinary income. Subject to certain limitations of the federal income tax laws, corporate stockholders might be eligible for the dividends received deduction and domestic non-corporate stockholders may be eligible for the reduced federal income tax rate of 20% on qualified dividends. Unless we qualified for relief under specific statutory provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we ceased to qualify as a REIT. We cannot predict whether, in all circumstances, we would qualify for such statutory relief.

Qualified REIT Subsidiaries

A qualified REIT subsidiary (which we refer to as a “QRS”) is any corporation in which we own 100% of the outstanding stock and for which no election has been made to classify it as a taxable REIT subsidiary. The separate existence of a QRS is disregarded for federal income tax purposes. As such, assets, liabilities and income of a QRS would generally be treated as our assets, liabilities and income for purposes of each of the above REIT qualification tests. In February 2014, we incorporated a wholly-owned QRS, Anworth Properties, Inc., which commenced operations in March 2014. In August 2017, we incorporated another wholly-owned QRS, Anworth Mortgage Loans, Inc., which commenced operations in October 2018. Our subsidiaries may own, from time to time, REIT-qualifying assets, such as certain types of mortgage assets and rental real estate assets.

Taxable REIT Subsidiaries

A taxable REIT subsidiary is any corporation in which we own stock (directly or indirectly) and that we and such corporation jointly elect to classify as a taxable REIT subsidiary. A taxable REIT subsidiary is not subject to the REIT asset, income and distribution requirements, nor is its assets, liabilities or income treated as our assets, liabilities or income for purposes of each of the above REIT qualification tests. We have incorporated Anworth Property Services, Inc., a wholly-owned subsidiary which we intend will be treated as a taxable REIT subsidiary, although it has not yet commenced operations. Our taxable REIT subsidiary will provide an entity through which we may participate in various activities that might otherwise have adverse tax consequences if conducted directly by a REIT or through a QRS. Unlike a REIT, a taxable REIT subsidiary pays standard corporate taxes on its income. Examples of activities in which a taxable REIT subsidiary might engage include: sales of assets in the ordinary course of business that would be a prohibited transaction if sold by the parent REIT; certain securitization activities; and certain service activities (including management of properties owned by third parties and non-customary services to real estate tenants). We generally intend to make a taxable REIT subsidiary election with respect to any other corporation in which we acquire securities constituting more than 10% by vote or value of such corporation and that is not a QRS. However, the aggregate value of all of our taxable REIT subsidiaries must be limited to 20% of the total value of our assets.

We may be subject to a 100% penalty tax on certain transactions with a taxable REIT subsidiary that are not on an arm’s length basis. We intend for the terms of any transactions with a taxable REIT subsidiary to be consistent with arm’s length terms.

We generally expect to derive any income from any taxable REIT subsidiaries in the form of dividends. Such dividends are not real estate source income for purposes of the 75% income test, although they will qualify for purposes of the 95% test. Therefore, when aggregated with our non-real estate source income, such dividends must not exceed 25% of our gross income in any year. We intend to monitor the value of our investment in, and the distributions from, our taxable REIT subsidiaries to ensure compliance with all applicable REIT income and asset tests in the event that we establish any taxable REIT subsidiaries.

Taxable REIT subsidiaries are generally subject to corporate level tax on their net income and will generally be able to distribute only net after-tax earnings to their stockholders, including us, as dividend distributions. Any dividends that we pay which are attributable to dividends received by us from taxable REIT subsidiaries can qualify for the 20% tax rate on qualified dividends in the hands of our stockholders that are not corporations.

Taxation of Taxable U.S. Stockholders

For purposes of the discussion in this Annual Report on Form 10-K, the term “U.S. stockholder” means a holder of our stock that is, for U.S. federal income tax purposes:

- a citizen or resident of the U.S.;
- a corporation (including an entity treated as a corporation for federal income tax purposes), partnership or other entity created or organized in or under the laws of the U.S. or of any state thereof or in the District of Columbia, unless Treasury regulations provide otherwise;
- an estate the income of which is subject to U.S. federal income taxation regardless of its source; or
- a trust (i) whose administration is subject to the primary supervision of a U.S. court and which has one or more U.S. persons who have the authority to control all substantial decisions of the trust or (ii) that has a valid election in place to be treated as a U.S. person.

Distributions Generally

Distributions out of our current or accumulated earnings and profits, other than capital gain dividends, will generally be taxable to U.S. stockholders as ordinary income; provided, however, that all such distributions, other than distributions which are taxable as capital gain dividends or traceable to distributions from a taxable REIT subsidiary, as are received by a pass-through entity or an individual, became eligible for a 20% deduction from gross income starting in 2018 under the tax laws. This eligibility for a 20% deduction

will expire in 2025. Provided that we continue to qualify as a REIT, dividends paid by us will not be eligible for the dividends received deduction generally available to U.S. stockholders that are corporations. To the extent that we make distributions in excess of current and accumulated earnings and profits, the distributions will be treated as a tax-free return of capital to each U.S. stockholder and will reduce the adjusted tax basis which each U.S. stockholder has in our stock by the amount of the distribution, but not below zero. Distributions in excess of a U.S. stockholder’s adjusted tax basis in its stock will be taxable as capital gain and will be taxable as long-term capital gain if the stock has been held for more than one year. If we declare a dividend in October, November, or December of any calendar year which is payable to stockholders of record on a specified date in such a month and actually pay the dividend during January of the following calendar year, the dividend is deemed to be paid by us and received by the stockholder on December 31st of the previous year, but only to the extent we have any remaining undistributed earnings and profits (as computed under the Code) as of December 31st. Any portion of this distribution in excess of our previously undistributed earnings and profits as of December 31st should be treated as a distribution to our stockholders in the following calendar year for U.S. federal income tax purposes. Stockholders may not include in their own income tax returns any of our net operating losses or capital losses. Ordinary dividends to a U.S. stockholder generally will not be eligible for the favorable tax rates (currently 20% maximum rate) for “qualified dividend income.” However, the 20% tax rate for “qualified dividend income” will apply to our ordinary REIT dividends that are attributable to (i) dividends received by us from non-REIT corporations such as a taxable REIT subsidiary, and (ii) any income on which we have paid a corporate income tax.

Cost Basis Reporting

New federal income tax information reporting rules may apply to certain transactions in our shares acquired through our Dividend Reinvestment and Stock Purchase Plan. Where such rules apply, the “cost basis” calculated for the shares involved will be reported to the IRS and to you. For “cost basis” reporting purposes, you may identify by lot the shares that you transfer or that are redeemed, but if you do not timely notify us of your election, we will identify the shares that are transferred or redeemed on a “first in/first out” basis. The shares in our Dividend Reinvestment and Stock Purchase Plan are also eligible for the “average cost” basis method, should you so elect.

Brokers that are required to report the gross proceeds from a sale of shares on Form 1099-B are generally required to report the customer’s adjusted basis in the shares and whether any gain or loss with respect to the shares is long-term or short-term. In some cases, there may be alternative methods of determining the basis in shares that are disposed of, in which case a broker will apply a default method of its choosing if the investor does not indicate which method it chooses to have applied.

[Table of Contents](#)

Capital Gain Distributions

Distributions designated by us as capital gain dividends will be taxable to U.S. stockholders as capital gain income. We can designate distributions as capital gain dividends to the extent of our net capital gain for the taxable year of the distribution. This capital gain income will generally be taxable to non-corporate U.S. stockholders at a 20% or 25% rate based on the characteristics of the asset we sold that produced the gain. U.S. stockholders that are corporations may be required to treat up to 20% of certain capital gain dividends as ordinary income.

Retention of Net Capital Gains

We may elect to retain, rather than distribute as a capital gain dividend, our net capital gains. If we were to make this election, we would pay tax on such retained capital gains. In such a case, if we so elect, our stockholders would:

- include their proportionate share of our undistributed net capital gains in their taxable income;
- receive a credit for their proportionate share of the tax paid by us in respect of such net capital gain; and
- increase the adjusted basis of their stock by the difference between the amount of their share of our undistributed net capital gain and their share of the tax paid by us.

Passive Activity Losses, Investment Interest Limitations and Other Considerations of Holding Our Stock

Distributions that we make and gains arising from the sale or exchange of our stock by a U.S. stockholder will not be treated as passive activity income. As a result, U.S. stockholders will not be able to apply any “passive losses” against income or gains relating to our stock. Distributions by us, to the extent they do not constitute a return of capital, generally will be treated as investment income for purposes of computing the limitations under the Code on the deductibility of investment interest expense. Further, if we, or a portion of our assets, were to be treated as a taxable mortgage pool, or if we hold a residual interest in a REMIC, any resultant excess inclusion income that we derive which is allocated to you could not be offset by any losses or other deductions you may have.

Dispositions of Stock and Warrants

A U.S. stockholder or U.S. warrant holder that sells or disposes of our stock or warrants will recognize gain or loss for federal income tax purposes in an amount equal to the difference between the amount of cash or the fair market value of any property the stockholder or warrant holder receives on the sale or other disposition and the stockholder’s or warrant holder’s adjusted tax basis in the stock or warrants, as applicable. This gain or loss will be capital gain or loss and will be long-term capital gain or loss if the stockholder or warrant holder has held the stock or warrants for more than one year. In general, any loss recognized by a U.S. stockholder or warrant holder upon the sale or other disposition of our stock or warrants that the stockholder or warrant holder has held for six months or less will be treated as long-term capital loss to the extent the stockholder or warrant holder received distributions from us which were required to be treated as long-term capital gains. All or a portion of any loss that a U.S. stockholder or warrant holder realizes upon a taxable disposition of our stock or warrants may be disallowed if the stockholder purchases other stock within 30 days before or after the disposition.

Information Reporting and Backup Withholding

We report to our U.S. stockholders and the IRS the amount of dividends paid during each calendar year and the amount of any tax withheld. Under the backup withholding rules, a stockholder may be subject to backup withholding with respect to dividends paid and redemption proceeds unless the holder is a corporation or comes within other exempt categories and, when required, demonstrates this fact or provides a taxpayer identification number or social security number certifying as to no loss of exemption from backup withholding and otherwise complies with applicable requirements of the backup withholding rules. A U.S. stockholder that does not provide us with its correct taxpayer identification number or social security number may also be subject to penalties imposed by the IRS. A U.S. stockholder

[Table of Contents](#)

can meet this requirement by providing us with a correct, properly completed and executed copy of IRS Form W-9 or a substantially similar form. Backup withholding is not an additional tax. Any amount paid as backup withholding will be creditable against the stockholder’s income tax liability, if any, and otherwise be refundable. In addition, we may be required to withhold a portion of capital gain distributions made to any stockholders who fail to certify their non-foreign status.

Medicare Tax

Certain U.S. stockholders who are individuals, estates or trusts and whose income exceeds certain thresholds will be required to pay a 3.8% Medicare tax on dividends, interest and certain other investment income, including capital gains from the sale or disposition of our stock.

Taxation of Tax-Exempt Stockholders

The IRS has ruled that amounts distributed as a dividend by a REIT will be excluded from the calculation of unrelated business taxable income (which we refer to as “UBTI”) when received by a tax-exempt entity. Based on that ruling, provided that a tax-exempt stockholder has not held our stock as “debt financed property” within the meaning of the Code, i.e., property, the acquisition, or holding of which is financed through a borrowing by the tax-exempt U.S. stockholder, the stock is not otherwise used in an unrelated trade or business, and we do not hold a residual interest in a REMIC that gives rise to “excess inclusion” income, as defined in Section 860E of the Code, dividend income on our stock and income from the sale of our stock should not be unrelated business taxable income to a tax-exempt stockholder. However, if we or a pool of our assets were to be treated as a “taxable mortgage pool,” a portion of the dividends paid to a tax-exempt stockholder may be subject to tax as unrelated business taxable income. Although we do not believe that we, or any portion of our assets, will be treated as a taxable mortgage pool, no assurance can be given that the IRS might not successfully maintain that such a taxable mortgage pool exists.

For tax-exempt stockholders that are social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts, and qualified group legal services plans exempt from federal income taxation under Sections 501(c)(7), (c)(9), (c)(17) and (c)(20) of the Code, respectively, income from an investment in our stock will constitute unrelated business taxable income unless the organization is able to properly claim a deduction for amounts set aside or placed in reserve for certain purposes so as to offset the income generated by its investment in our stock. Any prospective and current investors should consult their tax advisors concerning these “set aside” and reserve requirements.

Notwithstanding the above, however, a substantial portion of the dividends that a tax-exempt stockholder receives may constitute UBTI if we are treated as a “pension-held REIT” and the stockholder is a pension trust which:

- is described in Section 401(a) of the Code; and
- holds more than 10%, by value, of the interests in the REIT.

Tax-exempt pension funds that are described in Section 401(a) of the Code and exempt from tax under Section 501(a) of the Code are referred to below as “qualified trusts.”

A REIT is a “pension-held REIT” if:

- it would not have qualified as a REIT but for the fact that Section 856(h)(3) of the Code provides that stock owned by a qualified trust shall be treated, for purposes of the 5/50 Rule, described above, as owned by the beneficiaries of the trust, rather than by the trust itself; and
- either at least one qualified trust holds more than 25%, by value, of the interests in the REIT, or one or more qualified trusts, each of which owns more than 10%, by value, of the interests in the REIT, holds in the aggregate more than 50%, by value, of the interests in the REIT.

[Table of Contents](#)

The percentage of any REIT dividend treated as unrelated business taxable income is equal to the ratio of:

- the unrelated business taxable income earned by the REIT, less directly related expenses, treating the REIT as if it were a qualified trust and therefore subject to tax on unrelated business taxable income, to
- the total gross income, less directly related expenses, of the REIT.

A de minimis exception applies where the percentage is less than 5% for any year. As a result of the limitations on the transfer and ownership of stock contained in our charter, we do not expect to be classified as a “pension-held REIT.”

Taxation of Non-U.S. Stockholders

The rules governing federal income taxation of “non-U.S. stockholders” are complex and no attempt will be made herein to provide more than a summary of these rules. “Non-U.S. stockholders” means beneficial owners of shares of our stock that are not U.S. stockholders (as such term is defined in the discussion above under the heading entitled “Taxation of Taxable U.S. Stockholders”).

PROSPECTIVE AND CURRENT NON-U.S. STOCKHOLDERS SHOULD CONSULT THEIR TAX ADVISORS TO DETERMINE THE IMPACT OF FOREIGN, FEDERAL, STATE AND LOCAL INCOME TAX LAWS WITH REGARD TO AN INVESTMENT IN OUR STOCK AND OUR ELECTION TO BE TAXED AS A REAL ESTATE INVESTMENT TRUST, INCLUDING ANY REPORTING REQUIREMENTS.

Distributions to non-U.S. stockholders that are not attributable to gain from our sale or exchange of U.S. real property interests, and that are not designated by us as capital gain dividends or retained capital gains, will be treated as dividends of ordinary income to the extent that they are made out of our current or accumulated earnings and profits. These distributions will generally be subject to a withholding tax equal to 30% of the distribution unless an applicable tax treaty reduces or eliminates that tax. However, if income from an investment in our stock is treated as effectively connected with the non-U.S. stockholder’s conduct of a U.S. trade or business, the non-U.S. stockholder generally will be subject to federal income tax at graduated rates on a net basis in the same manner as U.S. stockholders are taxed with respect to those distributions and also may be subject to the 30% branch profits tax in the case of a non-U.S. stockholder that is a corporation. We expect to withhold tax at the rate of 30% on the gross amount of any distributions made to a non-U.S. stockholder unless:

- a lower treaty rate applies and any required form, for example IRS Form W-8BEN, evidencing eligibility for that reduced rate is filed by the non-U.S. stockholder with us; or
- the non-U.S. stockholder files an IRS Form W-8ECI with us claiming that the distribution is effectively connected income.

Any portion of the dividends paid to non-U.S. stockholders that is treated as excess inclusion income will not be eligible for exemption from the 30% withholding tax or a reduced treaty rate.

Distributions in excess of our current and accumulated earnings and profits will not be taxable to non-U.S. stockholders to the extent that these distributions do not exceed the adjusted basis of the stockholder’s stock, but rather will reduce the adjusted basis of that stock. To the extent that distributions in excess of current and accumulated earnings and profits exceed the adjusted basis of a non-U.S. stockholder’s stock, these distributions will give rise to tax liability if the non-U.S. stockholder would otherwise be subject to tax on any gain from the sale or disposition of its stock, as described below. Because it generally cannot be determined at the time a distribution is made whether or not such distribution may be in excess of current and accumulated earnings and profits, the entire amount of any distribution normally will be subject to withholding at the same rate as a dividend. However, amounts so withheld are creditable against U.S. tax liability, if any, or refundable by the IRS to the extent that the distribution is subsequently determined to be in excess of our current and accumulated earnings and profits. We are also required to withhold 15% of any distribution in excess of our current and accumulated earnings and profits if our stock is a U.S. real property interest and

if we are not a domestically controlled REIT, as discussed below. Consequently, although we intend to generally withhold at a rate of 30% on the entire amount of any distribution to a non-U.S. stockholder, to the extent that we do not do so, any portion of a distribution not subject to withholding at a rate of 30% may be subject to withholding at a rate of 15%.

Distributions attributable to our capital gains which are not attributable to gain from the sale or exchange of a U.S. real property interest generally will not be subject to income taxation unless (1) investment in our stock is effectively connected with the non-U.S. stockholder’s U.S. trade or business (or, if an income tax treaty applies, is attributable to a U.S. permanent establishment of the non-U.S. stockholder), in which case the non-U.S. stockholder will be subject to the same treatment as U.S. stockholders with respect to such gain (except that a corporate non-U.S. stockholder may also be subject to the 30% branch profits tax), or (2) the non-U.S. stockholder is a non-resident alien individual who is present in the U.S. for 183 days or more during the taxable year and certain other conditions are satisfied, in which case the non-resident alien individual will be subject to a 30% tax on the individual’s capital gains.

For any year in which we qualify as a REIT, distributions that are attributable to gain from the sale or exchange of a U.S. real property interest, which includes some interests in real property, but generally does not include an interest solely as a creditor in mortgage loans or MBS, will be taxed to a non-U.S. stockholder under the provisions of the Foreign Investment in Real Property Tax Act of 1980 (which we refer to as “FIRPTA”). Under FIRPTA, distributions attributable to gain from sales of U.S. real property interests are taxed to a non-U.S. stockholder as if that gain were effectively connected with the stockholder’s conduct of a U.S. trade or business (effectively connected income). Non-U.S. stockholders thus would be taxed on such income at the normal capital gain rates applicable to U.S. stockholders, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals. Distributions that are subject to FIRPTA also may be subject to the 30% branch profits tax in the hands of a non-U.S. corporate stockholder. We are required to withhold 35% of any distribution that we designate (or, if greater, the amount that we could designate) as a capital gains dividend. The amount withheld is creditable against the non-U.S. stockholder’s FIRPTA tax liability.

A capital gain distribution from a REIT to a foreign investor will not be treated by a non-U.S. stockholder as effectively connected income, provided that (i) the distribution is received with respect to a class of stock that is regularly traded on an established securities market located in the U.S. (our stock currently is so traded) and (ii) the foreign investor does not own more than 10% of the class of stock at any time during the taxable year within which the distribution is received. In that case, the foreign investor is not

required to file a U.S. federal income tax return by reason of receiving such a distribution. Such a distribution is treated as an ordinary dividend that is subject to withholding and taxation as described above and is not treated as a capital gain. Also, the branch profits tax does not apply to such a distribution.

A gain recognized upon the sale of our stock by a non-U.S. stockholder could be treated as effectively connected income under FIRPTA if we are considered to be a United States Real Property Holding Corporation, or USRPHC. In general, a corporation is considered to be a USRPHC if more than 50% of its business assets at any time during a prescribed testing period (which is typically five years) consist of U.S. real property interests. Interests solely as a creditor, including most mortgage loans and MBS, are not considered to be U.S. real property interests. Although we hold certain U.S. real property interests, we do not believe that we are or have been a USRPHC, in which case FIRPTA would not apply to gain recognized upon a sale of our stock.

Even if we become a USRPHC in the future, gains recognized by a non-U.S. stockholder upon a sale of our stock generally will not be taxed under FIRPTA if we are a domestically-controlled REIT, which is a REIT in which at all times during a specified testing period less than 50% in value of the stock was held directly or indirectly by non-U.S. stockholders. Because our stock is publicly traded, we cannot assure our investors that we are or will remain a domestically-controlled REIT. Even if we are not a domestically-controlled REIT, however, a non-U.S. stockholder that owns, actually or constructively, 10% or less of our stock throughout a specified testing period will not recognize taxable gain on the sale of our stock under FIRPTA if the shares are traded on an established securities market.

If a gain from the sale of the stock were subject to taxation under FIRPTA, the non-U.S. stockholder would be subject to the same treatment as U.S. stockholders with respect to that gain, subject to applicable alternative minimum

tax and a special alternative minimum tax in the case of nonresident alien individuals. The 30% branch profits tax to which non-U.S. corporations are subject would not apply to such gain. In addition, the purchaser of the stock could be required to withhold 15% of the purchase price and remit such amount to the IRS.

The Protecting Americans from Tax Hikes Act of 2015, or the PATH Act, creates new exemptions from FIRPTA for foreign pension funds that meet certain requirements and for “qualified shareholders.” Qualified shareholders are certain foreign entities that are publicly traded “qualified collective investment vehicles” which are subject to exchange of information provisions pursuant to a tax treaty between the United States and their home country, maintain records identifying large shareholders and meet certain other requirements. To the extent that a non-U.S. stockholder is subject to either of these exemptions, FIRPTA will not apply either to gain recognized by the non-U.S. stockholder upon a sale of our stock or to capital gain dividend that is attributable to a sale by us of a U.S. real property interest.

A gain upon the sale of our stock by a non-U.S. stockholder that is not subject to FIRPTA will be taxable to a non-U.S. stockholder if:

- the non-U.S. stockholder’s investment in the stock is effectively connected with a trade or business in the U.S., in which case the non-U.S. stockholder will be subject to the same treatment as U.S. stockholders with respect to that gain; or
- the non-U.S. stockholder is a nonresident alien individual who was present in the U.S. for 183 days or more during the taxable year and other conditions are met, in which case the nonresident alien individual will be subject to a 30% tax on the individual’s capital gains.

Information Reporting and Backup Withholding

If the proceeds of a disposition of our stock are paid by or through a U.S. office of a broker-dealer, the payment is generally subject to information reporting and to backup withholding (currently at a rate of 28%) unless the disposing non-U.S. stockholder certifies as to his name, address and non-U.S. status or otherwise establishes an exemption. Generally, U.S. information reporting and backup withholding will not apply to a payment of disposition proceeds if the payment is made outside the U.S. through a foreign office of a foreign broker-dealer. If the proceeds from a disposition of our stock are paid to or through a foreign office of a U.S. broker-dealer or a non-U.S. office of a foreign broker-dealer that is (i) a “controlled foreign corporation” for federal income tax purposes, (ii) a foreign person 50% or more of whose gross income from all sources for a three-year period was effectively connected with a U.S. trade or business, (iii) a foreign partnership with one or more partners who are U.S. persons and who in the aggregate hold more than 50% of the income or capital interest in the partnership, or (iv) a foreign partnership engaged in the conduct of a trade or business in the U.S., then (a) backup withholding will not apply unless the broker-dealer has actual knowledge that the owner is not a foreign stockholder, and (b) information reporting will not apply if the non-U.S. stockholder satisfies certification requirements regarding its status as a foreign stockholder.

Foreign Accounts

Shareholders that acquire our stock through an account maintained at a non-U.S. financial institution should be aware that the Foreign Account Tax Compliance Act (which we refer to as “FATCA”) provides that a 30% withholding tax will be imposed on certain payments made to a foreign entity (such as dividends that we pay and proceeds from the sale of our stock) if such entity fails to satisfy certain new disclosure and reporting rules. FATCA generally requires that (i) in the case of shareholder that is foreign financial institution (defined broadly to include a hedge fund, a private equity fund, a mutual fund, a securitization vehicle or other investment vehicle), the entity identify and provide information with respect to financial accounts with such entity held (directly or indirectly) by U.S. persons and U.S.-owned foreign entities and (ii) in the case of a shareholder that is a non-financial foreign entity, the entity identify and provide information with respect to substantial U.S. owners of such entity.

The IRS has released guidance providing that FATCA withholding with respect to gross proceeds from the disposition of stock will not be imposed on payments made prior to January 1, 2019. The U.S. Treasury has signed certain Intergovernmental Agreements with other countries to implement the exchange of information required under

FATCA. Shareholders that invest in the Company through an account maintained at a non-U.S. financial institution are strongly encouraged to consult with their own tax advisors regarding the potential application and impact of FATCA and any Intergovernmental Agreement between the United States and their home jurisdiction in connection with FATCA compliance.

State, Local and Foreign Taxation

We may be required to pay state, local and foreign taxes in various state, local and foreign jurisdictions, including those in which we transact business or make investments, and our stockholders may be required to pay state, local and foreign taxes in various state, local and foreign jurisdictions, including those in which they reside. Our state, local and foreign tax treatment may not conform to the federal income tax consequences summarized above. In addition, a stockholder’s state, local and foreign tax treatment may not conform to the federal income tax consequences summarized above. Consequently, prospective investors should consult their tax advisors regarding the effect of state, local and foreign tax laws on an investment in our stock.

Possible Legislative or Other Actions Affecting Tax Considerations

Prospective investors and stockholders should recognize that the present U.S. federal income tax treatment of an investment in our stock may be modified by legislative, judicial or administrative action at any time and that any such action may affect investments and commitments previously made. The rules dealing with U.S. federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Treasury Department, resulting in revisions of regulations and revised interpretations of established concepts as well as statutory changes. Revisions in U.S. federal tax laws and interpretations thereof could adversely affect the tax consequences of an investment in our stock.

The recently enacted PATH Act contains changes to certain aspects of the U.S. federal income tax rules applicable to REITs. The Act modifies various rules that apply to a REIT’s ownership of and business relationship with its taxable REIT subsidiaries and reduces (beginning in 2018) the value of a REIT’s assets that may be in taxable REIT subsidiaries from 25% to 20%. The PATH Act makes permanent the reduction of the period (from ten years to five years) during which a REIT is subject to corporate-level tax on the recognition of built-in gains in assets of an acquired corporation.

The PATH Act also makes multiple changes related to FIRPTA, expands prohibited transaction safe harbors and qualifying hedges, and repeals for publicly offered REITs the rules that previously could apply to limit the deductibility of certain distributions if they were considered to be preferential dividends. Lastly, the PATH Act adjusts the way a REIT calculates earnings and profits in certain circumstances to avoid double taxation at the shareholder level, and expands the types of assets and income treated as qualifying for purposes of the REIT requirements. Investors are urged to consult their tax advisors with respect to these changes and the potential impact on an investment in our stock.

Item 1A. RISK FACTORS

Our business routinely encounters and attempts to address risks, some of which will cause our future results to differ, sometimes materially, from those originally anticipated. Below, we have described our present view of the most significant risks facing the Company. The risk factors set forth below are not the only risks that we may face or that could adversely affect us. If any of the circumstances described in the risk factors discussed in this Annual Report on Form 10-K actually occur, our business, financial condition and results of operations could be materially adversely affected. If this were to occur, the trading price of our securities could decline significantly and stockholders may lose all or part of their investment.

The following discussion of risk factors contains “forward-looking statements,” which may be important to understanding any statement in this Annual Report on Form 10-K or in our other filings and public disclosures. In particular, the following information should be read in conjunction with Item 7 – Management’s Discussion and Analysis of Financial Condition and Results of Operations and Item 8 – Financial Statements and Supplementary Data of this Annual Report on Form 10-K.

The following is a summary of the risk factors discussed in this Annual Report on Form 10-K:

Risks Related to Recent or Potential Economic, Legislative, and Regulatory Developments Affecting Our Industry

- Adverse developments in the residential mortgage market, the real estate market, and the broader financial and capital markets, as well as in the U.S. economy and the broader global economy, may adversely affect our business, results of operations, and financial condition;

- The U.S. government may make substantial changes to fiscal, tax, and other federal policies that may adversely affect our business;
- New laws may be passed affecting the relationship between Fannie Mae and Freddie Mac, on the one hand, and the federal government, on the other, which could adversely affect the price of Agency MBS;
- A failure by the U.S. government to reduce its budget deficit, resolve future debt ceiling or government funding crises or a further downgrade of U.S. sovereign debt and government-sponsored agency debt, could have a material adverse impact on our borrowings and the valuations of our mortgage-related assets and may have a material adverse impact on our stock price, financial condition and results of operations;
- We are subject to the risk that domestic and international crises, despite efforts by global governments to address such crises, may affect interest rates and the availability of financing in general, which could adversely affect our financing and our operating results;
- Mortgage loan modification programs and future legislative action may adversely affect the value of, and the returns on, mortgage-related assets in which we invest;
- A change in the LIBOR setting process could affect the interest rates that borrowing agreement counterparties charge on borrowings in general. Any such change could affect our borrowing agreements and could have an adverse impact on our net interest income;
- Government use of eminent domain to seize underwater mortgages could materially and adversely affect the value of, and the returns on, our Non-Agency MBS and residential mortgage loans; and
- Our business is subject to complex and evolving U.S. and international laws and regulations regarding privacy and data protection. Many of these laws and regulations are subject to change and uncertain interpretation and could result in claims, changes to our business practices and penalties, or otherwise harm our business.

Risks Related to our Financings and Leverage

- If we are unable to negotiate favorable terms and conditions on future borrowing arrangements with one or more of our lenders, our ability to acquire investments for our portfolio, our financial condition and earnings could be negatively impacted;
- Our leveraging strategy increases the risks of our operations;
- We may incur increased borrowing costs related to repurchase agreements and other borrowing facilities that would adversely affect our profitability and our book value;
- If we are unable to complete securitizations or experience delays on securitization closings, we would face a liquidity shortage in this area of our business, which would harm our operating results;

[Table of Contents](#)

- Any borrowing arrangements that we use to finance our assets may require us to provide additional collateral or pay down debt, and if these requirements are not met, our financial condition and prospects could deteriorate rapidly;
- Our use of repurchase agreements and other credit facilities to borrow funds may give our lenders greater rights in the event that either we or a lender files for bankruptcy;
- A failure to comply with restrictive covenants in our financing arrangements would have a material adverse effect on us, and any future financings may require us to provide additional collateral or pay down debt;
- Our hedging strategies may not be successful in mitigating our risks associated with interest rates; and
- The characteristics of hedging instruments present various concerns, including illiquidity, enforceability, and counterparty risks, which could adversely affect our business and results of operations.

Risks Related to our Investments and Investment Activity

- Competition may prevent us from acquiring mortgage-related assets at favorable yields, and that would negatively impact our profitability;
- A decrease or lack of liquidity in our investments may adversely affect our business, including our ability to value and sell our assets;
- If we are unable to find suitable investments, we may not be able to achieve our investment objectives or pay dividends;
- An increase in interest rates may harm our book value, which could adversely affect the cash available for distribution to you and could cause the price of our securities to decline;
- An increase in interest rates may cause a decrease in the volume of newly issued, or investor demand for, MBS and other mortgage-related assets, which could adversely affect our ability to acquire MBS and other mortgage-related assets that satisfy our investment objectives and to generate income and pay dividends;
- A flat or inverted yield curve may negatively affect our operations, book value and profitability due to its potential impact on investment yields and the supply of adjustable-rate mortgage products;
- Interest rate mismatches between our adjustable-rate investments and our borrowings used to fund our purchases of these assets may reduce our income during periods of changing interest rates;
- We may experience reduced net interest income from holding fixed-rate investments during periods of rising interest rates;
- Interest rate caps on our adjustable-rate MBS may reduce our income or cause us to suffer a loss during periods of rising interest rates;
- New assets we acquire may not generate yields as attractive or be as accretive to book value as have been experienced historically;
- Increased levels of prepayments from Agency MBS may decrease our net interest income;
- The timing and amount of prepayments could adversely affect our liquidity and our profitability;

- A decline in the fair market value of our Non-Agency MBS could result in us recording impairments on these investments, which may have an adverse effect on our results of operations and financial condition;
- Our investments in Non-Agency MBS and residential mortgage loans involve credit risk, which could materially adversely affect our results of operations;
- We may have significant credit risk, especially on Non-Agency MBS and residential mortgage loans in certain geographic areas and may be disproportionately affected by economic or housing downturns, natural disasters, terrorist events, adverse climate changes or other adverse events specific to those markets;
- We invest in Non-Agency MBS that are collateralized by loans of lower credit quality, such as Alt-A loans or securitized non-performing loans, which, due to lower underwriting standards, are subject to increased risk of losses;
- We may generate taxable income that differs from our GAAP income on our mortgage-related investments, which may result in significant timing differences in the recognition of income and losses;
- Generally, Non-Agency MBS have greater price sensitivity than Agency MBS, which could cause fluctuations in our book value. Such price fluctuations could cause repurchase agreement lenders to require greater amounts of collateral and higher margin requirements, which could affect our results of operations and could cause us to sell our Non-Agency MBS at potentially distressed prices in periods of significant price fluctuation. It could also cause repurchase agreement lenders to withdraw their financing from such investments;
- Our subordinated mortgage assets may be in the “first loss” position, subjecting us to greater risks of loss;
- If our Manager underestimates the collateral loss on our investments, we may experience losses;

- The servicing of the mortgage loans that are the underlying collateral of our mortgage-related assets is outside of our control, and if this servicing is not successful in limiting future delinquencies, defaults and losses, it could adversely affect our results of operations;
- We invest in securities in the developing Credit risk transfer sector that are subject to mortgage credit risk;
- We may invest in leveraged mortgage derivative securities that generally experience greater volatility in market prices, thus exposing us to greater risk with respect to their rate of return;
- We are dependent upon information systems and communication systems and their failure could significantly disrupt our business;
- We have a limited operating history in the business of acquiring and securitizing mortgage loans and we may not be successful;
- Representations and warranties made by us in loan sales and securitizations may subject us to liability that could result in loan losses, which could harm our operating results;
- We acquire, or will acquire, most of the loans from a limited number of originators and if we fail to properly manage these relationships, or if these originators experience origination problems, our ability to acquire loans from them could be harmed, which would negatively affect our operations;
- Our real estate-related assets (including mortgage loans and MBS) are subject to the risks associated with real property;

[Table of Contents](#)

- We expect to engage in securitization transactions relating to real estate mortgage loans that we will sponsor. In addition, we have invested in, and continue to invest in, mortgage-backed securities issued in securitization transactions sponsored by other companies. These types of transactions and investments expose us to potential material risks; and
- With respect to mortgage loans we own, or which we have purchased and will subsequently securitize, we may be subject to liabilities for potential violations of CFPB’s TILA-RESPA Integrated Disclosure rule (also referred to as “TRID”) or other similar consumer protection laws and regulations, which could adversely impact our business and operating results.

Risks Related to our Management

- We have no employees and our Manager is responsible for making all of our investment decisions. The employees of our Manager are not required to devote any specific amount of time to our business;
- We are completely dependent upon our Manager, who provides services to us through the Management Agreement, and we may not find suitable replacements for our Manager if the Management Agreement is terminated or such key personnel are no longer available to us. The loss of any key personnel of our Manager could harm our operations;
- The Management Agreement was not negotiated on an arm’s-length basis and the terms, including fees payable, may not be as favorable to us as if it were negotiated with an unaffiliated third party;
- If we elect to not renew the Management Agreement without cause, we would be required to pay our Manager a substantial termination fee;
- If we do not renew the Management Agreement for any reason, we would continue to be obligated to pay the sublease on our office premises in California;
- Various corporate actions require the approval of the majority of all shareholders;
- In the event of a change of control, we will owe certain of the officers and employees of our Manager a payment as specified in their Change of Control and Arbitration Agreements between these officers/employees and the Company;
- The management fee is payable regardless of our performance;
- The fee structure of the Management Agreement may limit our Manager’s ability to retain access to its key personnel;

- Some investors may not view our external management in a positive light, which may affect the market price of our common stock, and may make it more difficult for future offerings of our stock;
- Potential conflicts of interest could arise if our Manager were to take greater risk for the purpose of increasing our equity in order to earn a greater management fee;
- Our Manager’s liability is limited under the Management Agreement and we have agreed to indemnify our Manager against certain liabilities;
- Our Manager has limited resources and may not be able to defend itself in litigation;
- Failure of our Manager to comply with SEC rules and regulations could cause various disciplinary actions, which could cause a disruption in services provided to us, and may impact our business operations and our

profitability; and

- Our Board may change our operating policies and strategies without prior notice or stockholder approval and such changes could harm our business, results of operations and stock price.

Risks Related to Our Residential Properties Business

- We are in an industry that has significant competition, which makes this business difficult to evaluate, and may affect our ability to operate this business in a profitable manner;
- Many factors affect the single-family residential rental market, and the profitability of this business will be affected both by our assumptions about this market and this market’s conditions in our target areas;
- Initially, our portfolio of properties has been geographically concentrated, and any adverse developments in local economic conditions, or the demand for single-family rental homes in these markets, or the occurrence of natural disasters, may adversely affect the operating results of this business;
- Poor resident selection and defaults by renters may adversely affect the financial performance of this business and harm our reputation; and
- Declining real estate values and impairment charges could adversely affect the earnings and financial condition of this business.

Risks Related to REIT Compliance and Other Tax Matters

- If we are disqualified as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability;
- Complying with REIT requirements may cause us to forego otherwise attractive opportunities;
- Complying with REIT requirements may limit our ability to hedge effectively;
- Complying with REIT requirements may force us to liquidate otherwise attractive investments or to make investments inconsistent with our business plan;
- REIT distribution requirements could adversely affect our ability to execute our business plan and may require us to incur debt, sell assets, or take other actions to make such distributions;
- Even though we elected to be taxed as REIT, we may be required to pay certain taxes;
- Our ability to invest in and dispose of TBA contracts could be limited by our REIT status and we could lose our REIT status as a result of these investments;
- Complying with REIT requirements may force us to borrow to make distributions to stockholders;

- Dividends payable by REITs do not qualify for the reduced tax rates;
- The tax imposed on REITs engaging in “prohibited transactions” will limit our ability to engage in transactions, including certain methods of securitizing loans, which would be treated as sales for federal income tax purposes;
- We may incur excess inclusion income that would increase the tax liability of our stockholders; and

- Misplaced reliance on legal opinions or statements by issuers of mortgage-related assets could result in a failure to comply with REIT gross income or asset tests.

Additional Risk Factors

- Failure to maintain an exemption from the Investment Company Act would materially harm our results of operations;
- We presently are not, nor do we intend to be, regulated as an investment company. Fluctuations in our net income and in our book value will likely be greater than those of investment companies. This may affect investors or potential investors as to the appropriateness of our stock as compared to that of an investment company;
- The market price of our common stock may fluctuate significantly;
- We may not be able to use the money we raise from time to time to acquire investments at favorable prices;
- We have not established a minimum dividend payment level for our common stockholders and there are no assurances of our ability to pay dividends to them in the future;
- Our charter does not permit ownership of over 9.8% of our common or preferred stock and attempts to acquire our common or preferred stock in excess of the 9.8% limit are void without prior approval from our Board; and
- Because provisions contained in Maryland law, our charter and our bylaws may have an anti-takeover effect, investors may be prevented from receiving a “control premium” for their shares.

Risks Related to Recent or Potential Economic, Legislative, and Regulatory Developments Affecting Our Industry

Adverse developments in the residential mortgage market, the real estate market, and the broader financial and capital markets, as well as in the U.S. economy and the broader global economy, may adversely affect our business, results of operations, and financial condition.

Our results of operations are materially affected by conditions in the markets for mortgages and mortgage-related assets, including MBS and residential mortgage loans, as well as the broader financial markets and the economy generally. Significant adverse changes in financial market conditions leading to the forced sale of large quantities of mortgage-related and other financial assets would result in significant volatility in the market for mortgages and mortgage-related assets and potentially significant losses for us and certain other market participants. In addition, concerns over the U.S. economy or uncertainty regarding future U.S. monetary policy may contribute to increased interest rate volatility. This may have an adverse impact on the supply or value of mortgage-related assets and could also make it more difficult for us as well as others in the marketplace to obtain financing on favorable terms or at all.

The U.S. government may make substantial changes to fiscal, tax, and other federal policies that may adversely affect our business.

Changes by the U.S. government on U.S. fiscal and tax policies, trade, healthcare, immigration, foreign policies, and governmental regulations may impact the residential mortgage and real estate markets, the U.S. economy, and the broader global economy. Although we cannot predict the impact, if any, that any change in federal policies could have on our business, they could negatively affect our business. Until we know what policy changes are made and how these changes impact our business and the business of others that compete in our markets, over the long-term, we cannot predict whether we will benefit from such changes or be negatively affected by them.

New laws may be passed affecting the relationship between Fannie Mae and Freddie Mac, on the one hand, and the federal government, on the other, which could adversely affect the price of Agency MBS.

The interest and principal payments we expect to receive on the Agency MBS in which we invest will be guaranteed by Fannie Mae and Freddie Mac. Principal and interest on securities issued by Fannie Mae and Freddie Mac are not guaranteed by the U.S. government. All the Agency MBS in which we invest depend on a steady stream of payments on the mortgages underlying the securities.

Since September 2008, there have been increased market concerns about Fannie Mae’s and Freddie Mac’s ability to withstand future credit losses associated with securities held in their investment portfolios, and on which they provide guarantees, without the direct support of the federal government. Fannie Mae and Freddie Mac were placed into the conservatorship of the FHFA, their federal regulator, pursuant to its powers under The Federal Housing Finance Regulatory Reform Act of 2008, a part of the Housing and Economic Recovery Act of 2008.

In addition to the FHFA becoming the conservator of Fannie Mae and Freddie Mac, the U.S. Department of the Treasury has taken various actions intended to provide Fannie Mae and Freddie Mac with additional liquidity and ensure their financial stability. The U.S. Treasury can hold its portfolio of Agency MBS to maturity and, based on mortgage market conditions, may make adjustments to the portfolio. This flexibility may adversely affect the pricing and availability for our target investments.

It is also possible that if and when the U.S. Treasury commits to purchase Agency MBS in the future, it could create additional demand that would increase the pricing of Agency MBS that we seek to acquire.

Shortly after Fannie Mae and Freddie Mac were placed in federal conservatorship, the Secretary of the U.S. Treasury suggested that the guarantee payment structure of Fannie Mae and Freddie Mac should be re-examined. The future roles of Fannie Mae and Freddie Mac could be significantly reduced and the nature of their guarantees could be eliminated or considerably limited relative to historical measurements. The U.S. Treasury could also stop providing credit support to Fannie Mae and Freddie Mac in the future. Any changes to the nature of the guarantees provided by Fannie Mae and Freddie Mac could redefine what constitutes an Agency MBS and could have broad adverse market implications. In addition, if Fannie Mae or Freddie Mac was eliminated, or their structures were to change radically, we would not be able to acquire Agency MBS from these companies, which would eliminate a major component of our business model.

Our income could be negatively affected in a number of ways depending on the manner in which related events unfold. For example, the current credit support provided by the U.S. Treasury to Fannie Mae and Freddie Mac, and any additional credit support it may provide in the future, could have the effect of lowering the interest rate we expect to receive from Agency MBS that we seek to acquire, thereby tightening the spread between the interest we earn on our portfolio of targeted assets and our cost of financing that portfolio. A reduction in the supply of Agency MBS could also negatively affect the pricing of Agency MBS we seek to acquire by reducing the spread between the interest we earn on our portfolio of targeted assets and our cost of financing that portfolio.

Any law affecting these government-sponsored enterprises may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by Fannie Mae or Freddie Mac. As a result, such laws could increase the risk of loss on investments in Fannie Mae and/or Freddie Mac Agency MBS. It also is possible that such laws could adversely impact the market for such securities and spreads at which they trade. All of the foregoing could materially adversely affect our business, operations and financial condition.

A failure by the U.S. government to reduce its budget deficit, or resolve future debt ceiling or government funding crises, or a further downgrade of U.S. sovereign debt and government-sponsored agency debt, could have a material adverse impact on our borrowings and the valuations of our mortgage-related assets and may have a material adverse impact on our stock price, financial condition and results of operations.

There continue to be concerns over the ability of the U.S. government to reduce its budget deficit, and resolve its debt crisis and continued government funding crises. The U.S. sovereign debt and government-sponsored agency debt

credit ratings continue to be monitored to account for the risk that U.S. lawmakers fail to reduce its overall debt. A failure by the U.S. government to reach agreement on future budgets and debt ceilings, reduce its budget deficit, or avoid government shutdowns, or a future downgrade of U.S. sovereign debt and government-sponsored agencies debt could have a material adverse effect on the U.S. economy and the global economy.

In particular, this could cause disruption in the capital markets and impact the stability of future U.S. treasury auctions and the trading market for U.S. government securities, resulting in increased interest rates and impaired access to credit. These factors could negatively impact our borrowing costs, our liquidity and the valuation of the mortgage-related assets we currently own in our portfolio, which could have a material adverse impact on our stock price, financial condition and our results of operations.

We are subject to the risk that domestic and international crises, despite efforts by global governments to address such crises, may affect interest rates and the availability of financing in general, which could adversely affect our financing and our operating results.

In the years following the financial and credit crisis of 2007-2008, several large European banks experienced financial difficulty and were either rescued by government assistance or by other large European banks. Several European governments attempted to shore-up their financial sectors through loans, credit guarantees, capital infusions, promises of continued liquidity funding and interest rate cuts. Additionally, other governments of the world’s largest economic countries also implemented interest rate cuts. As there continues to be concern over the European countries’ economies, there is no assurance that government plans and programs will be successful in addressing global credit crises or in preventing other banks from failing. If unsuccessful, this could adversely affect our financing and operations as well as those of the entire mortgage sector in general.

As there continue to be concerns about many of the economies of European countries, there is a continuing risk to the financial condition and stability of major European banks. Many of the European banks have U.S. banking subsidiaries, which have provided financing to us, particularly repurchase agreement financing and warehouse lines of credit for the acquisition of various mortgage-related investments.

If the European credit crisis continues to impact major European banks, there is the possibility that it will also impact the operations of their U.S. banking subsidiaries. This could adversely affect our financing and operations as well as those of the entire mortgage sector in general.

Mortgage loan modification programs and future legislative action may adversely affect the value of, and the returns on, mortgage-related assets in which we invest.

The U.S. government, through the Federal Housing Authority and the Federal Deposit Insurance Corporation, has implemented programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. The programs may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans or the rate of interest payable on the loans, or extending the payment terms of the loans. In addition, members of the U.S. Congress have indicated support for additional legislative relief for homeowners. These loan modification programs, as well as future legislative or regulatory actions that result in the modification of outstanding mortgage loans, may adversely affect the value of, and the returns on, the mortgage-related investments in which we invest.

A change in the LIBOR setting process could affect the interest rates that borrowing agreement counterparties charge on borrowings in general. Any such change could affect our borrowing agreements and could have an adverse impact on our net interest income.

Over the past several years, U.S. and British banking authorities assessed fines on several major financial institutions for LIBOR manipulation. LIBOR is an unregulated rate based on estimates that lenders submitted to the British Bankers’ Association, a trade group that compiled the information and published daily the LIBOR rate. On February 1, 2014, the administration of LIBOR was transferred from the British Bankers’ Association to the Intercontinental Exchange Benchmark Administration, or the IBA, following authorization by the Financial Conduct

Authority (the United Kingdom regulators). In July 2017, the Financial Conduct Authority announced that by the end of 2021, LIBOR would be replaced with a more reliable alternative. At this time, we do not know what changes will be made by the Financial Conduct Authority. In the United States, the Alternative Reference Rates Committee selected the Secured Overnight Financing Rate, or SOFR, an overnight secured U.S. Treasury repurchase agreement rate, as the new rate and adopted a proposed transition plan for the change from U.S. LIBOR to SOFR. The calculation of LIBOR under the IBA is the average of the interest rates that some of the world’s leading banks charge each other for short-term loans. It is unclear at this time how the change to another alternative to LIBOR will affect the interest rates that repurchase agreement counterparties and lenders charge on borrowings in general and how they could specifically affect our borrowing agreements.

Government use of eminent domain to seize underwater mortgages could materially and adversely affect the value of, and the returns on, our Non-Agency MBS and residential mortgage loans.

The mortgages securing our Non-Agency MBS and residential mortgage loans are located in different geographic regions across the United States. Several county and municipal governments have discussed using eminent domain to seize from mortgage holders the mortgages of borrowers who are underwater but not in default. In August 2013, the FHFA released a statement expressing serious concerns on the use of eminent domain to restructure mortgages based on a review it conducted since requesting public input on the proposal in August 2012 and indicated that it may take action in response to such use. However, if definitive action is taken by any local governments and such actions withstand Constitutional and other legal challenges resulting in mortgages securing our Non-Agency MBS and residential mortgage loans being seized using eminent domain, the consideration received from the seizing authorities for such mortgages may be substantially less than the outstanding principal balance, which would result in a realized loss and a corresponding write-down of the principal balance of those mortgages. The result of these seizures would be that the amount we receive on our Non-Agency MBS and residential mortgage loans would be less than we would have otherwise received if the mortgage loans had not been seized, which may result in a decline in the market value and an other-than-temporary impairment of these assets. If governments adopt such plans and mortgages securing our Non-Agency MBS and residential mortgage loans are seized on a widespread scale, it could have a material adverse effect on the value of and/or returns on our mortgage-related assets and our results of operations.

Our business is subject to complex and evolving U.S. and international laws and regulations regarding privacy and data protection. Many of these laws and regulations are subject to change and uncertain interpretation and could result in claims, changes to our business practices and penalties, or otherwise harm our business.

Regulatory authorities around the world are considering a number of legislative and regulatory proposals concerning data protection, including measures to ensure that encryption of users’ data does not hinder law enforcement agencies’ access to data. In addition, the interpretation and application of consumer and data protection laws in the United States, Europe, and in other countries in the world are often uncertain and in flux. It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data protection or with the data protection on service providers that we rely upon. If borrower or consumer data, including personally identifiable information, is lost, exposed, stolen, or subject to unauthorized access or use as a result of accidents, error, or malfeasance by employees, independent contractors or others working for us on our behalf, we may be liable for losses suffered by individuals whose identities are stolen as a result of a data breach on the systems used by our various service providers, and any liability could be material. Even if we are not liable for such losses, any breach of these systems could expose us to material costs in notifying affected individuals and providing credit monitoring services to them as well as regulatory fines or penalties. In addition, any breach of these systems could disrupt our normal business operations and expose us to reputational damage and lost business, revenues and profits.

Recent legal developments in Europe have created compliance uncertainty regarding certain transfers of personal data from Europe to the United States. For example, the General Data Protection Regulation, or the GDPR, which became effective in the European Union, or EU, on May 25, 2018, not only applies to companies and organizations in the EU but also applies to organizations based outside the EU if they collect or process personal data of individuals located inside the EU. According to the European Commission, personal data is any information relating to an individual, whether it relates to his or her private, professional or public life, and can include anything such as a name, a home address, an email address, bank details, or medical information.

The California Consumer Privacy Act, or the CCPA, is a bill intended to enhance privacy rights and consumer protection for residents of California. The bill was passed by the California State Legislature and signed into law by Jerry Brown, then-Governor of California, on June 28, 2018. The CCPA applies to any business that collects consumers’ personal data and does business in California and has annual gross revenue in excess of \$25 million, or possesses the personal information of 50,000 or more consumers, households, or devices.

These laws and regulations are subject to change and uncertain interpretation and could result in claims, changes to our business practices and penalties, or otherwise harm our business.

Risks Related to our Financings and Leverage

If we are unable to negotiate favorable terms and conditions on future borrowing arrangements with one or more of our lenders, our ability to acquire investments for our portfolio, our financial condition and earnings could be negatively impacted.

The terms and conditions of each borrowing arrangement with our lenders are negotiated on a transaction-by-transaction basis. Our access to financing depends upon many factors over which we have little or no control including, but not limited to: general market conditions; each lender’s view of the quality and value of our assets and our liquidity; regulatory requirements; our current and future earnings potential; and the market price of our stock. Key terms and conditions of each transaction include interest rates, maturity dates, asset pricing procedures and margin requirements. We cannot assure you that we will be able to continue to negotiate favorable terms and conditions on our future borrowing arrangements. This could negatively impact our ability to acquire investments for our portfolio.

Also, during periods of market illiquidity or due to perceived credit quality deterioration of the collateral pledged, a lender may require that less favorable asset pricing procedures be employed or the margin requirements be increased. Possible market developments, including a sharp rise in interest rates, a change in prepayment rates, or increasing market concern about the value or liquidity of MBS and residential mortgage loans, may reduce the market value of our portfolio, which may cause our lenders to require additional collateral. Under these conditions, we may determine it is prudent to sell assets to improve our ability to pledge sufficient collateral to support our remaining borrowings. Such sales may be at disadvantageous times, which may harm our operating results and net profitability.

If one or more major market participants fail, it could negatively impact the marketability of mortgage-related assets, and this could negatively affect the value of the investments in our portfolio, thus reducing our book value.

Our leveraging strategy increases the risks of our operations.

Use of leverage can enhance our investment returns (and at times when we reduce our leverage, our profitability may be reduced as a result). Leverage, however, also increases risks. In the following ways, the use of leverage increases our risk of loss and may reduce our net income by increasing the risks associated with other risk factors including a decline in the market value of, or a default on, a mortgage-related asset:

- The use of leverage increases our risk of loss resulting from various factors including rising interest rates, increased interest rate volatility, downturns in the economy and reductions in the availability of financing or deterioration in the conditions of any of our mortgage-related assets.
- Substantially all of our borrowings are secured by our mortgage-related assets. A decline in the market value of the assets used to secure these debt obligations could limit our ability to borrow or result in lenders requiring us to pledge additional collateral to secure our borrowings. In that situation, we could be required to sell our investments under adverse market conditions in order to obtain the additional collateral required by the lender. If these sales are made at prices lower than the carrying value of the investments, we would experience losses.
- A default of a mortgage-related asset that constitutes collateral for our borrowings could also result in an involuntary liquidation of the mortgage-related asset. This would result in a loss to us of the difference

between the value of the mortgage-related asset upon liquidation and the amount borrowed against the mortgage-related asset.

- To the extent we are compelled to liquidate qualified REIT assets to repay debts, our compliance with the REIT rules regarding our assets and our sources of income could be affected, which could jeopardize our status as a REIT. Losing our REIT status would cause us to lose tax advantages applicable to REITs and may decrease our overall profitability and distributions to our stockholders.

We may incur increased borrowing costs related to repurchase agreements and other borrowing facilities that would adversely affect our profitability and our book value.

If interest rates on these agreements and on other borrowing facilities increase, that would harm our profitability. Our borrowing costs under repurchase agreements and other short-term borrowing facilities generally correspond to short-term interest rates such as LIBOR plus or minus a margin. The margins on these borrowings over or under short-term interest rates may vary depending upon:

- the movement of interest rates;
- the availability of financing in the market; and
- the value and liquidity of our mortgage-related assets.

If we are unable to complete securitizations or experience delays on securitization closings, we would face a liquidity shortage in this area of our business, which would harm our operating results.

We expect to rely significantly upon securitizations to generate cash proceeds to repay warehouse lines of credit and replenish our borrowing capacity. If we are unable to complete a securitization or experience delays, we may be required to utilize other sources of financing which, if available at all, may not be on the best terms for us. Shortages in financing would make it difficult for us to continue to purchase loans. In addition, delays in closing securitizations increase our credit and interest rate risks on our mortgage loans, as we would be holding them for an extended period of time. Several factors could affect our ability to complete a securitization including, among others, the following:

- Condition in the securities and secondary markets;
- The credit quality of the mortgage loans acquired;
- The volume of mortgage acquisitions;
- The ability to receive good ratings from the rating agencies; and
- Lack of investor demand for purchasing components of the securities.

Any borrowing arrangements that we use to finance our assets may require us to provide additional collateral or pay down debt, and if these requirements are not met, our financial condition and prospects could deteriorate rapidly.

Our repurchase agreements and other borrowing agreements involve the risk that the market value of the securities pledged or sold by us to the borrowing agreement counterparty may decline in value, in which case the counterparty may require us to provide additional collateral or to repay all or a portion of the funds advanced.

We may not have additional collateral or the funds available to repay our debt at that time, which would likely result in defaults unless we are able to raise the funds from alternative sources, which we may not be able to achieve on favorable terms or at all. Posting additional collateral would reduce our liquidity and limit our ability to leverage our assets. If we cannot meet these requirements, the counterparty could accelerate our indebtedness, increase the interest rate on advanced funds and terminate our ability to borrow funds from them, which could materially and adversely affect our financial condition and ability to implement our investment strategy. In addition, in the event that the counterparty

files for bankruptcy or becomes insolvent, our securities may become subject to bankruptcy or insolvency proceedings, thus depriving us of the benefit of these assets. In the event that we are unable to meet these collateral obligations, our financial condition and prospects could deteriorate rapidly.

Our use of repurchase agreements and other credit facilities to borrow funds may give our lenders greater rights in the event that either we or a lender files for bankruptcy.

Our borrowings under repurchase agreements and other credit facilities may qualify for special treatment under the bankruptcy code, giving our lenders the ability to avoid the automatic stay provisions of the bankruptcy code and to take possession of and liquidate our collateral under the repurchase agreements without delay in the event that we file for bankruptcy. Furthermore, the special treatment of repurchase agreements under the bankruptcy code may make it difficult for us to recover our pledged assets in the event that a lender files for bankruptcy. Thus, the use of borrowing agreements exposes our pledged assets to risk in the event of a bankruptcy filing by either a lender or us.

A failure to comply with restrictive covenants in our financing arrangements would have a material adverse effect on us, and any future financings may require us to provide additional collateral or pay down debt.

We are subject to various restrictive covenants contained in our financing arrangements and may become subject to additional covenants in connection with future financings. These covenants may limit our flexibility to pursue certain investments or incur additional debt. If we fail to meet or satisfy any of these covenants, subject to certain cure provisions, as applicable, we would be in default under those agreements and our indebtedness could be declared due and payable. In addition, our lenders could terminate their commitments, require the posting of additional collateral and enforce their interests against existing collateral. We may also be subject to cross-default and acceleration rights under our financing arrangements, whereby a default (such as a failure to comply with a covenant) under one financing arrangement could trigger a default under other financing arrangements.

Our hedging strategies may not be successful in mitigating our risks associated with interest rates.

We engage in hedging activity from time to time. As such, we use various derivative financial instruments to provide a level of protection against interest rate risks, but no hedging strategy can protect us completely. When interest rates change, we expect to record a gain or loss on derivatives, which would be offset by an inverse change in the value of loans. Additionally, from time to time, we may enter into hedging transactions in connection with our holdings of mortgage-related assets with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps and floors, options to purchase these items and futures and forward contracts. Our actual hedging decisions will be determined in light of the facts and circumstances existing at

the time and may differ from our currently anticipated hedging strategy. We cannot assure you that our use of derivatives will offset the risks related to changes in interest rates. It is likely that there will be periods in the future during which we will incur losses after accounting for our derivative financial instruments. The derivative financial instruments we select may not have the effect of reducing our interest rate risk. In addition, the nature and timing of hedging transactions may influence the effectiveness of these strategies. Poorly designed strategies or improperly executed transactions could actually increase our risk and losses. In addition, hedging strategies involve transaction and other costs. We cannot assure you that our hedging strategy and the derivatives that we use will adequately offset the risk of interest rate volatility or that our hedging transactions will not result in losses.

The characteristics of hedging instruments present various concerns, including illiquidity, enforceability, and counterparty risks, which could adversely affect our business and results of operations.

From time to time, we enter into interest rate swap agreements to hedge risks associated with movements in interest rates. Entities entering into interest rate swap agreements are exposed to credit losses in the event of non-performance by counterparties to these transactions. Effective October 12, 2012, the Commodities Futures Trading Commission, or the CFTC, issued new rules regarding interest rate swaps under the authority granted to it pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, or the Dodd-Frank Act. Although these rules do not directly affect the negotiations and terms of individual swap transactions between counterparties, they do require that after September 9, 2013, the clearing of all swap transactions occur through registered derivatives clearing organizations,

or swap execution facilities, through standardized documents under which each swap counterparty transfers its position to another entity whereby the centralized clearinghouse effectively becomes the counterparty to each side of the swap. It is the intent of the Dodd-Frank Act that the clearing of interest rate swaps in this manner is designed to avoid concentration of swap risk in any single entity by spreading and centralizing the risk in the clearinghouse and its members. In addition to greater initial and periodic margin (collateral) requirements and additional transaction fees both by the swap execution facility and the clearinghouse, the swap transactions are now subjected to greater regulation by both the CFTC and the SEC. These additional fees, costs, margin requirements, documentation, and regulation could adversely affect our business and results of operations.

Risks Related to our Investments and Investment Activity

Competition may prevent us from acquiring mortgage-related assets at favorable yields, and that would negatively impact our profitability.

Our net income largely depends on our ability to acquire mortgage-related assets at favorable spreads over our borrowing costs. In acquiring mortgage-related assets, we compete with other REITs, investment banking firms, savings and loan associations, banks, insurance companies, mutual funds, other lenders and other entities that purchase mortgage-related assets, many of which have greater financial resources than us, and many of which are not subject to the operating constraints associated with REIT tax compliance or maintenance of an exemption from the Investment Company Act.

As a result, we may not in the future be able to acquire sufficient mortgage-related assets at favorable spreads over our borrowing costs. If that occurs, our profitability will be harmed.

A decrease or lack of liquidity in our investments may adversely affect our business, including our ability to value and sell our assets.

Turbulent market conditions could significantly and negatively impact the liquidity of our assets. In some cases, it may be difficult to obtain third-party pricing on certain of our investment securities. Illiquid investments typically experience greater price volatility, as a ready market does not exist, and can be more difficult to value. In addition, third-party pricing for illiquid investments may be more subjective than for more liquid investments. The illiquidity of certain investment securities may make it difficult for us to sell such investments if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded certain of our investments. As a result, our ability to vary our portfolio in response to changes in economic and other conditions may be relatively limited, which could adversely affect our results of operations and financial condition.

If we are unable to find suitable investments, we may not be able to achieve our investment objectives or pay dividends.

The availability of mortgage-related assets meeting our criteria depends upon, among other things, the level of activity and quality of and demand for these investments in the mortgage securitization and secondary markets. The market for these investments depends upon various factors including the level of activity in the residential real estate market, the level of and difference between short-term and long-term interest rates, incentives for issuers to securitize mortgage loans and demand for these investments by institutional investors. The size and level of activity in the residential real estate lending market depends upon various factors, including the level of interest rates, regional and national economic conditions and real estate values. To the extent we are unable to acquire a sufficient volume of mortgage-related assets meeting our criteria, our results of operations would be adversely affected. Furthermore, we cannot assure you that we will be able to acquire sufficient mortgage-related assets at spreads above our cost of funds.

An increase in interest rates may harm our book value, which could adversely affect the cash available for distribution to you and could cause the price of our securities to decline.

Increases in interest rates may harm the market value of our mortgage-related assets.

Our hybrid adjustable-rate mortgage-related assets (during the fixed-rate component of the mortgages underlying such assets) and our fixed-rate securities are generally more harmed by these increases. In accordance with generally accepted accounting principles utilized in the United States of America, or GAAP, we reduce our book value by the amount of any decrease in the market value of our mortgage-related assets. Losses on securities classified as available-for-sale, which are determined by management to be other-than-temporary in nature, are reclassified from “accumulated other comprehensive income,” or AOCI, to current operations.

An increase in interest rates may cause a decrease in the volume of newly issued, or investor demand for, MBS and other mortgage-related assets, which could adversely affect our ability to acquire MBS and other mortgage-related assets that satisfy our investment objectives and to generate income and pay dividends.

Rising interest rates generally reduce the demand for consumer credit, including mortgage loans, due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of MBS and other mortgage-related assets available to us, which could affect our ability to acquire MBS and other mortgage-related assets that satisfy our investment objectives. Rising interest rates may also cause MBS and other mortgage-related assets that were issued prior to an interest rate increase to provide yields that exceed prevailing market interest rates.

If rising interest rates cause us to be unable to acquire a sufficient volume of MBS or mortgage-related assets with a yield that exceeds the borrowing cost we will incur to purchase MBS or mortgage-related assets, our ability to satisfy our investment objectives and to generate income and pay dividends in the amount expected, or at all, may be materially and adversely affected.

A flat or inverted yield curve may negatively affect our operations, book value and profitability due to its potential impact on investment yields and the supply of adjustable-rate mortgage products.

A flat yield curve occurs when there is little difference between short-term and long-term interest rates. An inverted yield curve occurs when short-term interest rates are higher than long-term interest rates. A flat or inverted yield curve may be an adverse environment for ARM product volume, as there may be little incentive for borrowers to choose an ARM product over a longer-term fixed-rate loan. If the supply of ARM product decreases, yields may decline due to market forces.

Our borrowing costs under repurchase agreements generally correspond to short-term interest rates such as LIBOR. A flat or inverted yield curve will likely result in lower profits.

Additionally, a flat or inverted yield curve may negatively impact the pricing of our securities. According to GAAP, if the values of our securities decrease, we reduce our book value by the amount of any decrease in the market value of our mortgage-related assets.

If we cannot renew or replace maturing borrowings, we may have to sell our mortgage-related assets under adverse market conditions and may incur permanent capital losses as a result. Any number of these factors in combination may cause difficulties for us, including a possible liquidation of a major portion of our portfolio at disadvantageous prices with consequent losses, which may render us insolvent.

Interest rate mismatches between our adjustable-rate investments and our borrowings used to fund our purchases of these assets may reduce our income during periods of changing interest rates.

We fund most of our acquisitions of adjustable-rate investments (including hybrid adjustable-rate investments) with borrowings that have interest rates based on indices and repricing terms similar to, but of shorter maturities than, the interest rate indices and repricing terms of our investments. Accordingly, if short-term interest rates increase, this may harm our profitability.

The interest rates of adjustable-rate investments may vary over time based upon changes in a short-term interest rate index. Therefore, in most cases, the interest rate indices and repricing terms of these adjustable-rate investments that we acquire and their funding sources will not be identical, thereby creating an interest rate mismatch between our assets

and liabilities. While the historical spread between relevant short-term interest rate indices has been relatively stable, there have been periods when the spread between these indices was volatile. During periods of changing interest rates, these mismatches could reduce our net income, dividend yield and the market price of our stock.

The interest rates on our borrowings generally adjust more frequently than the interest rates on our adjustable-rate MBS. For example, at December 31, 2019, our Agency MBS had a weighted average term to next rate adjustment of approximately 24 months, while our borrowings had a weighted average term to next rate adjustment of 28 days. After adjusting for interest rate swap transactions, the weighted average term to next rate adjustment was 978 days. Accordingly, in a period of rising interest rates, we could experience a decrease in net income or a net loss because the interest rates on our borrowings adjust faster than the interest rates on our adjustable-rate MBS.

We may experience reduced net interest income from holding fixed-rate investments during periods of rising interest rates.

We generally fund our acquisition of fixed-rate MBS and residential mortgage loans with short-term borrowings. During periods of rising interest rates, our costs associated with borrowings used to fund acquisition of fixed-rate assets are subject to increases while the income we earn from these assets remains substantially fixed. This reduces or could eliminate the net interest spread between the fixed-rate assets that we purchase and our borrowings used to purchase them, which could lower our net interest income or cause us to suffer a loss. At December 31, 2019, 1.2% of our MBS were 15-year fixed-rate Agency MBS, 4.7% of our MBS were 20-year fixed-rate Agency MBS, 59.6% of our MBS were 30-year fixed-rate Agency MBS, and approximately 14.0% of our MBS were fixed-rate Non-Agency MBS.

Interest rate caps on our adjustable-rate MBS may reduce our income or cause us to suffer a loss during periods of rising interest rates.

Our adjustable-rate MBS (including hybrid adjustable-rate MBS) are subject to periodic and lifetime interest rate caps. Periodic interest rate caps limit the amount an interest rate can increase during any given period. Lifetime interest rate caps limit the amount an interest rate can increase through maturity of a mortgage-backed security. Our borrowings are not subject to similar restrictions. Accordingly, in a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while interest rate caps would limit the interest rates on our adjustable-rate MBS. This problem is magnified for our adjustable-rate MBS that are not fully indexed. Further, some adjustable-rate MBS may be subject to periodic payment caps that result in a portion of the interest being deferred and added to the principal outstanding. As a result, we could receive less cash income on adjustable-rate MBS than we need to pay interest on our related borrowings. These factors could lower our net interest income or cause us to suffer a loss during periods of rising interest rates. At December 31, 2019, approximately 20.5% of our MBS were adjustable-rate securities.

New assets we acquire may not generate yields as attractive or be as accretive to book value as have been experienced historically.

We may acquire new assets as we receive principal and interest payments and prepayments from our existing assets. We also sell assets from time to time as part of our portfolio and asset/liability management programs. We may invest these proceeds into new earning assets.

New assets may not generate yields as attractive as we have experienced historically. Business conditions, including credit results, prepayment patterns and interest rate trends in the future, may not be as favorable as they have been during the periods we held the replaced assets.

New assets may not be as accretive to book value as existing assets. The market value of our assets is sensitive to interest rate fluctuations. In the past as short-term interest rates increased, the market value of our existing assets has declined. As we classify most of our Agency MBS and Non-Agency MBS as available-for-sale, accounting rules require that any unrealized losses from the decline in market value that are not considered to be an other-than-temporary impairment be carried as “accumulated other comprehensive loss” in the “Stockholders’ equity” section of the consolidated balance sheets.

[Table of Contents](#)

When short-term interest rates stop increasing, or start declining, or when the interest rates on these securities reset, the market value of these assets may increase. This may be more accretive to book value than the new assets that we acquire to replace existing assets.

Increased levels of prepayments from Agency MBS may decrease our net interest income.

Pools of mortgage loans underlie the MBS that we acquire. We generally receive payments from principal payments that are made on these underlying mortgage loans. When borrowers prepay their mortgage loans faster than expected, this results in prepayments that are faster than expected on the MBS.

Faster than expected prepayments could harm our profitability as follows:

- We primarily purchase Agency MBS that have a higher interest rate than the market interest rate at the time. In exchange for this higher interest rate, we pay a premium over the par value to acquire the security. In accordance with accounting rules, we amortize this premium over the term of the mortgage-backed security. If the mortgage-backed security is prepaid in whole or in part prior to its maturity date, however, we expense the premium that was prepaid at the time of the prepayment. At December 31, 2019, substantially all of our Agency MBS had been acquired at a premium.
- We anticipate that a substantial portion of our adjustable-rate Agency MBS may bear interest rates that are lower than their fully indexed rates, which are equivalent to the applicable index rate plus a margin. If an adjustable-rate mortgage-backed security is prepaid prior to or soon after the time of adjustment to a fully indexed rate, we will have held that mortgage-backed security while it was less profitable and lost the opportunity to receive interest at the fully indexed rate over the remainder of its expected life.
- If we are unable to acquire new Agency MBS similar to the prepaid MBS, our financial condition, results of operation and cash flow would suffer.

Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. Prepayment rates also may be affected by conditions in the housing and financial markets, general economic conditions, actions by the federal government and the relative interest rates on fixed-rate and adjustable-rate mortgage loans.

While we seek to minimize prepayment risk to the extent practical, in selecting investments, we must balance prepayment risk against other risks and the potential returns of each investment. No strategy can completely insulate us from prepayment risk.

The timing and amount of prepayments could adversely affect our liquidity and our profitability.

Prepayments may be difficult to predict and can vary significantly over time. As a holder of MBS, on a monthly basis, we receive a payment equal to a portion of our investment principal as the underlying mortgages are prepaid. With respect to our Agency MBS, we typically receive notice of monthly principal prepayments on the fifth business day of each month (more commonly referred to as “factor day”) and receive the related scheduled payment on a specified later date, which for (a) Agency MBS guaranteed by Fannie Mae is the 25th day of that month (or the next business day thereafter); and (b) Agency MBS guaranteed by Freddie Mac is the 15th day of the following month (or the next business day thereafter). This delay between factor day and receipt of payment creates a short-term receivable for us in the amount of any such principal prepayments. In general, on the date each month that the principal prepayments are announced (factor day), the value of our MBS pledged as collateral is reduced by the amount of the prepaid principal and, as a result, our repurchase agreement counterparties will typically initiate a margin call requiring the pledge of additional collateral or cash, in an amount equal to such prepaid principal, in order to re-establish the required ratio of borrowing to collateral value under such

repurchase agreements. As the posting of such additional collateral or payment of cash to our counterparties is on or about factor day and is prior to the receipt of the payment to us by the agencies, this would reduce and, depending on the magnitude of such principal prepayments, could be material to, our liquidity. As a

[Table of Contents](#)

result, in order to meet such margin calls, we could be forced to sell assets or take other actions in order to maintain liquidity.

If we were required to sell Agency MBS under adverse market conditions, we may receive sale prices lower than we might have received if we sold those securities under normal market conditions and, if these prices were lower than the amortized cost of the Agency MBS, we would incur losses. An increase in prepayment rates could have a material adverse effect on our business, financial condition and results of operations.

A decline in the fair market value of our Non-Agency MBS could result in us recording impairments on these investments, which may have an adverse effect on our results of operations and financial condition.

A majority of our Non-Agency MBS are accounted for under ASC 310-30, Loans and Debt Securities Acquired with Credit Deterioration (ASC 310-30). A debt security accounted for under ASC 310-30 is initially recorded at its purchase price (fair value). The amount of expected cash flows that exceed the initial investment represents accretable yield, which is recognized as interest income on a level yield basis over the life of the security. The excess of total contractual cash flows over the cash flows expected at its origination is considered to be non-accretable yield.

The Company must periodically reassess the expected cash flows of loans accounted for under ASC 310-30 along with the cash flows received. A significant increase in expected cash flows must be accounted for as an increase in the rate of accretion over the remaining life of the security. Conversely, if expected cash flows decrease, an other-than-temporary impairment must be recognized as a charge to earnings. Adjustments to the fair value of Non-Agency MBS, accounted for as available-for-sale securities, are recorded in AOCI. The determination as to whether impairment and accretable yield exists is based on cash flow projections related to the securities. As a result, the timing and amount of impairment and accretable yield constitutes a material estimate that is susceptible to significant change.

Our investments in Non-Agency MBS and residential mortgage loans involve credit risk, which could materially adversely affect our results of operations.

In general, Non-Agency MBS and residential mortgage loans carry greater investment risk than Agency MBS because they are not guaranteed as to principal and/or interest by the U.S. Government, any federal agency or any federally chartered corporation. Unexpectedly high rates of default (i.e., in excess of the default rates forecasted) and/or higher than expected loss severities on the mortgages collateralizing our Non-Agency MBS and residential mortgage loans may adversely affect the values of such assets. Accordingly, Non-Agency MBS and other investment assets of less-than-high credit quality could cause us to incur losses of income from, and/or losses in market value relating to, these assets if there are defaults of principal and/or interest on these assets.

We may have significant credit risk, especially on Non-Agency MBS and residential mortgage loans in certain geographic areas and may be disproportionately affected by economic or housing downturns, natural disasters, terrorist events, adverse climate changes or other adverse events specific to those markets.

A significant number of the mortgages collateralizing our mortgage assets may be concentrated in certain geographic areas. Any event that adversely affects the economy or real estate market in these areas could have a disproportionately adverse effect on our mortgage assets. In general, any material decline in the economy or significant difficulties in the real estate markets would be likely to cause a decline in the value of residential properties securing the mortgages in the relevant geographic area. This, in turn, would increase the risk of delinquency, default and foreclosure on real estate collateralizing our mortgage assets in this area. This may then materially adversely affect our credit loss experience on our mortgage assets in such area if unexpectedly high rates of default (i.e., in excess of the default rates forecasted) and/or higher than expected loss severities on the mortgages collateralizing such securities were to occur.

The occurrence of a natural disaster (such as an earthquake, tornado, hurricane, wildfires, or a flood), economic or housing downturns, terrorist events, significant adverse climate change, or any other adverse event may cause a sudden decrease in the value of real estate and would likely reduce the value of the properties securing the mortgages collateralizing or mortgage assets. Since certain natural disasters may not typically be covered by the standard hazard insurance policies maintained by borrowers, the borrowers may not be able to repair the properties or may stop paying

[Table of Contents](#)

their mortgages if the property is damaged. This would likely cause defaults and credit loss severities to increase on the pool of mortgages securing our mortgage assets which may materially adversely affect our results of operations and financial condition.

We invest in Non-Agency MBS that are collateralized by loans of lower credit quality, such as Alt-A loans or securitized non-performing loans, which, due to lower underwriting standards, are subject to increased risk of losses.

We invest in Non-Agency MBS backed by collateral pools containing mortgage loans that have been originated using underwriting standards that are less strict than those used in underwriting “prime mortgage loans” (mortgage loans that generally conform to the underwriting standards of Fannie Mae or Freddie Mac). These loans may experience delinquency, foreclosure, bankruptcy and loss rates that are higher than “prime mortgage loans,” which could cause the performance of Non-Agency MBS backed by such lower credit quality loans to be adversely affected, which could materially adversely impact our results of operations and financial condition.

We may generate taxable income that differs from our GAAP income on our mortgage-related investments, which may result in significant timing differences in the recognition of income and losses.

Generally, the cumulative net income we report over the life of an asset will be the same for GAAP and tax purposes, although the timing of this income recognition over the life of the asset could be materially different. Differences exist in the accounting for GAAP net income and REIT taxable net income, which could lead to significant variances in the amount and timing of when income and losses are recognized under these two measures.

As a REIT must distribute at least 90% of its annual taxable income (subject to certain adjustments) to our stockholders, such timing differences could affect the amount of the dividend distribution. However, dividends are declared and paid at the discretion of our Board and depend not only on REIT taxable net income, but also on our financial results, our overall financial condition, maintenance of our REIT qualification and such other factors as our board may deem relevant from time to time.

Generally, Non-Agency MBS have greater price sensitivity than Agency MBS, which could cause fluctuations in our book value. Such price fluctuations could cause repurchase agreement lenders to require greater amounts of collateral and higher margin requirements, which could affect our results of operations and could cause us to sell our Non-Agency MBS at potentially distressed prices in periods of significant price fluctuation. It could also cause repurchase agreement lenders to withdraw their financing from such investments.

Non-Agency MBS historically have been more price sensitive than Agency MBS which may limit the number of lenders willing to provide repurchase agreement financing for these securities. In periods of price volatility, we may be subject to higher margin requirements or may be required to pledge additional collateral which could affect our results of operations. Also, during periods of significant price fluctuation, lenders may cut back the amounts they are willing to finance on such investments or withdraw from lending on such securities. If we could not find replacement financing, this could cause us to sell our Non-Agency MBS at potentially distressed prices, which would adversely affect our results of operations and financial condition.

Our subordinated mortgage assets may be in the “first loss” position, subjecting us to greater risks of loss.

We invest in certain tranches of mortgage assets that are only entitled to a portion of the principal and interest payments made on mortgage loans underlying the securities issued by the securitization trust. In general, losses on a mortgage loan included in an MBS securitization trust will be borne first by the equity holder of the issuing trust, if any, and then by the “first loss” subordinated security holder and then by the “second loss” subordinate holder and so on.

We may acquire securities at every level of such a securitization trust, from the equity position to the most senior tranche. In the event of default and the exhaustion of any classes of securities junior to those which we acquire, our securities will suffer losses as well. In addition, if we overvalue the underlying mortgage portfolio, or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related MBS, the securities which we acquire may effectively become the “first loss” position ahead of the more senior

securities, which may result in significant losses. The prices of lower credit quality securities are generally less sensitive to interest rate changes than more highly-rated securities, but more sensitive to adverse economic downturns or individual issuer developments. A projection of an economic downturn could cause a decline in the value of lower credit quality securities because the ability of obligors or mortgages underlying MBS to make principal and interest payments may be impaired. In such event, existing credit support in the securitization structure may be insufficient to protect us against loss of our principal on these securities.

If our Manager underestimates the collateral loss on our investments, we may experience losses.

Our Manager values our potential investments based on loss-adjusted yields, taking into account estimated future losses on the mortgage loans that collateralize the investments, and the estimated impact of these losses on expected future cash flows. Our Manager’s loss estimates may not prove accurate, as actual results may vary from estimates. In the event that our Manager underestimates the pool level losses relative to the price we pay for a particular investment, we may experience losses with respect to such investment.

The servicing of the mortgage loans that are the underlying collateral of our mortgage-related assets is outside of our control, and if this servicing is not successful in limiting future delinquencies, defaults and losses, it could adversely affect our results of operations.

Third party servicers provide for the servicing of the mortgage loans that are the underlying collateral of our mortgage-related assets. These service providers control all aspects of loan collection, loss mitigation, default management and ultimate resolution of a defaulted loan. The efforts of these service providers may not be successful in limiting future delinquencies, defaults, and losses, which could adversely affect our results of operations.

We invest in securities in the developing Credit risk transfer sector that are subject to mortgage credit risk.

We invest in securities in the developing Credit risk transfer sector (“CRT Sector”).

The CRT Sector is comprised of the risk sharing transactions issued by Fannie Mae (“CAS”) and Freddie Mac (“STACR”) and similarly structured transactions arranged by third party market principals. The securities issued in the CRT Sector are designed to synthetically transfer mortgage credit risk from Fannie Mae and Freddie Mac to private investors. Currently, CAS and STACR transactions are structured and unsecured and unguaranteed bonds issued by Fannie Mae and Freddie Mac, respectively, whose principal payments are determined by the delinquency and prepayment experience of a reference pool of mortgages originated and guaranteed by Fannie Mae or Freddie Mac, respectively, in a particular quarter. Transactions arranged by third party market participants in the CRT Sector are similarly structured to reference a specific pool of loans that have been securitized by Fannie Mae or Freddie Mac and synthetically transfer mortgage credit risk related to those loans to the purchaser of the securities. The holder of the securities in the CRT

Sector has the risk that the borrowers may default on their obligations to make full and timely payments of principal and interest. Investments in securities in the CRT Sector could cause us to incur losses of income from, and/or losses in market value relating to, those assets if there are defaults of principal and/or interest on the pool of mortgages referenced in the transaction.

We may invest in leveraged mortgage derivative securities that generally experience greater volatility in market prices, thus exposing us to greater risk with respect to their rate of return.

We may acquire leveraged mortgage derivative securities that may expose us to a high level of interest rate risk. The characteristics of leveraged mortgage derivative securities result in greater volatility in their market prices. Thus, acquisition of leveraged mortgage derivative securities would expose us to the risk of greater price volatility in our portfolio and that could harm our net income and overall profitability.

We are dependent upon information systems and communication systems and their failure could significantly disrupt

our business.

Our business is highly dependent upon our information and communication systems. Although we have implemented various structural and security policy enhancements to our information systems in recent years, such as a cybersecurity policy manual, employee training, and enhanced firewall and antivirus/malware protection, problems with our computer systems could still occur. Any failure or interruption of our systems, or cyber-attacks, or security breaches of our networks or systems, or of those systems of our service providers, could cause delays or other problems in our securities and loan trading activities, which could have a material adverse effect on our operating results, the market price of our common stock and other securities, and our ability to pay dividends to our stockholders. In addition, we also face the risk of operational failure, termination or capacity constraints of any of the third parties with which we do business or that facilitate our business activities, including clearing agents or other financial intermediaries we use to facilitate our securities and loan transactions.

Computer malware, viruses, and computer hacking, phishing, and cyber-attacks have become more prevalent in our industry and may occur on our systems in the future. We rely heavily on financial, accounting, and other data processing systems, including those systems of our service providers. It is difficult to determine what, if any, negative impact may directly result from any specific interruption or cyber-attacks or security breaches of our networks or systems (or the networks or systems of, among other third parties, our lenders), or any failure to maintain performance, reliability, and security of our technical infrastructure. As a result, such computer malware, viruses, and computer hacking, phishing and cyber-attacks may negatively affect our operations.

We have a limited operating history in the business of acquiring and securitizing mortgage loans and we may not be successful.

The acquisition of mortgage loans and the securitization process are inherently complex and involve risks related to the type of mortgage loans we seek to acquire, including interest rate risk, credit risk, finding and maintaining funding sources, prepayment risk, borrower bankruptcies, foreclosures and other factors that we may not be able to properly manage. Less than optimal management of these risks may take years to become apparent. If we fail to properly manage these and other risks, this could harm our business and results of operations.

Representations and warranties made by us in loan sales and securitizations may subject us to liability that could result in loan losses, which could harm our operating results.

In connection with any securitizations we sponsor, we will make representations and warranties regarding the mortgage loans transferred to securitization trusts. The trustee in the securitization trust has recourse to us with respect to the breach of the standard representations and warranties regarding the loans made at the time such mortgage loans are transferred to the trust. While we would have recourse to the loan originators for any such breaches, there can be no assurance of the originators’ abilities to honor their respective obligations. Although we may attempt to limit the potential remedies of the trustee to mirror the potential remedies we receive from the originators from who we acquire loans, the remedies to the trustee are often broader than those we have from the originators. Furthermore, if we discover, prior to the securitization, that there is a breach of the representations and warranties we receive from the originators and they fail to repurchase or otherwise fail to cure any deficiency, we will not be able to securitize the loan and will have to hold the loan in our portfolio or sell it to another party, probably at a discount.

We acquire, or will acquire, most of the loans from a limited number of originators and if we fail to properly manage these relationships, or if these originators experience origination problems, our ability to acquire loans from them could be harmed, which would negatively affect our operations.

We acquire, or will acquire, most of the loans from a limited number of originators. Our ability to manage these relationships is a key aspect of our loan activities. If we do not manage these relationships properly, or if the originators experience origination problems, it would negatively affect the volume of loans we would acquire and could delay our ability to do securitizations, which would negatively affect our operations and financial results.

Our real estate-related assets (including mortgage loans and MBS) are subject to the risks associated with real

property.

We own assets secured by real estate, which are subject to various risks, including:

- Declines in the value of real estate;
- Acts of God, including earthquakes, flooding, and other natural disasters, which may result in uninsured losses;
- Acts of war or terrorism, including the consequences of terrorist attacks;
- Adverse changes in national, local economic, and general market conditions;
- Changes in governmental laws and regulations, fiscal policies and zoning ordinances and the related costs of compliance;
- Costs of remediation and liabilities associated with environmental conditions, such as indoor mold;
- Potential liabilities for other legal actions related to property ownership, including tort claims; and
- The potential for uninsured or under-insured property losses.

The occurrence of any of the foregoing, or similar events, may reduce our return from an affected property or asset and, consequently, could materially and adversely affect our business, financial condition and results of operations.

We expect to engage in securitization transactions relating to real estate mortgage loans that we will sponsor. In addition, we have invested in, and continue to invest in, mortgage-backed securities issued in securitization transactions sponsored by other companies. These types of transactions and investments expose us to potential material risks.

Engaging in securitization transactions generally requires us to incur short-term debt on a recourse basis to finance the accumulation of loans or other assets prior to securitization. If demand for investing in securitization transactions weakens, we may be unable to complete the securitization of loans accumulated for that purpose, which may hurt our business or financial results. In addition, in connection with engaging in securitization transactions, we engage in due diligence with respect to the loans we are securitizing and make representations and warranties relating to those loans. When engaging in securitization transactions, we also expect to prepare marketing and disclosure documentation, including term sheets and prospectuses that include disclosures regarding the securitization transaction and the assets being securitized. If our marketing and disclosure documentation are alleged or found to contain inaccuracies or omissions, we may be liable under federal and state securities laws (or other laws) for damages to third parties that invest in these securitization transactions, including in circumstances where we relied upon a third party in preparing accurate disclosures, or we may incur other expenses and costs in connection with disputing these allegations or settling claims.

We could be liable under federal and state securities laws (or other laws) for damages to third parties that invest in these securitization transactions, including liability for disclosures prepared by third parties or with respect to loans that we did not sell or contribute to the securitization. Additionally, we typically retain various third-party service providers when we engage in securitization transactions, including underwriters or initial purchasers, trustees, administrative and paying agents, and custodians, among others. We frequently contractually agree to indemnify these service providers against various claims and losses they may suffer in connection with the provision of services to us and/or the securitization trust. To the extent any of the service providers are liable for damages to third parties that have invested in these securitization transactions, we may incur costs and expenses as a result of these indemnities.

In recent years, there has also been debate as to whether there are defects in the legal process and legal documents governing transactions in which securitization trusts take legal ownership and establish their rights as first priority lien holders on underlying mortgaged property. To the extent there are problems with the manner in which title and lien priority rights were established or transferred, securitization transactions that we sponsor, and third-party sponsored securitizations in which we hold investments, may experience losses, which could materially affect our operating results

[Table of Contents](#)

and could damage our ability to engage in future securitization transactions.

With respect to mortgage loans we own, or which we have purchased and will subsequently securitize, we may be subject to liabilities for potential violations of CFPB’s TILA-RESPA Integrated Disclosure rule (also referred to as “TRID”) or other similar consumer protection laws and regulations, which could adversely impact our business and operating results.

Federal consumer protections laws and regulations have been enacted and promulgated that are designed to regulate residential mortgage loan underwriting and originators’ lending processes, standards and disclosures to borrowers. These laws and regulations include, among others, the CFPB’s “TRID, “ability-to-repay,” and “qualified mortgage” regulations. In addition, there are various other federal, state and local laws and regulations that are intended to discourage predatory lending practices by residential mortgage loan originators. Failure of residential mortgage loan originators or servicers to comply with these laws and regulations could subject us, as a purchaser of these loans, to monetary penalties and defenses to foreclosures, including by recoupment or setoff of finance charges and fees collected, and could result in rescission of affected residential mortgage loans, which could adversely impact our business and financial results.

Risks Related to Our Management

We have no employees and our Manager is responsible for making all of our investment decisions. The employees of our Manager are not required to devote any specific amount of time to our business.

Effective December 31, 2011, in accordance with the Management Agreement, we have no employees and all our prior employees became employees of our Manager. Our Manager is responsible for conducting our day-to-day operations and is responsible for the selection, purchase and sale of our investment portfolio; our financing and hedging activities; providing us with portfolio management and administrative services; and such other services and activities relating to our assets and operations as may be appropriate.

Mr. Joseph E. McAdams (our Chairman, Chief Executive Officer, and President) and others are officers and employees of our Manager and are also officers and employees of Pacific Income Advisers, Inc., or PIA, where they devote a portion of their time. These officers and employees are under no contractual obligations mandating minimum amounts of time to be devoted to our Company. In addition, a trust controlled in part by Mr. Lloyd McAdams (one of our directors and our former Chairman and Chief Executive Officer) is the principal stockholder of PIA.

These officers and employees are involved in investing approximately \$7.1 billion (including our assets) in MBS and other fixed income assets for institutional clients and individual investors through PIA at December 31, 2019. These multiple responsibilities and ownerships may create conflicts of interest if these officers and employees of our Company are presented with opportunities that may benefit both us and the clients of PIA. These officers allocate investments among our portfolio and the clients of PIA by determining the entity or account for which the investment is most suitable. In making this determination, these officers consider the investment strategy and guidelines of each entity or account with respect to acquisition of assets, leverage, liquidity and other factors that our officers determine appropriate. These officers, however, have no obligation to make any specific investment opportunities available to us and the above-mentioned conflicts of interest may result in decisions or allocations of securities that are not in our best interests.

Additionally, there is nothing in the Management Agreement that prevents our Manager or any of its Affiliates, officers, directors or employees from engaging in other businesses or from rendering services of any kind to any other Person or entity, whether or not the investment objectives or policies of any such other Person or entity are similar to those of the Company or in any way binds or restricts our Manager or any of its Affiliates, officers, directors or employees from buying, selling or trading any securities or commodities for their own accounts or for the accounts of others for whom our Manager or any of its Affiliates, officers, directors or employees may be acting.

The service to PIA by the officers and employees of our Manager allow them to spend only part of their time and effort managing our Company, as they are required to devote a portion of their time and effort to the management of other companies, and this may harm our overall management and operating results.

Messrs. Joseph E. McAdams, Charles J. Siegel, John T. Hillman, and others are officers and employees of PIA Farmland, Inc., where they devote a portion of their time. PIA Farmland, Inc., a privately-held real estate investment trust investing in U.S. farmland properties leased to independent farm operators, was incorporated in February 2013. These officers and employees are under no contractual obligations to PIA Farmland, Inc., its external manager, PIA, or to Anworth or its external manager, Anworth Management, LLC, as to their time commitment. To the extent that significant time is devoted to these other companies, this could harm our overall management and operating results.

We are completely dependent upon our Manager, who provides services to us through the Management Agreement, and we may not find suitable replacements for our Manager if the Management Agreement is terminated or such key personnel are no longer available to us. The loss of any key personnel of our Manager could harm our operations.

We no longer have any employees and are completely dependent on our Manager to conduct our operations pursuant to the Management Agreement. Our Manager has its own employees, which conduct its day-to-day operations. The Management Agreement does not require our Manager to dedicate specific personnel to our operations.

If we terminate the Management Agreement without cause, we may not, without the consent of our Manager, employ any employee of our Manager or any of its Affiliates, or any Person who has been employed by our Manager or any of its Affiliates at any time within the two year period immediately preceding the date on which the Person commences employment with us for two years after such termination of the Management Agreement. We will not have retention agreements with any of our officers. We believe that the successful implementation of our investment and financing strategies will depend upon the experience of certain of our Manager’s officers and employees. None of these individuals’ continued service is guaranteed. If the Management Agreement is terminated or these individuals leave our Manager, our Manager may be unable to replace them with persons with appropriate experience, or at all, and we may not be able to execute our business plan.

We depend upon the diligence, experience and skill of the officers and employees of our Manager for the selection, structuring and monitoring of our mortgage-related assets and associated borrowings. The key officers of our Manager include Mr. Joseph E. McAdams, its Chief Investment Officer, and our Chairman, President, and Chief Executive Officer; Mr. Charles J. Siegel, our Chief Financial Officer, Treasurer and Secretary; Mr. Brett Roth, its Senior Vice President; and Ms. Bistra Pashamova, its Senior Vice President. Our dependence on our Manager is heightened by the fact that they have a relatively small number of employees and the loss of any key person could harm our entire business, financial condition, cash flow and results of operations. In particular, the loss of the services of Mr. Joseph E. McAdams could seriously harm our business.

The Management Agreement was not negotiated on an arm’s-length basis and the terms, including fees payable, may not be as favorable to us as if it were negotiated with an unaffiliated third party.

Effective as of December 31, 2011, we entered into the Management Agreement, which effected the externalization of our management function. The Management Agreement was negotiated between related parties, and we did not have the benefit of arm’s-length negotiations of the type normally conducted with an unaffiliated third party. The terms of the Management Agreement, including fees payable, may not reflect the terms we may have received if it was negotiated with an unrelated third party. In addition, as a result of this relationship, we may choose not to enforce, or to enforce less vigorously, our rights under the Management Agreement because of our desire to maintain our ongoing relationship with our Manager.

If we elect to not renew the Management Agreement without cause, we would be required to pay our Manager a substantial termination fee.

It will be costly for us if we elect not to renew the Management Agreement without cause.

With the consent of the majority of our independent directors, and with at least 180-days’ prior written notice before the end of the calendar year, we may elect to not renew the Management Agreement at the end of the calendar year. If we elect not to renew the Management Agreement without cause, we will be required to pay our Manager a termination fee equal to three times the average annual management fee earned by our Manager during the

[Table of Contents](#)

24-month period immediately preceding the most recently completed quarter prior to the year-end termination of the Management Agreement.

After giving notice of our intent to not renew the Management Agreement without cause, we will continue to be required to pay our Manager the management fees stated in the Management Agreement until the end of the calendar year that the Management Agreement is not renewed. If such notice is given less than 180 days prior to the end of the calendar year, the management fees will be paid until termination of the Management Agreement at the end of the following calendar year.

At December 31, 2019, if this termination event had occurred, the termination fee, based on the average annual management fee earned by our Manager during the 24-month period immediately preceding the most recently completed quarter prior to the effective date of termination, would be approximately \$20.7 million.

If we do not renew the Management Agreement for any reason, we would continue to be obligated to pay the sublease on our office premises in California.

Our obligation to pay the sublease on our office premises does not end with termination of the Management Agreement. There can be no assurance that we can sublease our office space to another tenant at a rate which eliminates this obligation and is satisfactory to the sublessor and the building owner.

Various corporate actions require the approval of the majority of all shareholders.

There are corporate actions which can be implemented only if a majority of all shareholders approves at a convened meeting of shareholders. There can be no assurance that a majority of all shareholders will vote to approve any measure that only a majority of the voting shareholders had previously approved. Examples of actions which require the approval of a majority of all shareholders to pass are: an agreement of consolidation, merger, share exchange or transfer of assets; for dissolution of the Corporation; or for a business combination between the Corporation and an interested stockholder.

In the event of a change of control, we will owe certain of the officers and employees of our Manager a payment as specified in their Change of Control and Arbitration Agreements between these officers/employees and the Company.

In the event of a change of control of the Company, we would incur the costs of paying lump sum payments and other employee benefits to certain of the officers and employees of our Manager as specified in their Change of Control and Arbitration Agreement between these officers/employees and the Company.

The management fee is payable regardless of our performance.

Our Manager is entitled to receive a management fee from us that is based on 1.20% of our Equity (as defined in our Management Agreement), regardless of the performance of our investment portfolio. For example, we would pay our Manager a management fee for a specific period even if we experienced a net loss during the same period. Our Manager’s entitlement to substantial nonperformance-based compensation may reduce its incentive to devote sufficient time and effort to seeking investments that provide attractive risk-adjusted returns for our investment portfolio. This in turn could harm our ability to make distributions to our stockholders and the market price of our common stock.

The fee structure of the Management Agreement may limit our Manager’s ability to retain access to its key personnel.

Under the terms of the Management Agreement, we are required to pay our Manager a base management fee payable monthly in arrears in an amount equal to one twelfth of 1.20% of our Equity. Our Equity is defined as our month-end stockholders’ equity, adjusted to exclude the effect of any unrealized gains or losses included in either retained earnings or other comprehensive income, each as computed in accordance with GAAP. The Management Agreement does not provide our Manager with an incentive management fee that would pay our Manager additional compensation as a result of meeting performance targets. Some of our externally-managed competitors pay their managers an incentive management fee, which enables them to provide additional compensation to their key personnel.

[Table of Contents](#)

Thus, the lack of an incentive fee in the Management Agreement may limit the ability of our Manager to provide key personnel with additional compensation for strong performance, which could adversely affect our Manager’s ability to retain these key personnel. If our Manager were not able to retain any of the key personnel providing services to our Manager, it would have to find replacement personnel to provide those services. Those replacement key personnel may not be able to produce the same operating results as the current key personnel.

Some investors may not view our external management in a positive light, which may affect the market price of our common stock, and may make it more difficult for future offerings of our stock.

Although there are currently other mortgage REITs that are externally-managed, there may be times in the future when some investors may have a preference for internally-managed companies. There may also be times, if there are low returns from our portfolio, when our external management is not viewed in a positive light. In either of these cases, there may be a negative effect on the market price of our common stock, and this may make it difficult for future offerings of our common stock.

Potential conflicts of interest could arise if our Manager were to take greater risk for the purpose of increasing our equity in order to earn a greater management fee.

The Management Agreement does not contain an incentive fee. Our Manager is paid a base management fee payable monthly in arrears in an amount equal to one twelfth of 1.20% of our Equity, as defined in the Management Agreement. As the Management Agreement does not contain an incentive fee, our Manager may take greater risk in our investment portfolio to increase our equity in order to earn a greater management fee.

Our Manager’s liability is limited under the Management Agreement and we have agreed to indemnify our Manager against certain liabilities.

Pursuant to the Management Agreement, our Manager does not assume any responsibility other than to render the services called for thereunder and is not responsible for any action of our Board in following or declining to follow any advice or recommendation of our Manager. Our Manager and its Affiliates, and the directors, officers, employees and stockholders of our Manager and its Affiliates, are not liable to us, any subsidiary of ours, our Board or our stockholders for any acts or omissions by our Manager, its officers, employees or its Affiliates, performed in accordance with and pursuant to the Management Agreement, except by reason of acts constituting bad faith, willful misconduct, gross negligence or reckless disregard of their respective duties under this Management Agreement. We have agreed to indemnify our Manager and its Affiliates, its directors, officers, employees and stockholders of our Manager and its Affiliates (each a “Manager Indemnified Party”) of and from any and all expenses, losses, damages, liabilities, demands, charges and claims of any nature whatsoever (including reasonable attorneys’ fees) in respect of or arising from any acts or omissions of such Manager Indemnified Party, not constituting bad faith, willful misconduct, gross negligence or reckless disregard of duties of such Manager Indemnified Party under this Management Agreement.

Our Manager has limited resources and may not be able to defend itself in litigation.

The only fee that our Manager receives from us is the base management fee, as previously described. It is anticipated that most, if not all, of this fee will be used by our Manager for compensation to its employees and to pay for its other administrative expenses. Our Manager has limited resources. If our Manager were to be involved in litigation not related to our operations, it may not be able to defend itself and it may be forced to declare bankruptcy or go out of business and we would have to find another Manager. This could have a material adverse impact on our business and our operations.

Failure of our Manager to comply with SEC rules and regulations could cause various disciplinary actions, which could cause a disruption in services provided to us, and may impact our business operations and our profitability.

Under rules promulgated under the Dodd-Frank Act, our Manager is considered an investment adviser. In reliance upon the no-action letter issued by the SEC to the American Bar Association on January 18, 2012, we consider Anworth Management, LLC to be a “relying adviser,” which means that its registration as an investment adviser is integrated into

the existing registration of PIA, its “filing adviser.” Anworth Management, LLC and PIA are both subject to the Investment Advisers Act of 1940 and the rules and regulations of the SEC and also are subject to examination by the SEC. Any failure by Anworth Management, LLC, PIA, or any of their respective employees to comply with such rules and regulations could cause various disciplinary actions, up to and including loss of registration status as investment advisers. Such disciplinary actions could lead to disruptions in the services provided to us which may impact our business operations and our profitability.

Our Board may change our operating policies and strategies without prior notice or stockholder approval and such changes could harm our business, results of operations and stock price.

Our Board can modify or waive our current operating policies and our strategies without prior notice and without stockholder approval. We cannot predict the effect any changes to our current operating policies and strategies may have on our business, operating results and stock price, however, the effects may be adverse.

Risks Related to Our Residential Properties Business

We are in an industry that has significant competition, which makes this business difficult to evaluate, and may affect our ability to operate this business in a profitable manner.

Historically, the single-family residential rental business consisted primarily of private individual investors in local markets and was managed individually or by small local property managers. Within the past several years, several institutional companies and REITs have entered this market and have attempted to acquire and operate single-family properties on a large-scale basis and to achieve attractive yields employing technology through a disciplined approach to acquisitions and leasing, marketing and management. Many of our competitors may be larger and have greater financial, technical, leasing, marketing and other resources than we do, which may affect our ability to acquire our target properties at attractive prices and attract quality tenants.

In addition, although we have several employees who have previously personally engaged in this business on a small scale, we contract with various third-party professionals to assist us in acquiring and managing our properties and providing services to tenants. If these professionals do a poor job or don’t perform to our expectations, it could affect the prices we pay to acquire properties, our relationships with our tenants, the operation of our properties, and our reputation in this business. These factors make this business difficult to evaluate, and may affect our ability to operate this business in a profitable manner.

Many factors affect the single-family residential rental market, and the profitability of this business will be affected both by our assumptions about this market and this market’s conditions in our target areas.

The success of our business model will depend upon many factors including, but not limited to: the availability of properties that meet our investment criteria and our ability to acquire such properties at favorable prices; real estate appreciation or depreciation in our target markets; the condition of our properties; our ability to contain renovation, maintenance, marketing and other operating costs for our properties; our ability to maintain high occupancy rates and target rent levels; general economic conditions in our target markets, such as changes in employment and household earnings and expenses; the effects of rent controls, stabilization laws and other laws or regulations regarding rental rates and tenant rights; and changes in, and changes in enforcement of, laws, regulations and government policies including health, safety, environmental, property, zoning and tax laws.

We will have no control over many of these factors, which could adversely affect the profitability of this business. Our success will also depend, in part, on our assumptions about our target properties, our target renters, our renovation, maintenance and other operating costs, and our rental rates and occupancy levels and, if our assumptions prove to be inaccurate, this may adversely affect the profitability of this business.

Initially, our portfolio of properties has been geographically concentrated, and any adverse developments in local economic conditions, or the demand for single-family rental homes in these markets, or the occurrence of natural disasters, may adversely affect the operating results of this business.

Initially, our target markets are in the east coast of Florida and we are exposed to any adverse developments in local economic conditions or natural disasters in that area. Due to this geographic concentration, any such developments could affect our business to a greater extent than if our properties were less geographically concentrated.

Poor resident selection and defaults by renters may adversely affect the financial performance of this business and harm our reputation.

Our success depends, in large part, upon our ability to attract and retain qualified tenants. This will depend, in turn, upon our ability to screen applicants, identify good residents, avoid tenants who may default, and the willingness of our tenants to renew their leases. When properties are vacant, we are not earning rental income and incur maintenance costs as well as turnover costs associated with re-leasing the properties, such as marketing and leasing commissions. Additionally, if we have to evict tenants, we will incur legal costs and may have renovation costs if the tenants don’t properly maintain the properties or cause damage to the properties. Our reputation in the communities where our properties are located may be harmed if our tenants are not good neighbors or do damage to our properties or to the local communities.

Declining real estate values and impairment charges could adversely affect the earnings and financial condition of this business.

Our success depends upon our ability to acquire rental properties at attractive values, such that we can earn a satisfactory return on our investment primarily through rental income and secondarily through increases in property values. If we overpay for properties, or if their values subsequently decline or fail to rise because of market factors, we may not achieve our financial objectives. Additionally, U.S. GAAP requires companies to take an impairment charge if there is a permanent decline in the value of a property based upon a review of various market factors. An impairment charge would reduce the net income in the period in which it was taken. Even if we concluded that an impairment charge was not needed, a decline in the value of a property may become manifest over time through reduced rental income from the property, which would affect the earnings and financial condition of this business.

Risks Related to REIT Compliance and Other Tax Matters

If we are disqualified as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability.

We believe that, since our initial public offering in 1998, we have operated so as to qualify as a REIT under the Code and we intend to continue to meet the requirements for taxation as a REIT. Nevertheless, we may not remain qualified as a REIT in the future. Qualification as a REIT involves the application of highly technical and complex Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could require us to pay a penalty or jeopardize our REIT status. We hold certain assets and derive certain types of income that do not qualify under various gross asset and income requirements applicable to REITs and, if the amounts of such assets or income exceed thresholds permitted under the Code, our ability to qualify as a REIT could be jeopardized. Furthermore, Congress or the IRS might change tax laws or regulations and the courts might issue new rulings, in each case potentially having retroactive effects that could make it more difficult or impossible for us to qualify as a REIT. If we fail to qualify as a REIT in any tax year, then:

- we would be taxed as a regular domestic corporation, which, among other things, means being unable to deduct distributions to stockholders in computing taxable income and being subject to federal income tax on our taxable net income at regular corporate rates;
- any resulting tax liability could be substantial and would reduce the amount of cash available for distribution to stockholders;
- we would no longer be required to make distributions to our stockholders; and
- unless we were entitled to relief under applicable statutory provisions, we could be disqualified from treatment as a REIT for the subsequent four taxable years following the year during which we lost our

qualification and thus our cash available for distribution to stockholders would be reduced for each of the years during which we do not qualify as a REIT.

Complying with REIT requirements may cause us to forego otherwise attractive opportunities.

In order to qualify as a REIT for federal income tax purposes, we must continually satisfy tests concerning, among other things, our sources of income, the nature and diversification of our MBS and other assets, the amounts we distribute to our stockholders and the ownership of our stock. We may also be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may hinder our ability to operate solely on the basis of maximizing profits.

Complying with REIT requirements may limit our ability to hedge effectively.

Compliance with the REIT provisions of the Code may limit our ability to hedge our assets and operations. Under these provisions, any income that is generated from transactions intended to hedge our interest rate, inflation and/or currency risks will be excluded from gross income for purposes of the REIT 75% and 95% gross income tests if the instrument hedges (1) interest rate risk on liabilities incurred to carry or acquire real estate or (2) risk of currency fluctuations with respect to any item of income or gain that would be qualifying income under the REIT 75% or 95% gross income tests, and such instrument is properly identified under applicable Treasury Regulations. Income from hedging transactions that does not meet these requirements will generally constitute non-qualifying income for purposes of both the REIT 75% and 95% gross income tests. As a result of these rules, we may have to limit use of hedging techniques that might otherwise be advantageous, which could result in greater risks associated with interest rate or other changes than we would otherwise incur.

Complying with REIT requirements may force us to liquidate otherwise attractive investments or to make investments inconsistent with our business plan.

In order to qualify as a REIT, we must also determine that at the end of each calendar quarter at least 75% of the value of our assets consists of cash, cash items, government securities and qualified REIT real estate assets. The remainder of our investment in securities generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our assets can consist of the securities of any one issuer. No more than 20% of the total value of our assets can be stock in taxable REIT subsidiaries. If we fail to comply with these requirements, we must dispose of a portion of our assets within 30 days after the end of the calendar quarter in order to avoid losing our REIT status and suffering adverse tax consequences. The need to comply with these gross income and asset tests may cause us to acquire other assets that are qualifying real estate assets for purposes of the REIT requirements that are not part of our overall business strategy and might not otherwise be the best investment alternative for us.

REIT distribution requirements could adversely affect our ability to execute our business plan and may require us to incur debt, sell assets, or take other actions to make such distributions.

In order to continue to qualify as a REIT, we must distribute to stockholders each calendar year at least 90% of our REIT taxable net income (including certain items of non-cash income), determined without regard to the deduction of dividends paid and excluding net capital gains. To the extent that we satisfy the 90% distribution requirement but distribute less than 100% of our taxable net income, we will be subject to U.S. federal corporate income tax on our undistributed income. In addition, we will incur a 4% nondeductible excise tax on the amount, if any, by which our distributions in any calendar year are less than a minimum amount specified under U.S. federal income tax law.

We intend to distribute our taxable net income to stockholders in a manner intended to satisfy the 90% distribution requirement and to avoid both corporate income tax and the 4% nondeductible excise tax. Our taxable net income may substantially exceed our net income as determined by U.S. GAAP or differences in timing between the recognition of taxable net income and the actual receipt of cash may occur, in which case we may have taxable net income in excess of cash flow from our operating activities. In such event, we may generate less cash flow than taxable net income in a particular year and find it difficult or impossible to meet the REIT distribution requirements in certain

circumstances. In such circumstances, in order to satisfy the distribution requirement and to avoid U.S. federal corporate income tax and the 4% nondeductible excise tax in that year, we may be required to: (i) sell assets in adverse market conditions, (ii) borrow on unfavorable terms, (iii) distribute amounts that would otherwise be invested in future acquisitions, capital expenditures, or repayment of debt, or (iv) make a taxable distribution of our shares as part of a distribution in which stockholders may elect to receive shares or (subject to a limit measured as a percentage of the total distribution) cash, in order to comply with the REIT distribution requirements. Thus, compliance with the REIT distribution requirements may require us to take actions that may not otherwise be advisable given existing market conditions and hinder our ability to grow, which could adversely affect the value of our common stock.

Even though we elected to be taxed as REIT, we may be required to pay certain taxes.

Even though we have elected to be taxed as a REIT, we may be subject to certain U.S. federal, state, and local taxes on our income and assets, including taxes on any undistributed income, prohibited transactions, tax on income from some activities conducted as a result of a foreclosure, and state or local income, franchise, property, and transfer taxes, including mortgage recording taxes. In addition, in the future, we may hold some of our assets through wholly-owned taxable REIT subsidiaries. Any taxable REIT subsidiaries and any other taxable corporations in which we own an interest will be subject to U.S. federal, state, and local corporate taxes. Payment of these taxes generally would reduce our cash flow and the amount available for distribution to our stockholders.

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

We regularly purchase agency securities through TBA contracts. In certain instances, rather than take delivery of the agency securities subject to a TBA contract, we will dispose of the TBA contract through a dollar roll transaction in which we agree to purchase similar securities in the future at a predetermined price or otherwise, which may result in the recognition of income or gains. We account for dollar roll transactions as purchases and sales. The law is unclear regarding whether TBA contracts will be qualifying assets for the 75% asset test and whether income and gains from dispositions of TBA contracts will be qualifying income for the 75% gross income test.

Until such time as we seek and receive a favorable private letter ruling from the IRS, or we are advised by counsel that TBA contracts should be treated as qualifying assets for purposes of the 75% asset test, we will limit our investment in TBA contracts and any non-qualifying assets to no more than 25% of our assets at the end of any calendar quarter. Further, until such time as we seek and receive a favorable private letter ruling from the IRS or we are advised by counsel that income and gains from the disposition of TBA contracts should be treated as qualifying income for purposes of the 75% gross income test, we will limit our gains from dispositions of TBA contracts and any non-qualifying income to no more than 25% of our gross income for each calendar year. Accordingly, our ability to purchase agency securities through TBA contracts and to dispose of TBA contracts, through dollar roll transactions or otherwise, could be limited.

Moreover, even if we are advised by counsel that TBA contracts should be treated as qualifying assets or that income and gains from dispositions of TBA contracts should be treated as qualifying income, it is possible that the IRS could successfully take the position that such assets are not qualifying assets and such income is not qualifying income. In that event, we could be subject to a penalty tax or we could fail to qualify as a REIT if (i) the value of our TBA contracts, together with our non-qualifying assets for the 75% asset test, exceeded 25% of our gross assets at the end of any calendar quarter or (ii) our income and gains from the disposition of TBA contracts, together with our non-qualifying income for the 75% gross income test, exceeded 25% of our gross income for any taxable year.

Complying with REIT requirements may force us to borrow to make distributions to stockholders.

As a REIT, we must distribute at least 90% of our annual taxable net income (subject to certain adjustments) to our stockholders. At the time when we are required to make previously declared dividend distributions, declines in the value of our portfolio holdings and the resulting subsequent margins calls may have depleted most or all of our cash and cash equivalents. If this were to occur and if market conditions allowed us to do so, we would sell some of our portfolio holdings to generate sufficient funds to make the dividend payments. If market conditions did not allow us to sell portfolio holdings, we would be required to borrow funds on an unsecured basis to make the previously declared

dividend payments.

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

Current tax law generally provides for favorable tax rates (20% maximum in the case of non-corporate stockholders) on dividends received from corporations. However, dividends paid by REITs to these stockholders are generally not eligible for these reduced rates. Notwithstanding the foregoing, however, all such dividends, other than dividends which are taxable as capital gain dividends or traceable to dividends from a taxable REIT subsidiary, as are received by a pass-through entity or an individual, became eligible for a 20% deduction from gross income starting in 2018 under the tax laws.

This eligibility for a 20% deduction will expire in 2025. This legislation does not adversely affect the taxation of REITs or dividends paid by REITs, but the more favorable rates applicable to non-REIT corporate dividends could cause investors which are trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the stock of REITs, including our common stock. Investors and potential investors should consult with their tax advisors regarding the implications of this tax law on any investment in our stock.

The tax imposed on REITs engaging in “prohibited transactions” will limit our ability to engage in transactions, including certain methods of securitizing loans, which would be treated as sales for federal income tax purposes.

A REIT’s net income from prohibited transactions is subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property but including any mortgage loans, held in inventory primarily for sale to customers in the ordinary course of business. We might be subject to this tax if we were to sell a loan or securitize loans in a manner that was treated as a sale of such inventory for federal income tax purposes. Therefore, in order to avoid the prohibited transactions tax, we may choose not to engage in certain sales of loans other than through a taxable REIT subsidiary and may limit the structures we utilize for our securitization transactions even though such sales or structures might otherwise be beneficial for us. In addition, this prohibition may limit our ability to restructure our investment portfolio of mortgage loans from time to time, even if we believe that it would be in our best interest to do so.

We may incur excess inclusion income that would increase the tax liability of our stockholders.

In general, dividend income that a tax-exempt entity receives from us should not constitute unrelated business taxable income as defined in Section 512 of the Code. If we realize excess inclusion income and allocate it to stockholders, however, then this income would be fully taxable as unrelated business taxable income under Section 512 of the Code. If the stockholder is foreign, it would generally be subject to U.S. federal income tax withholding on this income without reduction pursuant to any otherwise applicable income tax treaty. U.S. stockholders would not be able to offset such income with their operating losses.

We generally structure our borrowing arrangements in a manner designed to avoid generating significant amounts of excess inclusion income. However, excess inclusion income could result if we held a residual interest in a REMIC. Excess inclusion income also may be generated if we were to issue debt obligations with two or more maturities and the terms of the payments on these obligations bore a relationship to the payments that we received on our mortgage loans or MBS securing those debt obligations. For example, we may engage in non-REMIC CMO securitizations. We also enter into various repurchase agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities if we default on our obligations. The IRS may determine that

these transactions give rise to excess inclusion income that should be allocated among our stockholders. We may invest in equity securities of other REITs and it is possible that we might receive excess inclusion income from those investments. Some types of entities, including, without limitation, voluntarily employee benefit associations and entities that have borrowed funds to acquire their shares of our stock, may be required to treat a portion of or all of the dividends they receive from us as unrelated business taxable income.

Misplaced reliance on legal opinions or statements by issuers of mortgage-related assets could result in a failure to

[Table of Contents](#)

comply with REIT gross income or asset tests.

When purchasing MBS, government securities and interests in loans held in securitization trusts, we may rely on opinions of counsel for the issuer or sponsor of such securities, or statements made in related offering documents or opinions of tax accountants, for purposes of determining whether and to what extent those securities constitute “real estate assets” for purposes of the REIT asset tests and produce income that qualifies under the REIT income tests. The inaccuracy of any such opinions or statements may harm our REIT qualification and result in significant corporate level tax.

Additional Risk Factors

Failure to maintain an exemption from the Investment Company Act would materially harm our results of operations.

We believe that we conduct our business in a manner that results in our not being regulated as an investment company under the Investment Company Act of 1940, as amended, or the Investment Company Act. If we fail to continue to qualify for an exemption from registration as an investment company, our ability to use leverage would be substantially reduced and we would be unable to conduct our business as we presently do.

Section 3(a)(1)(C) of the Investment Company Act defines an investment company as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire investment securities having a value exceeding 40% of the value of the issuer’s total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis, which we refer to as the 40% test. Excluded from the term “investment securities” are, among other things, U.S. government securities and securities issued by majority-owned subsidiaries that are not themselves investment companies and are not relying on the exception from the definition of investment company in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act.

The Investment Company Act has an exemption for entities that are primarily engaged in the business of purchasing or otherwise acquiring “mortgages and other liens on and interests in real estate.” Under the SEC’s current interpretation, we qualify for this exemption if we maintain at least 55% of our assets directly in qualifying assets and at least 80% of our assets must be in both the qualifying assets and other real estate related interests (and no more than 20% comprised of other miscellaneous assets). In meeting the 55% requirement under the Investment Company Act, the SEC has generally viewed the following asset types as qualifying interests: (1) assets that represent an actual interest in real estate; (2) loans or liens that are fully secured by real estate; (3) assets that can be viewed as the functional equivalent of, and provide the same economic experience as, an actual interest in real estate or a loan or lien fully secured by real estate, such as whole pool agency MBS. In meeting the 55% test, we treat MBS issued with respect to an underlying pool for which we hold all issued certificates as qualifying interests and partial pool agency MBS in other real estate related interests in complying with the 80% test. If the SEC or its staff adopts a contrary interpretation, we could be required to sell a substantial amount of our MBS under potentially adverse market conditions. Further, in order to maintain our exemption from registration as an investment company by acquiring “mortgages and other liens on and interests in real estate”, we may be precluded from acquiring MBS whose yield is somewhat higher than the yield on “mortgages and other liens on and interests in real estate” that could be purchased in a manner consistent with the exemption.

On August 31, 2011, the SEC issued a release soliciting comments on the mortgage REIT exemption under the Investment Company Act. The SEC indicated in its release that it is concerned that some mortgage companies may be subject to the kinds of abuses that the Investment Company Act was intended to address, such as misvaluations of a company’s investment portfolio and excessive leveraging. The release asked for comments on or before November 7, 2011 on whether the exclusion should be narrowed or changed in such a way that these potential abuses can be curtailed. The SEC also asked whether there are existing safeguards in the structure and operations of REITs and other mortgage companies that would address these or similar concerns. Although we believe that we have conducted our operations in a manner that would not be of the types of concerns addressed in the SEC’s release, we could be subject to any rules or regulations that the SEC could propose in changing or narrowing the current exclusion that mortgage REITs rely on to

[Table of Contents](#)

maintain an exemption from the Investment Company Act. If the SEC or its staff changes or narrows this exemption, we could be required to sell a substantial amount of our MBS under potentially adverse market conditions. Although, at the present time, it is unknown whether the SEC or its staff will make any changes to this exclusion or the nature of any such changes, it is possible that any such changes could impact our Asset Acquisition Policy, our leverage, our liquidity, the size of our investment portfolio, our ability to use interest rate swap agreements, our ability to borrow, and could have a material adverse effect on our business and results of operations.

We presently are not, nor do we intend to be, regulated as an investment company. Fluctuations in our net income and in our book value will likely be greater than those of investment companies. This may affect investors or potential investors as to the appropriateness of our stock as compared to that of an investment company.

While presently our assets are similar to those owned by some investment companies, we are not regulated as an investment company. Regulation as an investment company entails that all investment companies maintain significantly lower levels of financial leverage than we have employed since our organization began operations in 1998. Because of the differences in our leverage from that of investment companies, this results in the fluctuation in net income and in book value by us to likely be greater than that experienced by investment companies. Therefore, investors and potential investors in our company should, on an ongoing basis, carefully determine if this greater level of income fluctuation and book value fluctuation is appropriate for them as compared to whether the less volatile results of investment companies are more appropriate for them.

The market price of our common stock may fluctuate significantly.

The market price and marketability of shares of our securities may, from time to time, be significantly affected by numerous factors, including many over which we have no control and that may not be directly related to us. These factors including the following:

- price and volume fluctuations in the stock market from time to time, which are often unrelated to the operating performance of particular companies;
- significant volatility in the market price and trading volume of securities of REITs or other companies in our sector, which is not necessarily related to the operating performance of these securities;
- changes in regulatory policies, tax guidelines and financial accounting and reporting standards, particularly with respect to REITs;
- changes in interest rates;
- changes in business conditions and the general economy, including the consequences of actions by the U.S. government and other foreign governments to address the various economic conditions including, but not limited to, Brexit, trade imbalances, credit crisis, currency fluctuations, and the impact of other events, such as threats or actions by other nations such as North Korea and Iran, and global terrorism;
- changes in our dividend policy and earnings or variations in operating results;
- any shortfall in revenue or net income or any increase in losses from levels expected by securities analysts;
- general economic trends and other external factors;
- changes in financial estimates by analysts or publication of research reports about us or the real estate or specialty finance industry; and
- loss of major repurchase agreement and other credit providers.

[Table of Contents](#)

Fluctuations in the trading price of our common stock may adversely affect the liquidity of the trading market for our common stock and, in the event that we seek to raise capital through future equity financings, our ability to raise such equity capital.

We may not be able to use the money we raise from time to time to acquire investments at favorable prices.

We intend to seek to raise additional capital from time to time if we determine that it is in our best interests and the best interests of our stockholders, including through public offerings of our stock. The net proceeds of any offering could represent a significant increase in our equity. Depending on the amount of leverage that we use, the full investment of the net proceeds of any offering might result in a substantial increase in our total assets. There can be no assurance that we will be able to invest all of such additional funds in mortgage-related assets at favorable prices. We may not be able to acquire enough mortgage-related assets to become fully invested after an offering, or we may have to pay more for MBS than we have historically. In either case, the return that we earn on stockholders’ equity may be reduced.

We have not established a minimum dividend payment level for our common stockholders and there are no assurances of our ability to pay dividends to them in the future.

We intend to pay quarterly dividends and to make distributions to our common stockholders in amounts such that all or substantially all of our taxable net income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable us to qualify for the tax benefits accorded to a REIT under the Code. We have not established a minimum dividend payment level for our common stockholders and our ability to pay dividends may be harmed by the risk factors described in this Annual Report on Form 10-K. All distributions to our common stockholders will be made at the discretion of our Board and will depend on our earnings, our financial condition, maintenance of our REIT status and such other factors as our Board may deem relevant from time to time. There are no assurances of our ability to pay dividends in the future.

If we raise additional capital, our earnings per share and dividends per share may decline since we may not be able to invest all of the new capital during the quarter in which additional shares are sold and possibly the entire following calendar quarter.

Our charter does not permit ownership of over 9.8% of our common or preferred stock and attempts to acquire our common or preferred stock in excess of the 9.8% limit are void without prior approval from our Board.

For the purpose of preserving our REIT qualification and for other reasons, our charter prohibits direct or constructive ownership by any person of more than 9.8% of the lesser of the total number or value of the outstanding shares of our common stock or more than 9.8% of the outstanding shares of our preferred stock. Our charter’s constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of less than 9.8% of the outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of 9.8% of the outstanding stock and thus be subject to our charter’s ownership limit. Any attempt to own or transfer shares of our common or preferred stock in excess of the ownership limit without the consent of the Board shall be void and will result in the shares being transferred by operation of law to a charitable trust.

Because provisions contained in Maryland law, our charter and our bylaws may have an anti-takeover effect, investors may be prevented from receiving a “control premium” for their shares.

Provisions contained in our charter and bylaws, as well as Maryland corporate law, may have anti-takeover effects that delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a “control premium” for their shares. For example, these provisions may defer or prevent tender offers for our common stock or purchases of large blocks of our common stock, thereby limiting the opportunities for our stockholders to receive a premium for their common stock over then-prevailing market prices. These provisions include the following:

- *Ownership limit.* The ownership limit in our charter limits related investors including, among other things, any voting group, from acquiring over 9.8% of our common stock or more than 9.8% of our preferred stock

[Table of Contents](#)

without our permission.

- *Preferred Stock.* Our charter authorizes our Board to issue preferred stock in one or more classes and to establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval.
- *Maryland business combination statute.* Maryland law restricts the ability of holders of more than 10% of the voting power of a corporation’s shares to engage in a business combination with the corporation.
- *Maryland control share acquisition statute.* Maryland law limits the voting rights of “control shares” of a corporation in the event of a “control share acquisition.”

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

In February 2012, we signed a new sublease agreement with PIA that expires on June 30, 2022 for approximately 7,300 square feet of office space at our existing location in Santa Monica, California. We believe this facility is adequate for our intended level of operations.

Item 3. LEGAL PROCEEDINGS

We are not a party to any material pending legal proceedings.

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

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

Market Information

Our common stock began trading under the symbol ANH on the New York Stock Exchange on May 9, 2003. Our common stock previously traded under the symbol ANH on the American Stock Exchange. Prior to March 17, 1998, there had been no public market for our common stock.

Holders

As of March 4, 2020, there were approximately 679 record holders of our common stock. On March 4, 2020, the last reported sale price of our common stock on the New York Stock Exchange was \$3.44 per share.

Dividends

We pay cash dividends on a quarterly basis. The following table lists the cash dividends declared on each share of our common stock for our most recent two fiscal years. The dividends listed below were based primarily on our Board’s

[Table of Contents](#)

evaluation of earnings and consideration of actions necessary to maintain our REIT status for each listed quarter and were declared on the date indicated:

	Cash Dividends Per Common Share	Date Dividends Declared
2019		
First quarter ended March 31, 2019	\$ 0.13	March 14, 2019
Second quarter ended June 30, 2019	\$ 0.11	June 13, 2019
Third quarter ended September 30, 2019	\$ 0.10	September 17, 2019
Fourth quarter ended December 31, 2019	\$ 0.09	December 17, 2019
2018		
First quarter ended March 31, 2018	\$ 0.15	March 15, 2018
Second quarter ended June 30, 2018	\$ 0.14	June 15, 2018
Third quarter ended September 30, 2018	\$ 0.14	September 14, 2018
Fourth quarter ended December 31, 2018	\$ 0.13	December 14, 2018

[Table of Contents](#)

Issuer Purchase of Equity Securities

Period	Total Number of Shares Purchased This Quarter	Average Price Paid per Share	Total Number of Shares Previously Purchased Prior to This Quarter as Part of Publicly Announced Plans or Programs	Maximum Number of Shares That May Yet Be Purchased Under the Plans or Programs ⁽¹⁾
Month #1 (October 1-31)	—	\$ —	52,969,000	3,113,278
Month #2 (November 1-30)	—	\$ —	52,969,000	—
Month #3 (December 1-31)	—	\$ —	52,969,000	—
Total shares purchased this quarter	—	\$ —	—	—
Total shares available for repurchase at December 31, 2019				—

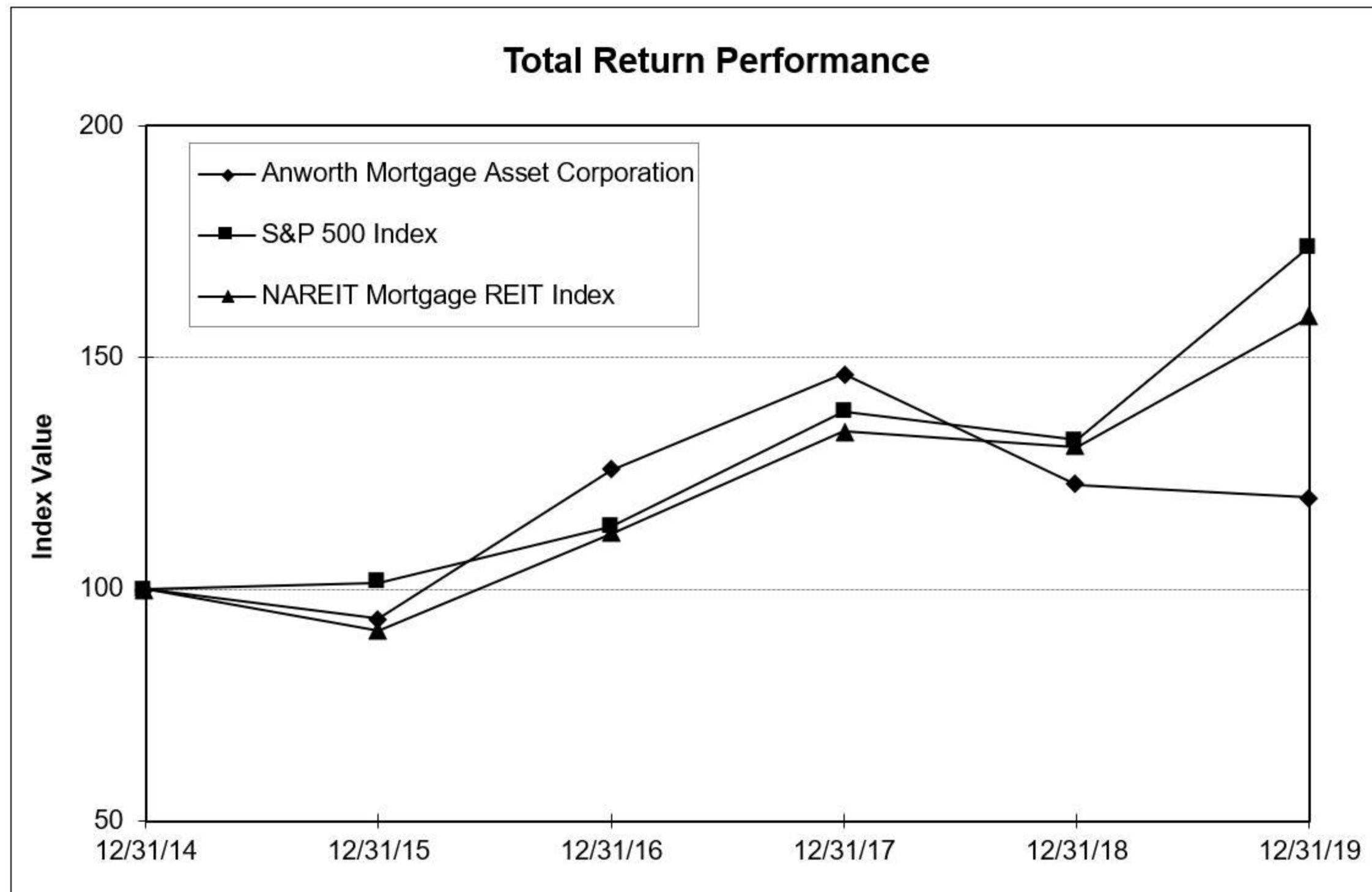
(1) On October 3, 2011, we announced that our Board had authorized a share repurchase program which permitted us to acquire up to 2,000,000 shares of our common stock. The shares were expected to be acquired at prevailing prices through open market transactions. Our Board also authorized the Company to repurchase an amount of our common stock up to the amount of common stock sold and issued through our Dividend Reinvestment and Stock Purchase Plan. Subsequently, our Board authorized the Company to repurchase up to an aggregate of an additional 45,000,000 shares (pursuant to six separate authorizations) between December 13, 2013 and January 22, 2016. In November 2019, our Board decided to no longer include the amount of common stock that we sold and issued through our Dividend Reinvestment and Stock Purchase Plan as shares available for repurchase under our share repurchase program. Therefore, as of December 31, 2019, there are no longer any shares available for repurchase by us under our share repurchase program.

During the year ended December 31, 2019, we did not repurchase any shares of our common stock under our share repurchase program.

[Table of Contents](#)

Total Return Comparison

The following graph presents a cumulative total stockholder return comparison of our common stock with the Standard & Poor’s 500 Index and the National Association of Real Estate Investment Trusts, Inc. Mortgage REIT Index:



Index	Period Ending					
	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18	12/31/19
Anworth Mortgage Asset Corporation	100.00	93.58	125.62	146.49	122.49	119.80
S&P 500 Index	100.00	101.38	113.51	138.29	132.23	173.86
NAREIT Mortgage REIT Index	100.00	91.12	111.95	134.10	130.71	158.60

The cumulative total stockholder return reflects stock price appreciation, if any, and the value of dividends for our common stock and for each of the comparative indices. The graph assumes that \$100 was invested on December 31, 2014 in our common stock, that \$100 was invested in each of the indices on December 31, 2014 and that all dividends were reinvested into additional shares of common stock at the frequency with which dividends are paid on the common stock during the applicable fiscal year. The total return performance shown in this graph is not necessarily indicative of and is not intended to suggest future total return performance. Measurement points are at the last trading day of the fiscal years represented above.

[Table of Contents](#)

Item 6. SELECTED FINANCIAL DATA

The selected financial data as of December 31, 2019 and 2018 and for the years ended December 31, 2019, 2018, and 2017 are derived from our consolidated financial statements included in this Annual Report on Form 10-K. The selected financial data as of December 31, 2017, 2016, and 2015 and for the years ended December 31, 2016 and 2015 are derived from consolidated financial statements not included in this Annual Report on Form 10-K. You should read these selected financial data together with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our consolidated financial statements and notes thereto that are included in this Annual Report on Form 10-K beginning on page F-1.

	For the Years Ended December 31,				
	2019	2018	2017	2016	2015
	(amounts in thousands, except per share data and days)				
Statements of Operations Data					
Days in period	365	365	365	366	365
Interest income net of amortization of premium and discount	\$ 154,395	\$ 159,972	\$ 142,748	\$ 140,452	\$ 145,498
Interest expense	(118,756)	(115,307)	(82,519)	(70,420)	(43,621)
Provision for loan losses	—	—	—	—	(203)
Net interest income	\$ 35,639	\$ 44,665	\$ 60,229	\$ 70,032	\$ 101,674
Expenses	(13,306)	(13,503)	(13,305)	(14,219)	(13,980)
Other (loss) income	(77,752)	(37,650)	7,448	(33,320)	(72,990)
Net (loss) income	\$ (55,419)	\$ (6,488)	\$ 54,372	\$ 22,493	\$ 14,704
Dividends on preferred stock	(9,189)	(9,189)	(8,173)	(6,583)	(6,437)
Net (loss) income available to common stockholders	\$ (64,608)	\$ (15,677)	\$ 46,199	\$ 15,910	\$ 8,267
Basic (loss) earnings per common share	\$ (0.65)	\$ (0.16)	\$ 0.48	\$ 0.17	\$ 0.08
Diluted (loss) earnings per common share	\$ (0.65)	\$ (0.16)	\$ 0.47	\$ 0.17	\$ 0.08
Average number of shares outstanding	98,739	98,314	96,764	96,408	103,412
Average number of diluted shares outstanding	98,739	98,314	100,479	101,068	107,751

	As of December 31,				
	2019	2018	2017	2016	2015
	(amounts in thousands, except per share data)				
Balance Sheets Data					
Agency MBS	\$ 3,510,051	\$ 3,548,719	\$ 4,278,797	\$ 3,925,193	\$ 4,892,782
Non-Agency MBS	\$ 643,610	\$ 795,203	\$ 760,825	\$ 641,246	\$ 682,061
Residential mortgage loans held-for-securitization	\$ 152,922	\$ 11,660	\$ —	\$ —	\$ —
Residential mortgage loans held-for-investment through consolidated securitization trusts	\$ 458,348	\$ 549,016	\$ 639,351	\$ 744,462	\$ 969,172
Total assets	\$ 4,938,631	\$ 5,039,700	\$ 5,765,541	\$ 5,395,776	\$ 6,636,340
Repurchase agreements	\$ 3,657,873	\$ 3,811,627	\$ 4,365,695	\$ 3,911,015	\$ 4,915,528
Warehouse line of credit	\$ 133,811	\$ —	\$ —	\$ —	\$ —
Asset-backed securities issued by securitization trusts	\$ 448,987	\$ 539,651	\$ 629,984	\$ 728,683	\$ 915,486
Junior subordinated notes	\$ 37,380	\$ 37,380	\$ 37,380	\$ 37,380	\$ 37,380
Total liabilities	\$ 4,366,679	\$ 4,458,595	\$ 5,068,119	\$ 4,740,754	\$ 5,934,189
Series B Preferred Stock	\$ 19,455	\$ 19,455	\$ 19,455	\$ 23,924	\$ 23,924
Stockholders' equity (common, Series A, and Series C Preferred)	\$ 552,497	\$ 561,650	\$ 677,967	\$ 631,098	\$ 678,227
Number of common shares outstanding	98,849	98,483	98,137	95,718	98,944
Book value per common share	\$ 4.60	\$ 4.71	\$ 5.91	\$ 5.95	\$ 6.25

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

Our Business

We were incorporated in Maryland on October 20, 1997 and commenced operations on March 17, 1998. Our principal business is to invest in, finance and manage a leveraged portfolio of residential mortgage-backed securities and residential mortgage loans which presently include the following types of investments:

- *Agency mortgage-backed securities*, or Agency MBS, which include residential mortgage pass-through certificates and collateralized mortgage obligations, or CMOs, which are securities representing interests in pools of mortgage loans secured by residential property in which the principal and interest payments are guaranteed by a government-sponsored enterprise, or GSE, such as the Federal National Mortgage Association, or Fannie Mae, or the Federal Home Loan Mortgage Corporation, or Freddie Mac.
- *Non-agency mortgage-backed securities*, or Non-Agency MBS, which are securities issued by companies that are not guaranteed by federally sponsored enterprises and that are secured primarily by first-lien residential mortgage loans.
- *Residential mortgage loans*. We acquire non-Qualified Mortgage, or Non-QM, residential mortgage loans (which are described further on page 79) from independent loan originators with the intent of holding these loans for securitization. These loans are financed by a warehouse line of credit until securitization. We also hold residential mortgage loans through consolidated securitization trusts. We finance these loans through asset-backed securities, or ABS, issued by the consolidated securitization trusts. The ABS, which are held by unaffiliated third parties, are non-recourse financing. The difference in the amount of the loans in the trusts and the amount of the ABS represents our retained net interest in the securitization trusts.

Our principal business objective is to generate net income for distribution to our stockholders primarily based upon the spread between the interest income on our mortgage assets and our borrowing costs to finance our acquisition of those assets.

We generally view our target investments as being influenced primarily by either interest rate risks or credit risks. Our Agency MBS are sensitive to changes in interest rates and related prepayment speeds. Our Non-Agency MBS and residential mortgage loans held-for-securitization or held-for-investment through consolidated securitization trusts are sensitive to changes in both interest rate risk and credit risk.

The assets which we allocate to Agency MBS are also allocated to one of two subcategories:

1. Agency MBS which have a fixed interest rate during the life of the mortgages; and
2. Agency MBS whose interest rates will change or adjust to current market levels at varying times.

We believe our hybrid investment model allows us to allocate assets across various sectors within the residential mortgage market with a focus on security selection and implementation of a relative value investment approach. Our asset allocation process takes into account the opportunities in the marketplace, cost of financing and cost of hedging interest rate, prepayment credit and other portfolio risks. As a result, mortgage-related asset allocation reflects management’s opportunistic approach to investing in the marketplace.

The following table provides the MBS asset allocation and asset allocation between our Agency MBS, Non-

Agency MBS and residential mortgage loans at December 31, 2019 and December 31, 2018:

	December 31, 2019		December 31, 2018	
	Dollar Amount (in thousands)	Percentage	Dollar Amount (in thousands)	Percentage
Agency MBS	\$ 3,510,051	73.66 %	\$ 3,548,719	72.36 %
Non-Agency MBS	643,610	13.51	795,203	16.21
Total MBS	\$ 4,153,661	87.17 %	\$ 4,343,922	88.57 %
Residential mortgage loans held-for-securitization	152,922	3.21	11,660	0.24
Residential mortgage loans held-for-investment through consolidated securitization trusts	458,348	9.62	549,016	11.19

Total mortgage-related assets	\$	<u>4,764,931</u>	<u>100.00 %</u>	\$	<u>4,904,598</u>	<u>100.00 %</u>
-------------------------------	----	------------------	-----------------	----	------------------	-----------------

When we change the allocation of our investment portfolio, our annualized yields and cost of financing will change. As previously discussed, our investment decisions are not driven solely by annualized yields but also by taking into account the uncertainty of faster or slower prepayments, extension risk and credit-related events.

Our MBS Portfolio

At December 31, 2019 and December 31, 2018, the fair value of our MBS portfolio (which consists primarily of Agency MBS and Non-Agency MBS) and its allocation were approximately as follows:

	December 31, 2019	December 31, 2018
	(dollar amounts in thousands)	
Fair value of MBS	\$ 4,153,661	\$ 4,343,922
Adjustable-rate Agency MBS less than 1-year reset	12 %	21 %
Adjustable-rate Agency MBS 1-3 year reset	2	5
Adjustable-rate Agency MBS 3-5 year reset	3	7
Adjustable-rate Agency MBS greater than 5-year reset	2	3
Total Adjustable-Rate Agency MBS	19 %	36 %
15-year fixed-rate Agency MBS	1	20
20-year fixed-rate Agency MBS	5	9
30-year fixed-rate Agency MBS	60	17
Non-Agency MBS	15	18
Total MBS	100 %	100 %

Results of Operations

Years Ended December 31, 2019 and 2018

For the year ended December 31, 2019, our net loss to common stockholders was approximately \$64.6 million, or \$(0.65) per basic and diluted share, based on a weighted average of 98.7 million basic and fully diluted shares outstanding. This included a net loss of \$55.4 million and the payment of preferred dividends of \$9.2 million. For the year ended December 31, 2018, our net loss to common stockholders was approximately \$15.7 million, or \$(0.16) per basic and diluted share, based on a weighted average of 98.3 million basic and fully diluted shares outstanding. This included a net loss of \$6.5 million and the payment of preferred dividends of \$9.2 million.

Net interest income for the year ended December 31, 2019 totaled \$35.6 million, or 19.7% of gross interest income, compared to \$44.7 million, or 23.7% of gross interest income, for the year ended December 31, 2018. Net interest income is comprised of the interest income earned on mortgage investments (net of premium amortization expense) and other interest income less interest expense from borrowings. Interest and other interest income net of premium amortization expense for the year ended December 31, 2019 was \$154.4 million, compared to \$160.0 million for the year ended December 31, 2018, a decrease of 3.5%, due primarily to a decrease in interest income on securitized

residential mortgage loans of approximately \$3.0 million (due to paydowns on this portfolio) and a decrease in the weighted average portfolio outstanding, from approximately \$4.62 billion in 2018 to approximately \$3.95 billion in 2019, partially offset by an increase in the weighted average coupons on MBS (from 3.57% in 2018 to 3.93% in 2019), a decrease in premium amortization expense of \$2.0 million, an increase in interest on residential mortgage loans held-for-securitization of \$4.3 million (due to this activity commencing at the end of December 2018), and an increase in other interest income of \$1.3 million, due primarily to interest earned on restricted cash balances. Interest expense for the year ended December 31, 2019 was \$118.8 million, compared to \$115.3 million for the year ended December 31, 2018, an increase of approximately 3.0%, which resulted primarily from an increase in the weighted average interest rates, from 2.20% in 2018 to 2.64% in 2019, and an increase in interest expense on our warehouse line of credit of \$4.1 million (due to this activity commencing in 2019), partially offset by a decrease in interest expense on asset-backed securities issued by securitization trusts of approximately \$3.0 million (due to paydowns on this portfolio), and a decrease in the average borrowings outstanding, from \$4.11 billion in 2018 to \$3.52 billion in 2019.

The results of our operations are affected by a number of factors, many of which are beyond our control, and primarily depend on, among other things, the level of our net interest income, the market value of our mortgage-related assets, the supply of, and demand for, mortgage-related assets in the marketplace, and the terms and availability of financing. Our net interest income varies primarily as a result from changes in interest rates, the slope of the yield curve (the differential between long-term and short-term interest rates), borrowing costs (our interest expense) and prepayment speeds on our MBS and loan portfolios, the behavior of which involves various risks and uncertainties. Interest rates and prepayment speeds, as measured by the constant prepayment rate, vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty. With respect to our business operations, increases in interest rates, in general, may, over time, cause: (i) the interest expense associated with our borrowings, which are primarily comprised of repurchase agreements, to increase; (ii) the value of our MBS and loan portfolios and, correspondingly, our stockholders’ equity to decline; (iii) coupons on our MBS and loans to reset, although on a delayed basis, to higher interest rates; (iv) prepayments on our MBS and loan portfolios to slow, thereby slowing the amortization of our purchase premiums; and (v) the value of our interest rate swap agreements and, correspondingly, our stockholders’ equity to increase. Conversely, decreases in interest rates, in general, may, over time, cause: (a) prepayments on our MBS and loan portfolios to increase, thereby accelerating the amortization of our purchase premiums; (b) the interest expense associated with our borrowings to decrease; (c) the value

of our MBS and loan portfolios and, correspondingly, our stockholders’ equity to increase; (d) the value of our interest rate swap agreements and, correspondingly, our stockholders’ equity to decrease; and (e) coupons on our MBS and loans to reset, although on a delayed basis, to lower interest rates. In addition, our borrowing costs and credit lines are further affected by the type of collateral pledged and general conditions in the credit markets.

During the year ended December 31, 2019, premium amortization expense decreased by \$2.0 million, or 6.9%, to \$26.8 million from \$28.8 million during the year ended December 31, 2018, due primarily to less unamortized premium from a lower average MBS portfolio outstanding. The prepayment rate assumptions used in our projection of long-term CPR percentages are based on historical prepayment rates on our MBS assets as well as assumptions about future mortgage rates and their expected impact on future prepayments. Given our current expectations for prepayments and market conditions, we do not expect a significant change in future prepayment assumptions.

The table below shows the approximate constant prepayment rate of our MBS:

Portfolio	Year Ended December 31, 2019				Year Ended December 31, 2018			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
MBS	25 %	21 %	18 %	13 %	14 %	16 %	16 %	13 %

We review our MBS portfolios relative to current market conditions, trading prices of individual MBS, the general level of mortgage interest rates, prepayment activity, other investment opportunities and the duration of our portfolio versus the duration of our liabilities. Although there is no set pattern or expectation of a trend to sales of MBS, we may sell some of the securities in our portfolio based upon these factors. During the year ended December 31, 2019, we received proceeds of approximately \$2.95 billion from the sales of Agency MBS and recognized a net loss of approximately \$9.9 million, and we received proceeds of approximately \$30 million from the sales (including calls) of Non-Agency MBS and recognized a net gain of approximately \$76 thousand. During the year ended December 31, 2018,

[Table of Contents](#)

we received proceeds of approximately \$781 million from the sales of Agency MBS and recognized a net loss of approximately \$23.8 million, and we received proceeds of approximately \$6 million from the sales of Non-Agency MBS and recognized a net gain of approximately \$175 thousand. During the years ended December 31, 2019 and December 31, 2018, we did not sell any of our investments in the securitization trusts. We had no set plan to sell any of our securities, nor were we required to do so. Asset sales during 2019 and 2018 were primarily a function of reallocating our portfolio from more interest rate-sensitive securities, such as Agency MBS, to more credit-sensitive investments, such as residential mortgage loans held-for-securitization, and rebalancing our portfolio by disposing of lower yielding securities. During the year ended December 31, 2019, we had unrealized gains of \$17.0 million on trading investments as compared to unrealized losses of \$4.9 million on trading investments during the year ended December 31, 2018. During the year ended December 31, 2019, we recognized a gain (including derivative income) of approximately \$14.2 million on TBA Agency MBS, as compared to a loss (including derivative income) of approximately \$8.7 million on TBA Agency MBS during the year ended December 31, 2018.

During the year ended December 31, 2019, we also had a loss on interest rate swaps recognized in our statements of operations of approximately \$98.9 million, consisting primarily of \$106.5 million in the change in fair value (see the section entitled “Derivative Financial Instruments–Accounting for Derivative and Hedging Activities” in Note 1 to the accompanying consolidated financial statements for additional information), and approximately \$3.9 million in AOCI amortization, partially offset by approximately \$11.5 million in net cash settlements received. During the year ended December 31, 2018, we also had a gain on interest rate swaps recognized in our statements of operations of approximately \$0.6 million, consisting primarily of approximately \$8.1 million in net cash settlements, partially offset by \$3.5 million in the change in fair value (see the section entitled “Derivative Financial Instruments–Accounting for Derivative and Hedging Activities” in Note 1 to the accompanying consolidated financial statements for additional information), and approximately \$4.0 million in AOCI amortization. During the year ended December 31, 2019, rental income from our residential rental properties increased by approximately \$39 thousand. During the year ended December 31, 2019, we sold one of our residential rental properties and realized a gain of approximately \$31 thousand. During the year ended December 31, 2018, we sold two of our residential rental properties and realized a gain of approximately \$54 thousand. During the year ended December 31, 2019, there was an impairment charge on Non-Agency MBS of approximately \$2.1 million, compared to an impairment charge of approximately \$2.9 million during the year ended December 31, 2018.

Total expenses were approximately \$13.3 million for the year ended December 31, 2019, compared to approximately \$13.5 million for the year ended December 31, 2018. For the year ended December 31, 2019, we incurred management fees of approximately \$6.7 million, which is based on a percentage of our equity (see Note 12 to the accompanying consolidated financial statements), compared to management fees of approximately \$7.1 million for the year ended December 31, 2018. Rental properties depreciation and expenses decreased by \$8 thousand during 2019. “Other expenses” increased by approximately \$0.2 million.

Years Ended December 31, 2018 and 2017

The discussion comparing the results of operations for the years ended December 31, 2018 and December 31, 2017 can be found in, and is incorporated by reference to the information under, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations–Years Ended December 31, 2018 and 2017,” of our [Annual Report on Form 10-K for the fiscal year ended December 31, 2018](#).

Financial Condition

MBS Portfolio

At December 31, 2019, we held Agency MBS which had an amortized cost of approximately \$3.46 billion, consisting primarily of approximately \$0.77 billion of adjustable-rate MBS and approximately \$2.69 billion of fixed-rate MBS. This amount represents an approximate 3.6% decrease from the \$3.59 billion held at December 31, 2018. This decrease was due primarily to paydowns in the portfolio, primarily in the adjustable-rate MBS. Of the adjustable-rate Agency MBS owned by us, 61% were adjustable-rate pass-through certificates whose coupons reset within one year. The remaining 39% consisted of hybrid adjustable-rate Agency MBS that have an initial interest rate that is fixed for a

certain period, usually one to ten years, and thereafter adjust annually for the remainder of the term of the loan. At December 31, 2019, the Non-Agency MBS had an amortized cost of approximately \$613.6 million, a fair value of approximately \$643.6 million, and a contractually required principal of approximately \$801.9 million. At December 31, 2018, the Non-Agency MBS had an amortized cost of approximately \$785.6 million, a fair value of approximately \$795.2 million, and a contractually required principal of approximately \$982.8 million.

The following table presents a schedule of our MBS at fair value owned at December 31, 2019 and December 31, 2018 as classified by type of issuer:

Agency	December 31, 2019		December 31, 2018	
	Fair Value	Portfolio Percentage	Fair Value	Portfolio Percentage
	(in thousands)		(in thousands)	
Fannie Mae (FNM)	\$ 2,617,084	63.0 %	\$ 2,104,322	48.4 %
Freddie Mac (FHLMC)	892,967	21.5	1,444,397	33.3
Non-Agency MBS	643,610	15.5	795,203	18.3
Total MBS	<u>\$ 4,153,661</u>	<u>100.0 %</u>	<u>\$ 4,343,922</u>	<u>100.0 %</u>

The following table classifies our portfolio of MBS owned at December 31, 2019 and December 31, 2018 by type of interest rate index:

Index	December 31, 2019		December 31, 2018	
	Fair Value	Portfolio Percentage	Fair Value	Portfolio Percentage
	(in thousands)		(in thousands)	
Agency MBS:				
One-month LIBOR	\$ 386	— %	\$ 448	— %
Six-month LIBOR	1,426	—	8,295	0.2
One-year LIBOR	767,275	18.5	1,463,081	33.7
Six-month certificate of deposit	297	—	379	—
One-year constant maturity treasury	17,552	0.4	71,485	1.6
Cost of Funds Index	2,532	0.1	3,717	0.1
15-year fixed-rate	48,226	1.2	892,451	20.5
20-year fixed-rate	194,577	4.7	366,502	8.5
30-year fixed-rate	2,477,780	59.6	742,361	17.1
Total Agency MBS	<u>\$ 3,510,051</u>	<u>84.5 %</u>	<u>\$ 3,548,719</u>	<u>81.7 %</u>
Non-Agency MBS	643,610	15.5	795,203	18.3
Total MBS	<u>\$ 4,153,661</u>	<u>100.0 %</u>	<u>\$ 4,343,922</u>	<u>100.0 %</u>

The fair values indicated do not include interest earned but not yet paid. With respect to our hybrid adjustable-rate Agency MBS, the fair value of these securities appears on the line associated with the index based on which the security will eventually reset once the initial fixed interest rate period has expired. The fair value of our MBS is reported to us independently, either from third-party pricing services or from dealers who are major financial institutions and are considered to be market makers for these types of instruments. For more detail on the fair value of our MBS, see Note 9 to the accompanying consolidated financial statements.

Agency MBS

The weighted average coupon and average amortized cost of our Agency MBS at December 31, 2019, September 30, 2019, June 30, 2019, March 31, 2019, and December 31, 2018 were as follows:

	December 31, 2019	September 30, 2019	June 30, 2019	March 31, 2019	December 31, 2018
Agency MBS Portfolio:					

Weighted Average Coupon:

Adjustable-rate Agency MBS	3.95 %	3.96 %	4.20 %	4.34 %	4.09 %
Hybrid adjustable-rate Agency MBS	2.78	2.71	2.53	2.52	2.52
15-year fixed-rate Agency MBS	3.50	3.50	3.50	3.13	2.90
20-year fixed-rate Agency MBS	3.56	3.56	3.56	3.70	3.69
30-year fixed-rate Agency MBS	3.56	3.85	4.02	4.05	4.04
Total Agency MBS	3.54 %	3.69 %	3.73 %	3.75 %	3.44 %
Average Amortized Cost:					
Adjustable-rate Agency MBS	102.04 %	102.29 %	102.38 %	102.67 %	102.65 %
Hybrid adjustable-rate Agency MBS	102.11	102.25	102.40	102.53	102.49
15-year fixed-rate Agency MBS	101.81	101.82	101.88	102.06	102.28
20-year fixed-rate Agency MBS	103.96	104.09	104.21	104.02	104.48
30-year fixed-rate Agency MBS	102.33	102.39	102.64	102.73	102.90
Total Agency MBS	102.35 %	102.46 %	102.64 %	102.74 %	102.73 %
Current yield on Agency MBS (weighted average coupon divided by average amortized cost)	3.46 %	3.60 %	3.64 %	3.65 %	3.35 %

At December 31, 2019 and December 31, 2018, the unamortized net premium paid for our Agency MBS was approximately \$79.4 million and \$95.2 million, respectively.

At December 31, 2019, the current yield on our Agency MBS increased to 3.46% from 3.35% at December 31, 2018. This was due primarily to the increase in the weighted average coupon. As noted in the trend above, the weighted average coupon has increased by approximately 10 basis points from December 31, 2018. During the three months ended December 31, 2019, the weighted average coupon for our total Agency MBS decreased by 15 basis points, due primarily to the decrease in the coupon on 30-year fixed-rate MBS. One of the factors that also impact the reported yield on our MBS portfolio is the actual prepayment rate on the underlying mortgages. We analyze our MBS and the extent to which prepayments impact the yield. When the rate of prepayments exceeds expectations, we amortize the premiums paid on mortgage assets over a shorter time period, resulting in a reduced yield to maturity on our mortgage assets. Conversely, if actual prepayments are less than the assumed constant prepayment rate, the premium would be amortized over a longer time period, resulting in a higher yield to maturity.

Non-Agency MBS

Non-Agency MBS yields are based on our estimate of the timing and amount of future cash flows and our cost basis. Our cash flow estimates for these investments are based on our observations of current information and events and include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses and other factors.

Non-Agency MBS include the following types of securities:

- *Legacy Non-Agency MBS* – These are collateralized by loans that were generally originated prior to the 2008 financial crisis and, therefore, trade at a deep discount due to having experienced a significant amount of high levels of defaults by the underlying borrowers. While these underlying loans will generally experience losses, the securities were generally acquired at deep discounts to face/par value, which we believe serves to mitigate this potential exposure to credit risk.

Table of Contents

- *Non-performing* – These are collateralized by loans that were generally originated prior to 2008 and have been repackaged into newer securitization pools. They may or may not be currently non-performing or delinquent but there is a higher expectation of loss on these loans. Resolution of these loans typically occurs from loan modifications, short sales, and foreclosures. These loan pools usually have a greater degree of overcollateralization to support the securities.
- *Credit Risk Transfer* – These securities are designed to synthetically transfer mortgage credit risk from Fannie Mae, Freddie Mac, and other issuers to private investors. As loans default, the securities may incur principal write-downs. These are allocated to the tranches within a deal according to the cash flow structure of the securities.

The following table summarizes our Non-Agency MBS portfolio by type at December 31, 2019 and December 31, 2018:

December 31, 2019

Portfolio Type	Fair Value	Amortized Cost	Contractual Principal	Weighted Average		
				Amortized Cost	Coupon	Yield

		(in thousands)							
Legacy Non-Agency MBS	\$	497,408	\$	477,786	\$	655,447	73 %	5.52 %	5.49 %
Non-performing		11,052		10,938		11,000	99	5.50	6.05
Credit Risk Transfer		135,150		124,852		135,489	92	4.20	5.80
Total Non-Agency MBS	\$	643,610	\$	613,576	\$	801,936	77 %	5.30 %	5.56 %

December 31, 2018

Portfolio Type	Fair Value	Amortized Cost	Contractual Principal	Weighted Average		
				Amortized Cost	Coupon	Yield
		(in thousands)				
Legacy Non-Agency MBS	\$ 561,940	\$ 553,292	\$ 738,210	75 %	5.56 %	5.57 %
Non-performing	101,744	102,450	102,760	99	5.14	5.42
Credit Risk Transfer	131,519	129,898	141,839	92	4.30	5.72
Total Non-Agency MBS	\$ 795,203	\$ 785,640	\$ 982,809	80 %	5.34 %	5.58 %

At December 31, 2019 and December 31, 2018, the unamortized net discount on our Non-Agency MBS was approximately \$188.4 million and \$197.2 million, respectively.

Financing

The following information pertains to our repurchase agreement borrowings at December 31, 2019, September 30, 2019, June 30, 2019, March 31, 2019, December 31, 2018, and December 31, 2017:

	December 31, 2019	September 30, 2019	June 30, 2019	March 31, 2019	December 31, 2018	December 31, 2017
	(dollar amounts in thousands)					
Total repurchase agreements outstanding	\$ 3,657,873	\$ 3,255,102	\$ 3,155,843	\$ 3,760,634	\$ 3,811,627	\$ 4,365,695
Average repurchase agreements outstanding during the quarter	\$ 3,322,672	\$ 3,227,250	\$ 3,606,154	\$ 3,910,458	\$ 3,891,158	\$ 4,424,295
Average repurchase agreements outstanding during the year	\$ 3,516,634	\$ N/A	\$ N/A	\$ N/A	\$ 4,110,250	\$ 3,994,507
Maximum monthly amount during the quarter	\$ 3,657,873	\$ 3,255,102	\$ 4,048,665	\$ 4,214,226	\$ 3,914,585	\$ 4,434,518
Maximum monthly amount during the year	\$ 4,214,226	\$ N/A	\$ N/A	\$ N/A	\$ 4,357,754	\$ 4,434,518
Average interest rate on outstanding repurchase agreements	2.07 %	2.41 %	2.76 %	2.81 %	2.67 %	1.64 %
Average days to maturity	28 days	31 days	26 days	31 days	32 days	31 days
Average interest rate after adjusting for interest rate swaps	2.13 %	2.34 %	2.38 %	2.32 %	2.23 %	1.77 %
Weighted average maturity after adjusting for interest rate swaps	978 days	940 days	1,198 days	1,222 days	1,217 days	674 days

At December 31, 2019, the repurchase agreements had the following balances, weighted average interest rates, and remaining weighted average maturities:

	Agency MBS		Non-Agency MBS		Total MBS	
	Balance	Weighted Average Interest Rate	Balance	Weighted Average Interest Rate	Balance	Weighted Average Interest Rate
	(in thousands)		(in thousands)		(in thousands)	
Overnight	\$ —	— %	\$ —	— %	\$ —	— %
Less than 30 days	1,680,000	2.04	427,873	2.80	2,107,873	2.20

30 days to 90 days	1,550,000	1.89	—	—	1,550,000	1.89
Over 90 days	—	—	—	—	—	—
Demand	—	—	—	—	—	—
	<u>\$ 3,230,000</u>	<u>1.97 %</u>	<u>\$ 427,873</u>	<u>2.80 %</u>	<u>\$ 3,657,873</u>	<u>2.07 %</u>
Weighted average maturity	30 days		11 days		28 days	
Weighted average interest rate after adjusting for interest rate swaps					2.13 %	
Weighted average maturity after adjusting for interest rate swaps					978 days	
MBS pledged as collateral under the repurchase agreements and interest rate swaps	\$ 3,419,375		\$ 535,315		\$ 3,954,690	

79

[Table of Contents](#)

At December 31, 2018, the repurchase agreements had the following balances, weighted average interest rates, and remaining weighted average maturities:

	Agency MBS		Non-Agency MBS		Total MBS	
	Balance	Weighted Average Interest Rate	Balance	Weighted Average Interest Rate	Balance	Weighted Average Interest Rate
	(in thousands)		(in thousands)		(in thousands)	
Overnight	\$ —	— %	\$ —	— %	\$ —	— %
Less than 30 days	1,510,000	2.46	576,627	3.55	2,086,627	2.76
30 days to 90 days	1,725,000	2.57	—	—	1,725,000	2.57
Over 90 days	—	—	—	—	—	—
Demand	—	—	—	—	—	—
	<u>\$ 3,235,000</u>	<u>2.52 %</u>	<u>\$ 576,627</u>	<u>3.55 %</u>	<u>\$ 3,811,627</u>	<u>2.67 %</u>
Weighted average maturity	35 days		13 days		32 days	
Weighted average interest rate after adjusting for interest rate swaps					2.23 %	
Weighted average maturity after adjusting for interest rate swaps					1,217 days	
MBS pledged as collateral under the repurchase agreements and interest rate swaps	\$ 3,433,252		\$ 726,428		\$ 4,159,680	

The average interest rate on outstanding repurchase agreements, after adjusting for interest rate swap transactions, decreased from 2.23% at December 31, 2018 to 2.13% at December 31, 2019. The decrease was due primarily to a reduction in the swap weighted average interest rate, from 2.10% at December 31, 2018 to 2.02% at December 31, 2019. The weighted average term to next rate adjustment after adjusting for interest rate swap transactions decreased from 1,217 days at December 31, 2018 to 978 days at December 31, 2019. This was due primarily to the decrease in the average notional amount of swap agreements, which had a lesser effect at December 31, 2019 than at December 31, 2018 on extending the average maturity of our borrowings, as shown in the table under “Hedging Strategies.”

Residential Mortgage Loans Held-for-Securitization

At December 31, 2019, we owned approximately \$152.9 million of residential mortgage loans which are being held until we have a sufficient quantity for securitization. Non-QM loans do not comply with the rules of the Consumer Financial Protection Bureau, or the CFPB, relating to Qualified Mortgages. Post-crisis, the CFPB issued rules on what is required for a loan to be qualified as a Qualified Mortgage, or QM. These rules have certain requirements, such as debt-to-income ratio, being fully-amortizing, and limits on loan fees. Non-QM loans do not comply with at least one of these requirements, but that does not necessarily imply that they carry more risk. Even though these loans may not have traditional documentation of income, such as a Form W-2 or paychecks, they generally have stated income and may have alternate documentation, such as bank statements, CPA letters, or tax returns. The loans we are acquiring have high FICO scores, as well as other strong borrower attributes, which are factors we analyze in making acquisitions. See Note 6, “Residential Mortgage Loans Held-for-Securitization,” to our accompanying consolidated financial statements for more information regarding the residential mortgage loans held-for-securitization.

These loans are financed by a warehouse line of credit. At December 31, 2019, the amount outstanding on this line of credit (including warehouse transaction costs) was \$133.8 million. As this line of credit started in 2019, there was no amount outstanding at December 31, 2018. The interest rate on the amounts advanced under this line of credit is at LIBOR + 2.25%, which was approximately 4.46% for the year ended December 31, 2019. Additionally, we paid a facility fee on this line of credit, which was approximately \$654 thousand for the year ended December 31, 2019. The facility fee plus legal fees paid to secure this line of credit is being amortized over one year. See Note 9, “Fair Values of Financial Instruments,” to our accompanying consolidated financial statements for more information regarding the fair value of these investments and their related financing.

80

Residential Mortgage Loans Held-for-Investment Through Consolidated Securitization Trusts

At December 31, 2019, we owned approximately \$9.4 million in net interests on certain securitization trusts. The underlying mortgage loans held in the securitization trusts (classified as residential mortgage loans held-for-investment through consolidated securitization trusts) and the related financing (asset-backed securities issued by the securitization trusts) are consolidated on our consolidated balance sheets and are carried at cost. See Note 4 to the consolidated financial statements for more information regarding consolidation of the securitization trusts. See Note 9 to the accompanying consolidated financial statements for more information regarding the fair value of these investments and their related financing.

Residential Properties Portfolio

At December 31, 2019, we owned 85 single-family residential properties which are all located in Southeastern Florida and are carried at a total cost, net of accumulated depreciation, of approximately \$13.5 million. During the year ended December 31, 2019, we sold one of our residential properties for a gain of approximately \$31 thousand. At December 31, 2018, we owned 86 single-family residential properties which were carried at a total cost, net of accumulated depreciation, of approximately \$13.8 million. During the year ended December 31, 2018, we sold two of our residential properties for a gain of approximately \$54 thousand.

Hedging Strategies

As we intend to hedge our exposure to rising rates on funds borrowed to finance our investments in securities, we periodically enter into derivative transactions, primarily in the form of interest rate swaps. We designate interest rate swaps as cash flow hedges for tax purposes. To the extent that we enter into hedging transactions to reduce our interest rate risk on indebtedness incurred to acquire or carry real estate assets, any income or gain from the disposition of hedging transactions should be qualifying income under the REIT rules for purposes of the 75% and 95% gross income test. To qualify for this exclusion, the hedging transaction must be clearly identified as such before the close of the day on which it was acquired, originated or entered into.

As part of our asset/liability management policy, we may enter into hedging agreements, such as interest rate swaps. These agreements are entered into to try to reduce interest rate risk and are designed to provide us with income and capital appreciation in the event of certain changes in interest rates. We review the need for hedging agreements on a regular basis consistent with our capital investment policy. Interest rate swaps are derivative instruments as defined by ASC 815-10. We do not anticipate entering into derivative transactions for speculative or trading purposes. In accordance with the swap agreements, we pay a fixed-rate of interest during the term of the interest rate swaps and we receive a payment that varies with the three-month LIBOR rate.

The following table pertains to all of our interest rate swaps at each quarter-end for the years ended December 31, 2019 and December 31, 2018:

	Year Ended December 31, 2019				Year Ended December 31, 2018			
	Q4	Q3	Q2	Q1	Q4	Q3	Q2	Q1
Aggregate notional amount of interest rate swaps	\$2.501 billion	\$2.191 billion	\$2.956 billion	\$3.356 billion	\$3.306 billion	\$3.331 billion	\$3.146 billion	\$3.081 billion
Average maturity of interest rate swaps	4.0 years	3.9 years	3.6 years	3.9 years	3.9 years	3.9 years	4.0 years	3.8 years
Weighted average fixed-rate paid on interest rate swaps	2.02 %	2.08 %	2.09 %	2.13 %	2.10 %	2.04 %	1.99 %	1.88 %

Interest rate swaps are used to provide protection from increases in interest rates having a negative impact on the market value of our portfolio that could result in our lenders requiring additional collateral for our repurchase agreement borrowings. An increase or decrease in the notional value of these agreements or contracts usually provides an increase or decrease in protection to our portfolio’s change in value due to interest rate changes. However, there are other methods that can also lessen our portfolio’s change in value due to interest rate increases. Among them are acquiring mortgages that are inherently less sensitive to interest rate changes and borrowings using long-term agreements.

After August 22, 2014, none of our interest rate swaps were designated for hedge accounting. For both terminated interest rate swaps and the de-designated interest rate swaps, as long as there is the probability that the forecasted transactions that were being hedged (i.e., rollovers of our repurchase agreement borrowings) are still expected to occur, the amount of the gain or loss in AOCI remains in AOCI and is amortized over the remaining term of the interest rate swaps. At December 31, 2019, the net unrealized loss in AOCI on the interest rate swaps was approximately \$7.6 million, as compared to an unrealized loss of approximately \$11.5 million at December 31, 2018.

At December 31, 2019, we had approximately \$250 million in notional amount of TBA Agency MBS. At December 31, 2018, we had approximately \$900 million in notional amount of TBA Agency MBS.

For more information on the amounts, policies, objectives and other qualitative data on our derivatives, see Notes 1, 9, and 15 to the accompanying consolidated financial statements.

Liquidity and Capital Resources

Agency MBS and Non-Agency MBS Portfolios

Our primary source of funds consists of repurchase agreements which totaled \$3.66 billion at December 31, 2019. As collateral for the repurchase agreements and interest rate swaps, we had pledged approximately \$3.42 billion in Agency MBS and approximately \$535 million in Non-Agency MBS. Our other significant sources of funds for the year ended December 31, 2019 consisted of payments of principal from our MBS portfolio in the amount of \$909.2 million and proceeds from the sales of MBS of approximately \$2.95 billion.

For the year ended December 31, 2019, there was a net increase in cash, cash equivalents, and restricted cash of approximately \$79.5 million. This consisted of the following components:

- Net cash provided by operating activities for the year ended December 31, 2019 was approximately \$64.7 million. This is comprised primarily of a net loss of \$55.4 million and adding back or subtracting the following non-cash items: the amortization of premium and discounts on Agency MBS of approximately \$26.8 million; accretion of discounts on Non-Agency MBS of approximately \$5.3 million; depreciation on rental properties of \$478 thousand; amortization of premium on residential loans of \$177 thousand; a realized loss on sales of MBS of approximately \$9.9 million; a loss on interest rate swaps of approximately \$98.9 million; the amortization of restricted stock of \$78 thousand; an impairment charge on Non-Agency MBS of approximately \$2.1 million; and net settlements on interest rate swaps, net of amortization, of approximately \$11.5 million; partially offset by a gain on derivatives, net of derivative income on TBA Agency MBS, of approximately \$14.2 million; an unrealized gain on Trading Agency MBS of approximately \$17.0 million; a gain on sale of residential properties of \$31 thousand; and accretion of discount of approximately \$116 thousand. Net cash provided by operating activities also included an increase in accrued expenses of approximately \$2.2 million; a decrease in interest receivable of approximately \$1.2 million; and a decrease in reverse repurchase agreements of approximately \$5 million, partially offset by an increase in prepaid expense of approximately \$8.3 million and a decrease in accrued interest payable of approximately \$3.8 million;
- Net cash provided by investing activities for the year ended December 31, 2019 was approximately \$108.4 million, which consisted of \$909.2 million from principal payments on MBS; proceeds from sales of MBS of approximately \$2.95 billion; payments on residential mortgage loans held-for-investment through consolidated securitization trusts of approximately \$121 thousand; principal payments on loans held-for-securitization of \$31 million; and sales of residential properties of approximately \$95 thousand, partially offset by purchases of MBS of approximately \$3.60 billion; purchases of loans held-for-securitization of approximately \$179.5 million; and improvements on residential properties of approximately \$362 thousand.
- Net cash (used in) financing activities for the year ended December 31, 2019 was approximately \$93.6 million. This consisted of borrowings on repurchase agreements of approximately \$32.30 billion, offset by repayments on repurchase agreements of approximately \$32.454 billion; borrowings on our warehouse line of credit of \$156.0 million, offset by repayments on the warehouse line of credit of \$22.2 million; proceeds from

sales of common stock of approximately \$1.4 million; net settlements on TBA Agency MBS of approximately \$19.7 million; and derivative counterparty margin of \$367 thousand, partially offset by dividends paid of \$46.4 million on common stock; dividends paid of approximately \$9.2 million on preferred stock; termination of interest rate swaps of \$39.2 million; and amortization of shelf offering expense of \$318 thousand.

Relative to our MBS portfolio at December 31, 2019, all of our repurchase agreements were fixed-rate term repurchase agreements with original maturities ranging from 27 days to 3 months. At December 31, 2019, we had borrowed funds under repurchase agreements with 18 different financial institutions. As the repurchase agreements mature, we enter into new repurchase agreements to take their place. Because we borrow money based on the fair value of our MBS and because increases in short-term interest rates or increasing market concern about the liquidity or value of our MBS can negatively impact the valuation of MBS, our borrowing ability could be reduced and lenders may initiate margin calls in the event short-term interest rates increase or the value of our MBS declines for other reasons. We had adequate cash flow, liquid assets and unpledged collateral with which to meet our margin requirements during the year ended December 31, 2019 but there can be no assurance we will have adequate cash flow, liquid assets and unpledged collateral with which to meet our margin requirements in the future.

Our leverage (including repurchase agreements and our warehouse line of credit, but excluding the ABS issued by securitization trusts) on total capital (including all preferred stock and junior subordinated notes) was 6.2x at December 31, 2019, which was also 6.2x at December 31, 2018.

In the future, we expect that our primary sources of funds will continue to consist of borrowed funds under repurchase agreement transactions and of monthly payments of principal and interest on our MBS portfolios. Our liquid assets generally consist of unpledged MBS, cash and cash equivalents. A large negative change in the market value of our MBS might reduce our liquidity, requiring us to sell assets with the likely result of realized losses upon sale.

During the year ended December 31, 2019, we raised approximately \$1.36 million in capital under our Dividend Reinvestment and Stock Purchase Plan.

At December 31, 2019, our authorized capital included 20 million shares of \$0.01 par value preferred stock, which we have classified as Series A Cumulative Preferred Stock, or Series A Preferred Stock, Series B Cumulative Convertible Preferred Stock, or Series B Preferred Stock, and Series C Cumulative Redeemable Preferred Stock, or Series C Preferred Stock.

On January 27, 2015, we completed a public offering of 300,000 shares of our Series C Preferred Stock at a public offering price of \$24.50 per share and received net proceeds of approximately \$7 million. The shares were sold pursuant to the Company's effective shelf registration statement on Form S-3. The Series C Preferred Stock has no maturity date and is not subject to any sinking fund or mandatory redemption. On or after January 27, 2020, we may, at our option, redeem the Series C Preferred Stock for cash, in whole or from time to time in part, at a redemption price of \$25.00 per share plus accrued and unpaid dividends, if any, to the redemption date.

On August 10, 2016, we entered into an At Market Issuance Sales Agreement, or the FBR Sales Agreement, with FBR Capital Markets & Co., or FBR, pursuant to which we may offer and sell from time to time through FBR, as our agent, up to \$196,615,000 maximum aggregate amount of our common stock, Series B Preferred Stock, and Series C Preferred Stock, in such amounts as we may specify by notice to FBR, in accordance with the terms and conditions set forth in the FBR Sales Agreement. During the year ended December 31, 2019, we did not sell any shares of stock under the FBR Sales Agreement. At December 31, 2019, there was approximately \$152.7 million available for sale and issuance under the FBR Sales Agreement.

On October 3, 2011, we announced that our Board had authorized a share repurchase program which permitted us to acquire up to 2,000,000 shares of our common stock. The shares are expected to be acquired at prevailing prices through open market transactions. Our Board also authorized the Company to purchase an amount of our common stock up to the amount of common stock sold through our Dividend Reinvestment and Stock Purchase Plan. Subsequently, our Board authorized the Company to acquire an aggregate of an additional 45,000,000 shares (pursuant to six separate

[Table of Contents](#)

authorizations) between December 13, 2013 and January 22, 2016. In November 2019, our Board decided to no longer include the amount of common stock sold through our Dividend Reinvestment and Stock Purchase Plan as stock available for repurchase. During the year ended December 31, 2019, we did not repurchase any shares of our common stock under our share repurchase program.

Disclosure of Contractual Obligations

The following table represents the contractual obligations of the Company at December 31, 2019:

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
	(in thousands)				
Repurchase agreements ⁽¹⁾	\$ 3,657,873	\$ 3,657,873	\$ —	\$ —	\$ —
Warehouse line of credit	133,811	133,811	—	—	—
Junior subordinated notes ⁽²⁾	37,380	—	—	—	37,380
Lease commitment	1,353	530	823	—	—
Total	<u>\$ 3,830,417</u>	<u>\$ 3,792,214</u>	<u>\$ 823</u>	<u>\$ —</u>	<u>\$ 37,380</u>

- (1) These represent amounts due by maturity.
- (2) These represent amounts due by contractual maturity. However, we do have the option to redeem these as more fully described in Note 8 to the accompanying consolidated financial statements.

Stockholders’ Equity

We use available-for-sale treatment for most of our Agency MBS and for our Non-Agency MBS, which are carried on our balance sheets at fair value rather than historical cost. Based upon this treatment, our total equity base at December 31, 2019 was \$552.5 million. Common stockholders’ equity was approximately \$454.2 million, or a book value of \$4.60 per share. Common stockholders’ equity serves as the basis for how book value per common share is calculated.

Under our available-for-sale accounting treatment used for most of our MBS, unrealized fluctuations in fair values of assets are assessed to determine whether they are other-than-temporary. To the extent we determine that these unrealized fluctuations are not other-than-temporary, they do not impact GAAP income or taxable income but rather are reflected on the balance sheets by changing the carrying value of the assets and reflecting the change in stockholders’ equity under “accumulated other comprehensive income, unrealized gain (loss) on available-for-sale securities.”

As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting on all of our assets. As a result, comparisons with some companies that use historical cost accounting for all of their balance sheets may not be meaningful.

Unrealized changes in the fair value of MBS have one significant and direct effect on our potential earnings and dividends: positive fair value changes will increase our equity base and allow us to increase our borrowing capacity, while negative changes will tend to reduce borrowing capacity under our capital investment policy. A very large negative change in the net market value of our MBS might reduce our liquidity, requiring us to sell assets with the likely result of realized losses upon sale. “Accumulated other comprehensive income, unrealized gain” on available-for-sale Agency MBS was approximately \$43.6 million, or 1.26% of the amortized cost of our Agency MBS, at December 31, 2019. This, along with “Accumulated other comprehensive loss, derivatives” of approximately \$7.6 million, and “Accumulated other comprehensive income, unrealized gain on Non-Agency MBS” of approximately \$30.0 million, constitutes the total “Accumulated other comprehensive income” of approximately \$66.0 million.

Non-GAAP Financial Measures Related to Operating Results

In addition to the Company’s operating results presented in accordance with GAAP, the following tables include the following non-GAAP financial measures: core earnings (including per common share), total interest income, and

average asset yield, including TBA dollar roll income, paydown expense on Agency MBS, effective total interest expense, and effective cost of funds. The first table below reconciles the Company’s net loss to common stockholders for the year ended December 31, 2019 to core earnings for the same period. Core earnings represents net loss to common stockholders (which is the nearest comparable GAAP measure) adjusted for the items shown in the table below. The second table below reconciles the Company’s total interest and other income for the year ended December 31, 2019 (which is the nearest comparable GAAP measure) to the total interest income and average asset yield, including TBA dollar roll income and paydown expense on Agency MBS, and shows the annualized amounts as a percentage of the Company’s average earning assets, and also reconciles the Company’s total interest expense (which is the nearest comparable GAAP measure) to the effective total interest expense and effective cost of funds and shows the annualized amounts as a percentage of the Company’s average borrowings.

The Company’s management believes that:

- these non-GAAP financial measures are useful because they provide investors with greater transparency to the information that the Company uses in its financial and operational decision-making process;
- the inclusion of paydown expense on Agency MBS is more indicative of the current earnings potential of the Company’s investment portfolio, as it reflects the actual principal paydowns which occurred during the period. Paydown expense on Agency MBS is not dependent on future assumptions on prepayments or the cumulative effect from prior periods of any current changes to those assumptions, as is the case with the GAAP measure, “Premium amortization on Agency MBS”;
- the adjustment for depreciation expense on residential rental properties is a non-cash item, as this is added back by other companies to derive funds from operations; and
- the presentation of these measures, when analyzed in conjunction with the Company’s GAAP operating results, allows investors to more effectively evaluate the Company’s performance to that of its peers, particularly those that have discontinued hedge accounting and those that have used similar portfolio and derivative strategies.

These non-GAAP financial measures should not be used as a substitute for the Company’s operating results for the year ended December 31, 2019. An analysis of any non-GAAP financial measure should be used in conjunction with results presented in accordance with GAAP.

	Year ended	
	December 31, 2019	
	Amount	Per Share
	(in thousands)	
Net (loss) to common stockholders	\$ (64,608)	\$ (0.65)
Adjustments to derive core earnings:		
Realized net loss on sales of MBS	9,770	0.10
Impairment charge on Non-Agency MBS ⁽¹⁾	2,108	0.02
Unrealized (gain) on Agency MBS held as trading investments	(17,036)	(0.17)
Unrealized loss on interest rate swaps, net	98,907	1.00
(Gain) on derivatives-TBA Agency MBS, net	(14,166)	(0.14)
(Gain) on sales of residential properties	(31)	—
Net settlement on interest rate swaps after de-designation ⁽²⁾	11,459	0.12
Dollar roll income on TBA Agency MBS ⁽³⁾	4,885	0.05
Premium amortization on MBS	26,820	0.27
Paydown expense ⁽⁴⁾	(22,253)	(0.23)
Depreciation expense on residential rental properties ⁽⁵⁾	478	—
Core earnings	\$ 36,333	\$ 0.37
Basic weighted average number of shares outstanding	98,739	

- (1) Impairment charge on Non-Agency MBS represents the amount applied against current GAAP earnings when future loss expectations exceed previously-existing loss expectations. When future loss expectations become less than previously existing loss expectations, the difference would be amortized into earnings over the life of the security.
- (2) Net settlement on interest rate swaps after de-designation include all subsequent net payments made on interest rate swaps which were de-designated as hedges in August 2014 and are recorded in “(Loss) gain on interest rate swaps, net.”
- (3) Dollar roll income on TBA Agency MBS is the income resulting from the price discount typically obtained by extending the settlement of TBA Agency MBS to a later date. This is a component of both the “(Loss) gain on derivatives, net” that are shown on the Company’s financial statements.
- (4) Paydown expense on Agency MBS represents the proportional expense of Agency MBS purchase premiums relative to the Agency MBS principal payments and prepayments which occurred during the quarter.
- (5) Depreciation expense is added back in the core earnings calculation, as it is a non-cash item, and it is similarly added back in other companies’ calculation of core earnings or funds from operations.

[Table of Contents](#)

Effective Net Interest Rate Spread

	Year Ended December 31, 2019	
	Amount	Annualized Percentage
	(in thousands)	
Average Asset Yield, Including TBA Dollar Roll Income:		
Total interest income	\$ 154,395	3.39 %
Income-rental properties	1,800	0.04
Dollar roll income on TBA Agency MBS ⁽¹⁾	4,885	0.11
Premium amortization on Agency MBS	26,820	0.59
Paydown expense ⁽²⁾	(22,253)	(0.49)
Less: Other income	(1,427)	(0.03)
Total interest and other income and average asset yield, including TBA dollar roll income	<u>\$ 164,220</u>	<u>3.61 %</u>
Effective Cost of Funds:		
Total interest expense	\$ 118,756	2.91 %
Net settlement on interest rate swaps after de-designation ⁽³⁾	(11,459)	(0.28)
Effective total interest expense and effective cost of funds	<u>\$ 107,297</u>	<u>2.63 %</u>
Effective net interest rate spread		<u>0.98 %</u>
Average earning assets	\$ 4,549,322	
Average borrowings	<u>\$ 4,081,213</u>	

- (1) Dollar roll income on TBA Agency MBS is the income resulting from the price discount typically obtained by extending the settlement of TBA Agency MBS to a later date. This is a component of the “(Loss) on derivatives, net” that is shown on the Company’s statements of operations.
- (2) Paydown expense on Agency MBS represents the proportional expense of Agency MBS purchase premiums relative to the Agency MBS principal payments and prepayments which occurred during the quarter.
- (3) Net settlement on interest rate swaps after de-designation include all subsequent net payments made on interest rate swaps which were de-designated as hedges in August 2014 and are recorded in “(Loss) gain on interest rate swaps, net,” which is a component of the “Loss on derivatives, net” shown on the Company’s consolidated statements of operations.

Critical Accounting Policies and Estimates

Management has the obligation to ensure that its policies and methodologies are in accordance with GAAP. Management has reviewed and evaluated its critical accounting policies and believes them to be appropriate.

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying consolidated financial statements. In preparing these consolidated financial statements, management has made its best estimates and judgments on the basis of information then readily available to it of certain amounts included in the consolidated financial statements, giving due consideration to materiality. Application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ materially and adversely from these estimates.

Our accounting policies are described in Note 1 to the accompanying consolidated financial statements. Management believes the more significant of our accounting policies are the following:

Revenue Recognition

The most significant source of our revenue is derived from our investments in MBS. We reflect income using the effective yield method which, through amortization of premiums and accretion of discounts at an effective yield, recognizes periodic income over the estimated life of the investment on a constant yield basis, as adjusted for actual prepayment activity and estimated prepayments. Management believes our revenue recognition policies are appropriate to reflect the substance of the underlying transactions.

Interest income on our Agency MBS is accrued based on the actual coupon rate and the outstanding principal amounts of the underlying mortgages. Premiums and discounts are amortized or accreted into interest income over the expected lives of the securities using the effective interest yield method, adjusted for the effects of actual prepayments and estimated prepayments based on ASC 320-10.

Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, street consensus prepayment speeds and current market conditions. If our estimate of prepayments is incorrect, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income, which could be material and adverse.

For a majority of the Non-Agency MBS purchased at a discount, these are accounted for under “Loans and Debt Securities Acquired with Credit Deterioration” (ASC 310-30). A debt security accounted for under ASC 310-30 is initially recorded at its purchase price (fair value). The amount of expected cash flows that exceed the initial investment represents the market yield adjustment, which is recognized as interest income on a level yield basis over the life of the security. The excess of total contractual principal over the cash flows expected at its origination is considered to be non-accretable yield. The Company must periodically reassess the expected cash flows of loans accounted for under ASC 310-30 along with the cash flows received. A significant increase in expected cash flows must be accounted for as an increase in the rate of accretion over the remaining life of the security. Conversely, if expected cash flows decrease, an other-than-temporary impairment must be recognized as a charge to earnings. Adjustments to the fair value of Non-Agency MBS, accounted for as available-for-sale securities, are recorded in “accumulated other comprehensive income,” or AOCI. The determination as to whether impairment and market yield adjustment exists is based on cash flow projections related to the securities. As a result, the timing and amount of impairment and market yield adjustment constitutes a material estimate that is susceptible to significant change.

The Company has reviewed ASU 2014-09, “Revenue From Contracts With Customers” and its related pronouncements and guidelines. This ASU became effective beginning with the quarter ended March 31, 2018 and did not have a material impact on our financial statements. Our revenue streams are from investments in MBS and residential mortgage loans. These are considered financial instruments under ASU 2014-09 and are excluded from the scope of this ASU, as they are covered under various other ASC topics. A smaller portion of our business is the ownership and rental of residential properties. These residential properties leases are also excluded from ASU 2014-09, as they are covered under ASC 840, “Leases.” All of our leases are short-term, being one year or less.

Valuation and Classification of Investment Securities

We carry our investment securities on our balance sheet at fair value. The fair values of our Agency MBS are generally based on third party bid price indications provided by independent brokers and independent third party pricing services. If, in the opinion of management, one or more securities prices reported to us are not reliable or unavailable, management reviews the fair value based on characteristics of the security it receives from the issuer and available market information. The fair values reported reflect estimates and may not necessarily be indicative of the amounts we could realize in a current market exchange. We review various factors (i.e., expected cash flows, changes in interest rates, credit protection, etc.) in determining whether and to what extent an other-than-temporary impairment exists. To the extent that unrealized losses on our Agency MBS are attributable to changes in interest rates and not credit quality, and because we did not have the intent at December 31, 2019 to sell these investments, nor is it not more likely than not that we will be required to sell these investments before recovery of their amortized cost bases, which may be at maturity, we do not consider these investments to be other-than-temporarily impaired. Losses (that are related to credit quality) on securities classified as available-for-sale, which are determined by management to be other-than-temporary in nature, are reclassified from “Accumulated other comprehensive income (loss)” to current-period income (loss). Assets classified as trading investments are reported at fair value with unrealized gains and losses included in our consolidated statements of operations. For more detail on the fair value of our Agency MBS, see Note 9 to the accompanying consolidated financial statements.

In determining the fair value of our Non-Agency MBS, management considers a number of observable market data points, including prices obtained from well-known major financial brokers that make markets in these instruments, pricing from independent pricing services, and timely trading activity in the marketplace. Management reviews these

inputs in the valuation of our Non-Agency MBS. We understand that in order to determine the fair market value of a security, market participants not only consider the characteristics of the type of security and its underlying collateral but also take into consideration the historical performance data of the underlying collateral of that security including loan delinquency, loan losses and credit enhancement. In addition, we also collect and consider current market intelligence on all major markets, including benchmark security evaluations and bid list results from various sources. To the extent that unrealized losses on our Non-Agency MBS are attributable to changes in interest rates and not credit quality, and because we did not have the intent at December 31, 2019 to sell these investments, nor is it not more likely than not that we will be required to sell these investments before recovery of their amortized cost bases, which may be at maturity, we do not consider these investments to be other-than-temporarily impaired. Losses (that are related to credit quality) on securities classified as available-for-sale, which are determined by management to be other-than-temporary in nature, are reclassified from “accumulated other comprehensive income (loss)” to current-period income (loss). For more detail on the fair value of our Non-Agency MBS, see Note 9 to the accompanying consolidated financial statements.

Our MBS are valued using various market data points as described above, which management considers to be directly or indirectly observable parameters. Accordingly, our MBS are classified as Level 2 in the fair value hierarchy.

Residential Mortgage Loans Held-for-Securitization

Residential mortgage loans held for securitization are held at our wholly-owned subsidiary, Anworth Mortgage Loans, Inc. (incorporated August 2017) with the intent to sponsor our own securitizations. Loans purchased with the intent to securitize are recorded on the trade date. Any fees associated with acquiring the loans held for securitization are deferred as well as any premium paid to acquire the loans. These are included in the loan balance and amortized using the effective interest yield method. Upon securitization, the costs of securitization such as underwriting fees, legal fees, and accounting fees are added to the loan balances and amortized using the effective interest yield method. Interest income is recorded as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due, at which point the loan is placed on nonaccrual status. When a non-accrual loan has cured, meaning all delinquent principal and interest has been remitted by the borrower; the loan is placed back on accrual status. Alternatively, nonaccrual loans may be placed back on accrual status after the loan is considered re-performing, generally when the loan has been current for 6 months.

The residential mortgage loans held for securitization are financed by a warehouse line of credit. Under this borrowing facility, we make various representations and warranties and the loans must also meet certain eligibility criteria. We may be required to remove a loan from a warehouse line of credit. The company does not maintain a loan repurchase reserve, as any risk of loss due to loan repurchase would normally be covered by recourse to the companies from whom we acquired the loans.

Residential Mortgage Loans Held-for-Investment Through Consolidated Securitization Trusts

Residential mortgage loans held-for-investment through consolidated securitization trusts are carried at unpaid principal balance net of any allowance for loan losses. These estimates for the allowance for loan losses require consideration of various observable inputs including, but not limited to, historical loss experience, delinquency status, borrower credit scores, geographic concentrations and loan-to-value ratios, and are adjusted for current economic conditions as deemed necessary by management. Many of these factors are subjective and cannot be reduced to a mathematical formula. In addition, since we have not incurred any direct losses on our portfolio, we review national historical credit performance information from external sources to assist in our analysis. Changes in our estimates can significantly impact the allowance for loan losses and provision expense. The allowance reflects management’s best estimate of the credit losses inherent in the loan portfolio at the balance sheet date. It is also possible that we will experience credit losses that are different from our current estimates or that the time of those losses may differ from our estimates.

[Table of Contents](#)

Accounting for Derivatives and Hedging Activities

In accordance with ASC 815, we recognize all derivatives as either assets or liabilities and we measure these investments at fair value. Changes in fair value for derivatives not designated as hedges are recorded in our consolidated statements of operations as “Gain (loss) on derivatives.”

In accordance with ASC 815-10, a derivative that is designated as a hedge is recognized as an asset/liability and measured at estimated fair value. In order for our interest rate swap agreements to qualify for hedge accounting, upon entering into the swap agreement, we must anticipate that the hedge will be highly “effective,” as defined by ASC 815-10.

Prior to March 18, 2014 and August 22, 2014, when on those dates we de-designated our interest rate swaps from hedge accounting, on the date we entered into a derivative contract, we designated the derivative as a hedge of the variability of cash flows that were to be received or paid in connection with a recognized asset or liability (a “cash flow” hedge). Changes in the fair value of a derivative that were highly effective and that were designated and qualified as a cash flow hedge, to the extent that the hedge was effective, were recorded in “other comprehensive income” and reclassified to income when the forecasted transaction affected income (e.g., when periodic settlement interest payments were due on repurchase agreements). The swap agreements were carried on our balance sheets at their fair value based on values obtained from large financial institutions who were market makers for these types of instruments. Hedge ineffectiveness, if any, was recorded in current-period income.

We formally assessed, both at the hedge’s inception and on an ongoing basis, whether the derivatives that were used in hedging transactions were highly effective in offsetting changes in the cash flows of hedged items and whether those derivatives were expected to remain highly effective in future periods. If it was determined that a derivative was not (or ceased to be) highly effective as a hedge, we discontinued hedge accounting.

When we discontinued hedge accounting, the gain or loss on the derivative remained in “Accumulated other comprehensive income (loss)” and is reclassified into income when the forecasted transaction affects income. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, we carry the derivative at its fair value on our balance sheets, recognizing changes in the fair value in current-period income. At December 31, 2019, none of our derivative instruments were designated as hedges for accounting purposes.

For purposes of the cash flow statement, cash flows from derivative instruments were classified with the cash flows from the hedged item. Cash flows from derivatives that are not hedges are classified according to the underlying nature or purpose of the derivative. For more detail on our derivative instruments, see Notes 1, 9, and 15 to the accompanying consolidated financial statements.

Income Taxes

Our financial results do not reflect provisions for current or deferred income taxes. Management believes that we have and intend to continue to operate in a manner that will allow us to be taxed as a REIT and, as a result, management does not expect to pay substantial, if any, corporate level taxes. Many of these requirements, however, are highly technical and complex. If we were to fail to meet these requirements, we would be subject to federal income tax.

Recent Accounting Pronouncements

A description of recent accounting pronouncements, the date adoption is required and the impact on our consolidated financial statements is contained in Note 1 to the accompanying consolidated financial statements.

Government Activity

Developments Concerning Fannie Mae and Freddie Mac

Payments on the Agency MBS in which we invest are guaranteed by Fannie Mae and Freddie Mac, which are stockholder corporations chartered by Congress with a public mission to provide liquidity, stability, and affordability to the U.S. housing market. Since 2008, Fannie Mae and Freddie Mac have been regulated by the Federal Housing Finance Agency, or the FHFA, the U.S. Department of Housing and Urban Development, the SEC, and the U.S. Department of the Treasury, or the U.S. Treasury, and are currently operating under the conservatorship of the FHFA. The U.S. Treasury has agreed to support the continuing operations of Fannie Mae and Freddie Mac with any necessary capital contributions while in conservatorship. However, the U.S. government does not guarantee the securities or other obligations of Fannie Mae or Freddie Mac.

Over the past several years, separate legislation has been introduced in both houses of the U.S. Congress to wind-down or reform both of these agencies. None of these bills have garnered enough support for a vote. It is currently unknown if, and when, any of these bills would become law and, if they did, what impact that would have on housing finance in general and what the impact would be on the existing securities guaranteed by Fannie Mae and Freddie Mac, as well as the impact on the pricing, supply, liquidity, and value of the MBS in which we invest.

Actions of the Federal Reserve

At an emergency meeting held on March 3, 2020, the Fed Open Market Committee of the Federal Reserve, or the FOMC, cut the Fed Funds rate by one-half of one percent to a new target range of 1.00% to 1.25%. This move was designed to shield the U.S. economy from the impact of the Coronavirus outbreak. We cannot predict whether or when any other actions may occur, or what impact, if any, such actions could have on our business, results of operations, and financial condition. Any other actions could negatively affect the availability of financing and the quantity and quality of available products and/or cause changes in interest rates and the yield curve, any and each of which could materially adversely affect our business, results of operations and financial condition, as well as those of the entire mortgage sector in general.

Other Recent Activity

During the past several years, there have been continuing liquidity and credit concerns surrounding the mortgage markets and the general global economy. While the U.S. government and other foreign governments have taken various actions to address these concerns, there are also concerns about the ability of the U.S. government to reduce its budget deficit as well as possible future rating downgrades of U.S. sovereign debt and government-sponsored agency debt. In August 2019, Congress agreed to increase the spending caps by \$320 billion and also to remove the debt ceiling limit for two years. This bill was signed by President Trump. A failure by the U.S. government to reach agreement on future budgets and debt ceilings, reduce its budget deficit, or a future downgrade of U.S. sovereign debt and government-sponsored agencies' debt, could have a material adverse effect on the U.S. economy and the global economy. These events could have a material adverse effect on our borrowing costs, the availability of financing, and the liquidity and valuation of securities in general, and also on the securities in our portfolio.

Over the past several years, U.S. and British banking authorities assessed fines on several major financial institutions for LIBOR manipulation. LIBOR is an unregulated rate based on estimates that lenders submitted to the British Bankers' Association, a trade group that compiled the information and published daily the LIBOR rate. On February 1, 2014, the administration of LIBOR was transferred from the British Bankers' Association to the Intercontinental Exchange Benchmark Administration, or the IBA, following authorization by the Financial Conduct Authority (the United Kingdom regulators). In July 2017, the Financial Conduct Authority announced that by the end of 2021, LIBOR would be replaced with a more reliable alternative. At this time, we do not know what changes will be made by the Financial Conduct Authority. In the United States, the Alternative Refinance Rates Committee selected the Secured Overnight Financing Rate, or SOFR, an overnight secured U.S. Treasury repurchase agreement rate, as the new rate, and adopted a proposed transition plan for the change from U.S. LIBOR to SOFR. The calculation of LIBOR under the IBA is the average of the interest rates that some of the world's leading banks charge each other for short-term loans. It is unclear at this time as to how the change to another alternative to LIBOR will affect the interest rates that

repurchase agreement counterparties and lenders charge on borrowings in general and how they could specifically affect our borrowing agreements.

On June 23, 2016, the citizens of the United Kingdom, or the UK, voted to leave, or Brexit, the European Union, or the EU. The UK had two years from its formal notification of withdrawal (given on March 29, 2017) from the EU to negotiate a new treaty to replace the terms of its EU membership. The UK was due to leave the EU in March 2019 and EU leaders had adopted formal guidelines about the future relationship between the EU and the UK. It is unknown at this time what effects the Brexit vote and the UK/EU relationship will have on interest rates, on stock markets (over the longer term), and the effect on the U.S. economy and the global economy. However, the recent legislative victory by the Conservative Party and British Prime Minister Boris Johnson makes it more likely for a United States/UK free trade agreement to occur. The UK formerly left the EU on January 31, 2020.

On January 16, 2020, the U.S. Congress passed the USMCA trade agreement. This will become effective when the legislatures of the U.S., Mexico, and Canada all approve it. As both the U.S. and Mexico have already approved this trade agreement, it needs only the passage by the Canadian Parliament to become effective. It is believed that the USMCA trade agreement will be beneficial to U.S. workers, manufacturers, and farmers in particular, as well as improving trade relations amongst all three nations.

Subsequent Events

On January 2, 2020, the conversion rate of our Series B Preferred Stock increased from 5.5379 to 5.5992 shares of our common stock based upon the common stock dividend of \$0.09 per share that was declared on December 17, 2019.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We seek to manage the interest rate, market value, liquidity, prepayment and credit risks inherent in all financial instruments in a prudent manner designed to insure our longevity while, at the same time, seeking to provide an opportunity for stockholders to realize attractive total rates of return through ownership of our common stock. While we do not seek to avoid risk completely, we do seek, to the best of our ability, to assume risk that can be quantified from historical experience, to actively manage that risk, to earn sufficient returns to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

Interest Rate Risk

We primarily invest in adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage assets. Hybrid mortgages are ARMs that have a fixed interest rate for an initial period of time (typically one to ten years) and then convert to an adjustable-rate for the remaining loan term. Our debt obligations are generally repurchase agreements of limited duration that are periodically refinanced at current market rates.

ARMs are typically subject to periodic and lifetime interest rate caps that limit the amount an ARM interest rate can change during any given period. ARMs are also typically subject to a minimum interest rate payable. Our borrowings are not subject to similar restrictions. Hence, in a period of increasing interest rates, interest rates on our borrowings could increase without limitation, while the interest rates on our mortgage assets could be limited. This problem would be magnified to the extent we acquire mortgage assets that are not fully indexed. Further, some ARM assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. These factors could lower our net operating income or cause a net loss during periods of rising interest rates, which would negatively impact our liquidity, net income and our ability to make distributions to stockholders.

We fund the purchase of a substantial portion of our ARM assets with borrowings that have interest rates based on indices and repricing terms similar to, but of shorter maturities than, the interest rate indices and repricing terms of our mortgage assets. Thus, we anticipate that in most cases the interest rate indices and repricing terms of our mortgage assets and our funding sources will not be identical, thereby creating an interest rate mismatch between assets and

[Table of Contents](#)

liabilities. During periods of changing interest rates, such interest rate mismatches could negatively impact our net operating income, dividend yield and the market price of our common stock.

Most of our adjustable-rate assets are based on the one-year constant maturity treasury rate and the one-year LIBOR rate and our debt obligations are generally based on LIBOR. These indices generally move in the same direction, but there can be no assurance that this will continue to occur.

Our ARM assets and borrowings reset at various different dates for the specific asset or obligation. In general, the repricing of our debt obligations occurs more quickly than on our assets. Therefore, on average, our cost of funds may rise or fall more quickly than does our earnings rate on the assets.

Further, our net income may vary somewhat as the spread between one-month interest rates and six- and twelve-month interest rates varies.

We also fund the acquisition of fixed-rate MBS with short-term borrowings. During periods of rising interest rates, our costs associated with borrowings used to fund acquisitions of fixed-rate assets are subject to increases while the income we receive from these assets remains fixed. This reduces or could eliminate the net interest spread between the fixed-rate MBS that we purchase and our borrowings used to purchase them, which could negatively impact our net operating income.

At December 31, 2019 and December 31, 2018, our MBS and related borrowings will prospectively reprice based on the following time frames:

December 31, 2019

	Investments ₍₁₎		Borrowings	
	Amount	Percentage of	Amount	Percentage of
	(in thousands)	Total Investments	(in thousands)	Total Borrowings
Agency MBS Portfolio:				
Investment Type/Rate Reset Dates:				
15-year fixed-rate investments	\$ 48,226	1.2 %	\$ —	— %
20-year fixed-rate investments	194,577	4.7	—	—
30-year fixed-rate investments	2,477,780	59.6	—	—
Adjustable-Rate Investments/Obligations:				
Less than 3 months	62,788	1.5	3,230,000	88.3
Greater than 3 months and less than 1 year	429,685	10.3	—	—

Greater than 1 year and less than 3 years	68,650	1.7	—	—
Greater than 3 years and less than 5 years	126,949	3.1	—	—
Greater than 5 years	101,396	2.4	—	—
Non-Agency MBS Portfolio:				
Floating-rate MBS (less than 3 months) ⁽²⁾	42,978	1.0	427,873	11.7
Hybrid MBS	18,717	0.5	—	—
Fixed-rate MBS	581,915	14.0	—	—
Total MBS Portfolio	<u>\$ 4,153,661</u>	<u>100.0 %</u>	<u>\$ 3,657,873</u>	<u>100.0 %</u>

(1) Based on when they contractually reprice and do not reflect the effect of any prepayments.

(2) Floating-rate Non-Agency MBS are based on 1-month LIBOR.

[Table of Contents](#)

December 31, 2018

	Investments ⁽¹⁾		Borrowings	
	Amount (in thousands)	Percentage of Total Investments	Amount (in thousands)	Percentage of Total Borrowings
Agency MBS Portfolio:				
Investment Type/Rate Reset Dates:				
15-year fixed-rate investments	\$ 892,451	20.5 %	\$ —	— %
20-year fixed-rate investments	366,502	8.5	—	—
30-year fixed-rate investments	742,361	17.1	—	—
Adjustable-Rate Investments/Obligations:				
Less than 3 months	111,676	2.6	3,235,000	84.9
Greater than 3 months and less than 1 year	805,092	18.6	—	—
Greater than 1 year and less than 3 years	205,324	4.7	—	—
Greater than 3 years and less than 5 years	299,870	6.8	—	—
Greater than 5 years	125,443	2.9	—	—
Non-Agency MBS Portfolio:				
Floating-rate MBS (less than 3 months) ⁽²⁾	47,680	1.1	576,627	15.1
Hybrid MBS	22,190	0.5	—	—
Fixed-rate MBS	725,333	16.7	—	—
Total MBS Portfolio	<u>\$ 4,343,922</u>	<u>100.0 %</u>	<u>\$ 3,811,627</u>	<u>100.0 %</u>

(1) Based on when they contractually reprice and do not reflect the effect of any prepayments.

(2) Floating-rate Non-Agency MBS are based on 1-month LIBOR.

Market Risk

Market Value Risk

Most of our MBS are classified as available-for-sale assets. As such, they are reflected at fair value (i.e., market value) with the periodic adjustment to fair value (that is not considered to be an other-than-temporary impairment) reflected as part of “Accumulated other comprehensive income” that is included in the equity section of our balance sheet. The market value of our assets can fluctuate due to changes in interest rates and other factors. At December 31, 2019, the fair value adjustment of our MBS reflected in AOCI increased to a positive adjustment (other comprehensive income) of approximately \$73.6 million from a negative adjustment (other comprehensive loss) at December 31, 2018 of approximately \$(19.3) million.

Real Estate Risk

Non-Agency MBS and residential property values are subject to volatility and may be affected adversely by a number of factors including national, regional and local economic conditions; local real estate conditions (such as an oversupply of housing); changes or continued weakness in specific industry segments; construction quality; age and design; demographic factors; and retroactive changes to building or similar codes. Decreases in property values reduce the value of the collateral for mortgage loans and the potential proceeds available to borrowers to repay the loans, which could cause us to suffer losses on our Non-Agency MBS and loan investments.

Liquidity Risk

Our primary liquidity risk arises from financing long-maturity MBS with short-term debt. The interest rates on our borrowings generally adjust more frequently than the interest rates on our adjustable-rate MBS. For example, at December 31, 2019, our Agency MBS had a weighted average term to next rate adjustment of approximately 24 months while our borrowings had a weighted average term to next rate adjustment of 28 days. After adjusting for interest rate swap transactions, the weighted average term to next rate adjustment was 978 days. Accordingly, in a period of rising

[Table of Contents](#)

interest rates, our borrowing costs will usually increase faster than our interest earnings from MBS. As a result, we could experience a decrease in net income or a net loss during these periods. Our assets that are pledged to secure short-term borrowings are high-quality liquid assets. As a result, we have been able to roll over our short-term borrowings as they mature. There can be no assurance that we will always be able to roll over our short-term debt.

During the past several years, there have been continuing liquidity and credit concerns surrounding the mortgage markets and the general global economy. While the U.S. government and other foreign governments have taken various actions to address these concerns, there are also concerns about the ability of the U.S. government to reduce its budget deficit as well as possible future rating downgrades of U.S. sovereign debt and government-sponsored agency debt. In August 2019, Congress agreed to increase the spending caps by \$320 billion and also to remove the debt ceiling limit for two years. This bill was signed by President Trump. A failure by the U.S. government to reach agreement on future budgets and debt ceilings, reduce its budget deficit, or a future downgrade of U.S. sovereign debt and government-sponsored agencies' debt, could have a material adverse effect on the U.S. economy and the global economy. These events could have a material adverse effect on our borrowing costs, the availability of financing, and the liquidity and valuation of securities in general, and also on the securities in our portfolio. As a result, there continues to be concerns about the potential impact on product availability, liquidity, interest rates, and changes in the yield curve. While we have been able to meet all of our liquidity needs to date, there are still concerns in the mortgage sector about the availability of financing generally.

At December 31, 2019, we had unrestricted cash of approximately \$8.2 million, short-term reverse repurchase agreements of \$15.0 million, \$90.7 million in unpledged Agency MBS, and \$108.3 million in unpledged Non-Agency MBS available to meet margin calls on short-term borrowings that could be caused by asset value declines or changes in lender collateralization requirements.

Prepayment Risk

Prepayments are the full or partial repayment of principal prior to the original term to maturity of a mortgage loan and typically occur due to refinancing of mortgage loans. Prepayment rates on mortgage-related securities and mortgage loans vary from time to time and may cause changes in the amount of our net operating income. Prepayments of ARM loans usually can be expected to increase when mortgage interest rates fall below the then-current interest rates on such loans and decrease when mortgage interest rates exceed the then-current interest rate on such loans, although such effects are not entirely predictable. Prepayment rates may also be affected by the conditions in the housing and financial markets, general economic conditions and the relative interest rates on fixed-rate loans and ARM loans underlying MBS. The purchase prices of our mortgage-related investments are generally based upon assumptions regarding the expected amounts and rates of prepayments. Where slow prepayment assumptions are made, we may pay a premium for our mortgage-related investments. To the extent such assumptions differ from the actual amounts of prepayments, we could experience reduced earnings or losses. The total prepayment of any of our mortgage-related investments purchased at a premium by us would result in the immediate write-off of any remaining capitalized premium amount and a reduction of our net operating income by such amount. In addition, in the event that we are unable to acquire new mortgage-related investments to replace the prepaid mortgage-related investments, our financial condition, cash flows and results of operations could be harmed.

We often purchase mortgage-related assets that have a higher interest rate than the market interest rate at the time. In exchange for this higher interest rate, we must pay a premium over par value to acquire these assets. In accordance with accounting rules, we amortize this premium over the term of the mortgage-related investments. As we receive repayments of mortgage principal, we amortize the premium balances as a reduction to our income. If the mortgage loans underlying mortgage-related investments were prepaid at a faster rate than we anticipate, we would amortize the premium at a faster rate. This would reduce our income.

Credit Risk

We review credit risk and other risks of loss associated with each of our potential investments. In addition, we may diversify our portfolio of mortgage-related assets to avoid undue geographic, insurer, industry and certain other types of concentrations. We believe that our investment strategy will generally keep our risk of credit losses low to

[Table of Contents](#)

moderate. However, we retain the risk of potential credit losses on all of the loans underlying our Non-Agency MBS. With respect to our investments in Non-Agency MBS that are collateralized by non-performing loans, there is a high expectation of losses on these loans. Resolution of the loans typically comes from loan modifications, short sales and foreclosures. With respect to these Non-Agency MBS, our investments are senior in the credit structure and credit support contained in these MBS deal structures provides a level of protection from losses. We seek to manage the remaining credit risk through our pre-acquisition due diligence process and by factoring assumed credit losses into the purchase prices we pay for Non-Agency MBS. In addition, with respect to any particular target investment, we evaluate relative valuation, supply and demand trends, the shape of yield curves, prepayment rates, delinquency and default rates, recovery of various sectors and vintage of collateral. Nevertheless, unanticipated credit losses could adversely affect our operating results.

We retain the risk of potential credit losses on all of our residential mortgage loans held-for-securitization or held-for-investment through consolidated securitization trusts. We seek to manage this risk by reviewing key loan credit metrics including, but not limited to, payment status, current loan-to-value ratios, current borrower credit scores and debt yields. These characteristics assist us in determining the likelihood and severity of loan loss as well as prepayment and extension expectations. We then perform structural analysis under multiple scenarios to establish likely cash flow profiles and credit enhancement levels relative to collateral performance projections. This analysis allows us to quantify our opinions of credit quality and fundamental value, which are key drivers of portfolio management decisions.

General

Many assumptions are made to present the information in the tables below and, as such, there can be no assurance that assumed events will occur, or that other events that could affect the outcomes will not occur; therefore, the tables below and all related disclosures constitute forward-looking statements.

The analyses presented utilize assumptions and estimates based on management’s judgment and experience. Furthermore, future sales, acquisitions and restructuring could materially change the interest rate risk profile for us. The tables quantify the potential changes in net income and portfolio value should interest rates immediately change (are “shocked”) and remain at the new level for the next twelve months. The results of interest rate shocks of plus and minus 100 and 200 basis points are presented. The cash flows from our portfolio of mortgage-related assets for each rate shock scenario are projected, based on a variety of assumptions including prepayment speeds, time until coupon reset, yield on future acquisitions, slope of the yield curve and size of the portfolio. Assumptions made on the interest rate-sensitive liabilities, which are repurchase agreements, include anticipated interest rates (no negative rates are utilized), collateral requirements as a percent of the repurchase agreement and amount of borrowing. Assumptions made in calculating the impact on net asset value of interest rate shocks include projected changes in U.S. Treasury interest rates, prepayment rates and the yield spread of mortgage-related assets relative to prevailing U.S. Treasury interest rates.

Tabular Presentation

The information presented in the table below projects the impact of instantaneous parallel shifts in interest rates on our annual projected net interest income (relative to the unchanged interest rate scenario) and the impact of the same instantaneous parallel shifts on our projected MBS portfolio value (the value of our assets, including the value of any derivative instruments or hedges, such as interest rate swaps). These projections are based on investments in place at December 31, 2019 and include all of our interest rate sensitive assets, liabilities, and hedges, such as interest rate swaps.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change in Projected Portfolio Value
(2)%	(64)%	(1.3)%
(1)%	(36)%	(0.4)%
0 %	0 %	0 %
1 %	22 %	(1.1)%
2 %	41 %	(3.3)%

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements and related financial information required to be filed hereunder are indexed under Item 15 of this Annual Report on Form 10-K and are incorporated herein by reference.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls

We maintain disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

Our management, with the participation of our Principal Executive Officer and Principal Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Annual Report on Form 10-K. Based on such evaluation, our Principal Executive Officer and Principal Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective.

Management Report on Internal Control Over Financial Reporting

The management of Anworth is responsible for establishing and maintaining adequate internal control over financial reporting. Anworth’s internal control system was designed to provide reasonable assurance to the Company’s management and board of directors regarding the preparation and fair presentation of prepared financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Our management assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2019. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control—Integrated Framework* from 2013. Based on our assessment, we believe that, as of December 31, 2019, Anworth’s internal control over financial reporting is effective based on the criteria set forth in the 2013 COSO Framework.

The Company’s independent auditors, RSM US LLP, have issued an audit report on the effectiveness of the Company’s internal control over financial reporting. This report appears on the following page of this Annual Report on Form 10-K.

[Table of Contents](#)

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors
Anworth Mortgage Asset Corporation

Opinion on the Internal Control Over Financial Reporting

We have audited Anworth Mortgage Asset Corporation and its subsidiaries’ (the Company) internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of the Company as of December 31, 2019 and 2018, the related consolidated statements of operations, comprehensive income, stockholders’ equity and cash flows for each of the three years in the period ended December 31, 2019, and the related notes to the consolidated financial statements and schedules, and our report, dated March 5, 2020, expressed an unqualified opinion.

Basis for Opinion

The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting in the accompanying Item 9A, “Management Report on Internal Control over Financial Reporting.” Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ RSM US LLP
Los Angeles, California

Item 9B. OTHER INFORMATION

None.

PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference from the information under the captions entitled “Election of Directors—Information Regarding Nominees for Director,” “Executive Officers and Compensation” and “Other Matters—Section 16(a) Beneficial Ownership Reporting Compliance” in our definitive proxy statement to be filed with the SEC no later than April 29, 2020.

Item 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference from the information under the caption entitled “Executive Officers and Compensation” in our definitive proxy statement to be filed with the SEC no later than April 29, 2020.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Certain of the information required by this Item is incorporated by reference from the information under the caption entitled “Security Ownership of Certain Beneficial Owners and Management” in our definitive proxy statement to be filed with the SEC no later than April 29, 2020.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated by reference from the information under the caption entitled “Certain Relationships and Related Transactions” in our definitive proxy statement to be filed with the SEC no later than April 29, 2020.

Item 14. AUDIT FEES AND SERVICES

The information required by this Item is incorporated by reference from the information under the caption entitled “Audit Committee Report—Audit and Related Fees” in our definitive proxy statement to be filed with the SEC no later than April 29, 2020.

PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

- (a) Documents filed as part of this report:
- (1) The following financial statements of the Company are included in Part II, Item 8 of this Annual Report on Form 10-K:

- Report of Independent Registered Public Accounting Firm, RSM US LLP;
- Consolidated Balance Sheets as of December 31, 2019 and December 31, 2018;
- Consolidated Statements of Operations: For the Years Ended December 31, 2019, December 31, 2018, and December 31, 2017;
- Consolidated Statements of Comprehensive Income: For the Years Ended December 31, 2019, December 31, 2018, and December 31, 2017;
- Consolidated Statements of Stockholders' Equity: For the Years Ended December 31, 2019, December 31, 2018, and December 31, 2017; and
- Consolidated Statements of Cash Flows: For the Years Ended December 31, 2019, December 31, 2018, and December 31, 2017;
- Notes to Consolidated Financial Statements.

(2) Schedules to financial statements:

- Schedule IV – Mortgage Loans on Real Estate

All other financial statement schedules have been omitted because they are either inapplicable or the information required is provided in the Company's Consolidated Financial Statements and Notes thereto, included in Part II, Item 8 of this Annual Report on Form 10-K.

(3) The following exhibits are either filed with, or incorporated by reference into, this Annual Report on Form 10-K.

[Table of Contents](#)

EXHIBIT INDEX

Exhibit Number	Description
1.1	At Market Issuance Sales Agreement, dated August 10, 2016, among Anworth, Anworth Management LLC and FBR Capital Markets & Co. (incorporated by reference from our Current Report on Form 8-K filed with the SEC on August 10, 2016)
3.1	Amended Articles of Incorporation of Anworth (incorporated by reference from our Registration Statement on Form S-11, Registration No. 333-38641, which became effective under the Securities Act of 1933, as amended, on March 12, 1998)
3.2	Articles of Amendment to Amended Articles of Incorporation (incorporated by reference from our Definitive Proxy Statement filed, pursuant to Section 14(a) of the Securities Exchange Act of 1934, as amended, with the SEC on May 14, 2003)
3.3	Articles of Amendment to Amended Articles of Incorporation (incorporated by reference from our Current Report on Form 8-K filed with the SEC on May 28, 2008)
3.4	Amended Bylaws of the Company (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 13, 2009)
3.5	Amendment of Bylaws to Amended Bylaws of the Company (incorporated by reference from our Current Report on Form 8-K filed with the SEC on April 1, 2014)
3.6	Articles Supplementary for Series A Cumulative Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on November 3, 2004)
3.7	Articles Supplementary for Series A Cumulative Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 21, 2005)
3.8	Articles Supplementary for Series B Cumulative Convertible Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 30, 2007)
3.9	Articles Supplementary for Series B Cumulative Convertible Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on May 21, 2007)

3.10	Articles Supplementary for Series C Cumulative Redeemable Preferred Stock (incorporated by reference from our Registration Statement on Form 8-A filed with the SEC on January 23, 2015)
3.11	Articles Supplementary for Series C Cumulative Redeemable Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 6, 2015)
4.1	Specimen Common Stock Certificate (incorporated by reference from our Registration Statement on Form S-11, Registration No. 333-38641, which became effective under the Securities Act of 1933 on March 12, 1998)
4.2	Specimen Series A Cumulative Preferred Stock Certificate (incorporated by reference from our Current Report on Form 8-K filed with the SEC on November 3, 2004)
4.3	Specimen Series B Cumulative Convertible Preferred Stock Certificate (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 30, 2007)

[Table of Contents](#)

Exhibit Number	Description
4.4	Specimen Series C Cumulative Redeemable Preferred Stock Certificate (incorporated by reference from our Registration Statement on Form 8-A filed with the SEC on January 23, 2015)
4.5	Specimen Anworth Capital Trust I Floating Rate Preferred Stock Certificate (liquidation amount \$1,000 per Preferred Security) (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.6	Specimen Anworth Capital Trust I Floating Rate Common Stock Certificate (liquidation amount \$1,000 per Common Security) (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.7	Specimen Anworth Floating Rate Junior Subordinated Note Due 2035 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.8	Junior Subordinated Indenture, dated as of March 15, 2005, between Anworth and JPMorgan Chase Bank (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.9	Description of Securities Registered Under Section 12 of the Securities Exchange Act of 1934, as amended
10.1*	2014 Equity Compensation Plan (incorporated by reference from our Registration Statement on Form S-8 filed with the SEC on August 5, 2014)
10.2*	2007 Dividend Equivalent Rights Plan (incorporated by reference from our Definitive Proxy Statement filed pursuant to Section 14(a) of the Securities Exchange Act of 1934, as filed with the SEC on April 26, 2007)
10.3*	2018 Dividend Reinvestment and Stock Purchase Plan (incorporated by reference from our Registration Statement on Form S-3, Registration No. 333-223697, which became effective under the Securities Act of 1933, as amended, on March 26, 2018)
10.4	Purchase Agreement, dated as of March 15, 2005, by and among Anworth, Anworth Capital Trust I, TABERNA Preferred Funding I, Ltd., and Merrill Lynch International (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
10.5	Second Amended and Restated Trust Agreement, dated as of September 26, 2005 by and among Anworth, JPMorgan Chase Bank, National Association, Chase Bank USA, National Association, Lloyd McAdams, Joseph McAdams, Thad Brown and the several Holders, as defined therein (incorporated by reference from our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, as filed with the SEC on March 16, 2006)
10.6*	Change in Control and Arbitration Agreement, dated June 27, 2006, between Anworth and Charles J. Siegel (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2006), as amended by Amendment to Anworth Mortgage Asset Corporation Change in Control and Arbitration Agreement, effective December 31, 2011, between Anworth and Charles J. Siegel (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 3, 2012)

10.7	Amended and Restated Administrative Services Agreement, dated August 20, 2010, between Anworth and PIA (incorporated by reference from our Current Report on Form 8-K filed with the SEC on August 20, 2010)
10.8	Management Agreement, dated as of December 31, 2011 by and between Anworth and Anworth Management, LLC (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 3, 2012)

Exhibit Number	Description
10.9	Sublease dated as of January 26, 2012, between Anworth and PIA (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2012, as filed with the SEC on August 6, 2012)
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification of the Principal Executive Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934
31.2	Certification of the Principal Financial Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934
32.1	Certifications of the Principal Executive Officer provided pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certifications of the Principal Financial Officer provided pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101	XBRL Instance Document
101	XBRL Taxonomy Extension Schema Document
101	XBRL Taxonomy Extension Calculation Linkbase Document
101	XBRL Taxonomy Definition Linkbase Document
101	XBRL Taxonomy Extension Labels Linkbase Document
101	XBRL Taxonomy Extension Presentation Linkbase Document

* Represents a management contract or compensatory plan, contract or arrangement in which any director or any of the named executives participates.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

DATED: March 5, 2020

ANWORTH MORTGAGE ASSET CORPORATION

/S/ JOSEPH E. MCADAMS
Joseph E. McAdams
Chief Executive Officer and President
(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
_____ /s/ JOSEPH E. MCADAMS Joseph E. McAdams	Chairman of the Board, Chief Executive Officer, and President (Principal Executive Officer)	March 5, 2020
_____ /s/ CHARLES J. SIEGEL Charles J. Siegel	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	March 5, 2020
_____ /s/ JOE E. DAVIS Joe E. Davis	Director	March 5, 2020
_____ /s/ ROBERT C. DAVIS Robert C. Davis	Director	March 5, 2020
_____ /s/ MARK S. MARON Mark S. Maron	Director	March 5, 2020
_____ /s/ JOSEPH LLOYD MCADAMS Joseph Lloyd McAdams	Director	March 5, 2020
_____ /s/ DOMINIQUE MIELLE Dominique Mielle	Director	March 5, 2020

[THIS PAGE INTENTIONALLY LEFT BLANK]

[Table of Contents](#)

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

	<u>Page</u>
Report of Independent Registered Public Accounting Firm, RSM US LLP	F-2
Consolidated Balance Sheets as of December 31, 2019 and 2018	F-3
Consolidated Statements of Operations for the Years Ended December 31, 2019, 2018, and 2017	F-4
Consolidated Statements of Comprehensive Income for the Years Ended December 31, 2019, 2018, and 2017	F-5
Consolidated Statements of Stockholders' Equity for the Years Ended December 31, 2019, 2018, and 2017	F-6
Consolidated Statements of Cash Flows for the Years Ended December 31, 2019, 2018, and 2017	F-7
Notes to Consolidated Financial Statements	F-8
Schedule IV - Mortgage Loans on Real Estate	F-41

[Table of Contents](#)

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and the Board of Directors
Anworth Mortgage Asset Corporation

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Anworth Mortgage Asset Corporation and its subsidiaries (the Company) as of December 31, 2019 and 2018, the related consolidated statements of operations, comprehensive income, stockholders’ equity and cash flows for each of the three years in the period ended December 31, 2019, and the related notes to the consolidated financial statements and schedules (collectively, the financial statements). In our opinion, the financial statements and schedules present fairly, in all material respects, the financial position of the Company as of December 31, 2019 and 2018, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2019, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company’s internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report, dated March 5, 2020, expressed an unqualified opinion on the effectiveness of the Company’s internal control over financial reporting.

Basis for Opinion

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

We have served as the Company’s auditor since 2008.

/s/ RSM US LLP
Los Angeles, California
March 5, 2020

[Table of Contents](#)

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES		
CONSOLIDATED BALANCE SHEETS		
(in thousands, except per share amounts)		
	December 31, 2019	December 31, 2018
ASSETS		
Agency MBS at fair value (including \$3,419,375 and \$3,433,252 pledged to counterparties at December 31, 2019 and December 31, 2018, respectively)	\$ 3,510,051	\$ 3,548,719
Non-Agency MBS at fair value (including \$535,315 and \$726,428 pledged to counterparties at December 31, 2019 and December 31, 2018, respectively)	643,610	795,203
Residential mortgage loans held-for-securitization	152,922	11,660
Residential mortgage loans held-for-investment through consolidated securitization trusts ⁽¹⁾	458,348	549,016
Residential real estate	13,499	13,782
Cash and cash equivalents	8,236	3,165
Reverse repurchase agreements	15,000	20,000
Restricted cash	104,699	30,296
Interest receivable	16,398	16,872
Derivative instruments at fair value	5,833	46,207
Right to use asset-operating lease	1,256	1,794
Prepaid expenses and other assets	8,779	2,986
Total Assets	<u>\$ 4,938,631</u>	<u>\$ 5,039,700</u>
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Liabilities:		
Accrued interest payable	\$ 16,757	\$ 24,828
Repurchase agreements	3,657,873	3,811,627
Warehouse line of credit	133,811	—
Asset-backed securities issued by securitization trusts ⁽¹⁾	448,987	539,651
Junior subordinated notes	37,380	37,380
Derivative instruments at fair value	52,197	15,901
Derivative counterparty margin	367	—
Dividends payable on preferred stock	2,297	2,297
Dividends payable on common stock	8,897	12,803
Payable for purchased loans	5,545	11,660
Accrued expenses and other liabilities	1,312	654
Long-term lease obligation	1,256	1,794
Total Liabilities	<u>\$ 4,366,679</u>	<u>\$ 4,458,595</u>

Series B Cumulative Convertible Preferred Stock: par value \$0.01 per share; liquidating preference \$25.00 per share (\$19,494 and \$19,494, respectively); 780 and 780 shares issued and outstanding at December 31, 2019 and December 31, 2018, respectively)	\$	19,455	\$	19,455
Stockholders' Equity:				
Series A Cumulative Preferred Stock: par value \$0.01 per share; liquidating preference \$25.00 per share (\$47,984 and \$47,984, respectively); 1,919 and 1,919 shares issued and outstanding at December 31, 2019 and December 31, 2018, respectively)	\$	46,537	\$	46,537
Series C Cumulative Preferred Stock: par value \$0.01 per share; liquidating preference \$25.00 per share (\$50,257 and \$50,257, respectively); 2,010 and 2,010 shares issued and outstanding at December 31, 2019 and December 31, 2018, respectively)		48,626		48,944
Common Stock: par value \$0.01 per share; authorized 200,000 shares, 98,849 and 98,483 shares issued and outstanding at December 31, 2019 and December 31, 2018, respectively)		988		985
Additional paid-in capital		983,401		981,964
Accumulated other comprehensive income (loss) consisting of unrealized gains and losses		65,984		(30,792)
Accumulated deficit		(593,039)		(485,988)
Total Stockholders' Equity	\$	552,497	\$	561,650
Total Liabilities and Stockholders' Equity	\$	4,938,631	\$	5,039,700

(1) The consolidated balance sheets include assets of consolidated variable interest entities, or VIEs, that can only be used to settle obligations and liabilities of the VIEs for which creditors do not have recourse to the Company. At December 31, 2019 and December 31, 2018, total assets of the consolidated VIEs were \$460 million and \$551 million (including accrued interest receivable of \$1.5 million and \$1.8 million), respectively (which is recorded above in the line item “Interest and dividends receivable”), and total liabilities were \$450 million and \$541 million (including accrued interest payable of \$1.4 million and \$1.7 million), respectively (which is recorded above in the line item “Accrued interest payable”). Please refer to Note 5, “Variable Interest Entities,” for further discussion.

See accompanying notes to consolidated financial statements.

[Table of Contents](#)

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)

	For the Year Ended December 31,		
	2019	2018	2017
Interest and other income:			
Interest-Agency MBS	\$ 90,173	\$ 95,656	\$ 76,657
Interest-Non-Agency MBS	38,038	40,733	38,266
Interest-securitized residential mortgage loans	20,443	23,463	27,720
Interest-residential mortgage loans held-for-securitization	4,314	—	—
Other interest income	1,427	120	105
	<u>154,395</u>	<u>159,972</u>	<u>142,748</u>
Interest expense:			
Interest expense on repurchase agreements	92,737	90,511	53,954
Interest expense on asset-backed securities	19,771	22,800	26,939
Interest expense on warehouse line of credit	4,148	—	—
Interest expense on junior subordinated notes	2,100	1,996	1,626
	<u>118,756</u>	<u>115,307</u>	<u>82,519</u>
Net interest income	<u>35,639</u>	<u>44,665</u>	<u>60,229</u>
Operating expenses:			
Management fee to related party	(6,699)	(7,098)	(7,503)
Rental properties depreciation and expenses	(1,517)	(1,525)	(1,372)
General and administrative expenses	(5,090)	(4,880)	(4,430)
Total operating expenses	<u>(13,306)</u>	<u>(13,503)</u>	<u>(13,305)</u>
Other (loss) income:			
Income-rental properties	1,800	1,761	1,710
Realized net (loss) on sales of available-for-sale MBS	(3,983)	(12,186)	(2,168)
Realized net (loss) on sales of Agency MBS held as trading investments	(5,787)	(11,429)	—
Impairment charge on Non-Agency MBS	(2,108)	(2,869)	(2,399)
Unrealized gain (loss) on Agency MBS held as trading investments	17,036	(4,911)	2,793

Gain on sale of residential mortgage loans held-for-investment through consolidated securitization trusts	—	—	378
Gain on sale of residential properties	31	54	—
(Loss) gain on derivatives, net	(84,741)	(8,071)	7,132
Recovery on Non-Agency MBS	—	1	2
Total other (loss) income	(77,752)	(37,650)	7,448
Net (loss) income	<u>\$ (55,419)</u>	<u>\$ (6,488)</u>	<u>\$ 54,372</u>
Dividends on preferred stock	(9,189)	(9,189)	(8,173)
Net (loss) income to common stockholders	<u>\$ (64,608)</u>	<u>\$ (15,677)</u>	<u>\$ 46,199</u>
Basic (loss) income per common share	\$ (0.65)	\$ (0.16)	\$ 0.48
Diluted (loss) income per common share	\$ (0.65)	\$ (0.16)	\$ 0.47
Basic weighted average number of shares outstanding	98,739	98,314	96,764
Diluted weighted average number of shares outstanding	98,739	98,314	100,479

See accompanying notes to consolidated financial statements.

F-4

[Table of Contents](#)

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in thousands)

	For the Year Ended December 31,		
	2019	2018	2017
Net (loss) income	<u>\$ (55,419)</u>	<u>\$ (6,488)</u>	<u>\$ 54,372</u>
Available-for-sale Agency MBS, fair value adjustment	68,355	(43,348)	(24,939)
Reclassification adjustment for loss on sales of Agency MBS included in net (loss) income	4,059	12,361	2,233
Available-for-sale Non-Agency MBS, fair value adjustment	20,547	(20,463)	28,730
Reclassification adjustment for (gain) on sales of Non-Agency MBS included in net (loss) income	(76)	(175)	(65)
Amortization of unrealized gains on interest rate swaps remaining in other comprehensive income	3,891	4,025	2,334
Reclassification adjustment for interest (income) expense on interest rate swaps included in net (loss) income	<u>—</u>	<u>(212)</u>	<u>79</u>
Other comprehensive income (loss)	96,776	(47,812)	8,372
Comprehensive income (loss)	<u><u>\$ 41,357</u></u>	<u><u>\$ (54,300)</u></u>	<u><u>\$ 62,744</u></u>

See accompanying notes to consolidated financial statements.

F-5

[Table of Contents](#)

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the Years Ended December 31, 2019, 2018, and 2017
(in thousands, except per share amounts)

	Series A	Series C	Series A	Series C	Common	Accum. Other	Accum. Other Comp. Income	Accum. Other
--	----------	----------	----------	----------	--------	--------------	---------------------------------	--------------

	Preferred Stock Shares Outstanding	Preferred Stock Shares Outstanding	Common Stock Shares Outstanding	Preferred Stock Par Value	Preferred Stock Par Value	Stock Par Value	Additional Paid-In Capital	Comp. Income Gain (Loss) Agency MBS	Gain (Loss) Non-Agency MBS	Comp. Income Gain (Loss) Derivatives	Accum. (Deficit)	Total
Balance, December 31, 2016	1,919	486	95,718	\$ 46,537	\$ 11,321	\$ 957	\$ 966,714	\$ 24,869	\$ 1,536	\$ (17,757)	\$ (403,079)	\$ 631,098
Issuance of Series C Preferred Stock		1,503			37,099							37,099
Issuance of common stock			642			6	3,943					3,949
Cancellation of common stock			(197)			(2)	2					—
Conversions of Series B Preferred Stock			1,974			20	9,503					9,523
Other comprehensive income, fair value adjustments and reclassifications								(22,706)	28,665	2,413		8,372
Net income											54,372	54,372
Amortization of restricted stock							81					81
Dividend declared - \$2.156252 per Series A preferred share											(4,139)	(4,139)
Dividend declared - \$1.5625 per Series B preferred share											(1,188)	(1,188)
Dividend declared - \$1.768578 per Series C preferred share											(2,841)	(2,841)
Dividend declared - \$0.60 per common share											(58,360)	(58,360)
Balance, December 31, 2017	1,919	1,989	98,137	\$ 46,537	\$ 48,420	\$ 981	\$ 980,243	\$ 2,163	\$ 30,201	\$ (15,344)	\$ (415,235)	\$ 677,966
Issuance of Series C Preferred Stock		21			524							524
Issuance of common stock			346			4	1,623					1,627
Other comprehensive income, fair value adjustments and reclassifications								(30,987)	(20,638)	3,813		(47,812)
Net (loss)											(6,488)	(6,488)
Amortization of restricted stock							98					98
Dividend declared - \$2.156252 per Series A preferred share											(4,140)	(4,140)
Dividend declared - \$1.5625 per Series B preferred share											(1,220)	(1,220)
Dividend declared - \$1.768578 per Series C preferred share											(3,833)	(3,833)
Dividend declared - \$0.56 per common share											(55,072)	(55,072)
Balance, December 31, 2018	1,919	2,010	98,483	\$ 46,537	\$ 48,944	\$ 985	\$ 981,964	\$ (28,824)	\$ 9,563	\$ (11,531)	\$ (485,988)	\$ 561,650
Issuance of common stock			366			3	1,359					1,362
Other comprehensive income, fair value adjustments and reclassifications								72,414	20,471	3,891		96,776
Net (loss)											(55,419)	(55,419)
Amortization of shelf offering expenses							(318)					(318)
Amortization of restricted stock							78					78
Dividend declared - \$2.156252 per Series A preferred share											(4,140)	(4,140)
Dividend declared - \$1.5625 per Series B preferred share											(1,220)	(1,220)
Dividend declared - \$1.768578 per Series C preferred share											(3,829)	(3,829)
Dividend declared - \$0.43 per common share											(42,443)	(42,443)
Balance, December 31, 2019	1,919	2,010	98,849	\$ 46,537	\$ 48,626	\$ 988	\$ 983,401	\$ 43,590	\$ 30,034	\$ (7,640)	\$ (593,039)	\$ 552,497

See accompanying notes to consolidated financial statements.

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the Year Ended December 31,		
	2019	2018	2017
Operating Activities:			
Net (loss) income	\$ (55,419)	\$ (6,488)	\$ 54,372
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Amortization of premium on MBS	26,820	28,800	34,080
Amortization/accretion of market yield adjustments (Non-Agency MBS)	5,277	6,345	3,454
Accretion of discount (residential mortgage loans)	(116)	(112)	(150)
Depreciation on rental properties	478	473	465
Amortization of premium on residential loans	298	—	—
Realized loss on sales of available-for-sale MBS	3,983	12,186	2,168
Realized loss on sales of Agency MBS held as trading investments	5,787	11,429	—
Unrealized (gain) loss on Agency MBS held as trading investments	(17,036)	4,911	(2,793)
Impairment charge on Non-Agency MBS	2,108	2,869	2,399
Impairment charge on residential mortgage loans held-for-investment through consolidated securitization trusts	—	18	—
(Gain) on sales of residential mortgage loans	—	—	(378)
(Gain) on sale of residential properties	(31)	(54)	—
Amortization of restricted stock	78	98	82
Recovery on Non-Agency MBS	—	(1)	(2)
Net settlements received (paid) on interest rate swaps, net of amortization	11,459	7,851	(6,714)
Unrealized loss(gain) on interest rate swaps, net	98,907	(585)	(8,310)
(Gain) loss on derivatives, net of derivative income - TBA Agency MBS	(14,166)	8,656	1,440
Changes in assets and liabilities:			
Decrease (increase) in reverse repurchase agreements	5,000	(20,000)	—
Decrease (increase) in interest receivable	1,158	(983)	(1,394)
(Increase) decrease in prepaid expenses and other	(8,272)	387	415

(Decrease) increase in accrued interest payable	(3,836)	11,085	7,721
Increase (decrease) in accrued expenses and payables	2,190	(548)	(787)
Net cash provided by operating activities	\$ 64,667	\$ 66,337	\$ 86,068
Investing Activities:			
MBS Portfolios:			
Proceeds from sales	\$ 2,950,885	\$ 787,260	\$ 736,900
Purchases	(3,603,083)	(1,146,699)	(2,393,106)
Principal payments	909,244	937,075	1,148,931
Residential mortgage loans held-for-securitization:			
Purchases	(179,455)	—	—
Principal payments	30,992	—	—
Residential mortgage loans held-for-investment through consolidated securitization trusts:			
Proceeds from sales	—	—	6,806
Principal payments	121	114	134
Residential properties purchases	(362)	(241)	(346)
Proceeds from sales of residential properties	95	203	—
Net cash provided by (used in) investing activities	\$ 108,437	\$ 577,712	\$ (500,681)
Financing Activities:			
Borrowings from repurchase agreements	\$ 32,300,305	\$ 23,720,955	\$ 26,868,172
Repayments on repurchase agreements	(32,454,059)	(24,275,023)	(26,413,492)
Borrowings from warehouse line of credit	156,037	—	—
Repayments on warehouse line of credit	(22,210)	—	—
Net settlements of TBA Agency MBS Contracts	19,650	(15,956)	(13,259)
Termination of interest rate swaps	(39,226)	—	(27,350)
Derivative counterparty margin	367	—	—
Proceeds from common stock issued	1,361	1,627	3,790
Proceeds (amortization) on Series C Preferred Stock issued	(318)	525	42,312
Preferred Stock dividends paid	(9,189)	(9,169)	(7,555)
Common stock dividends paid	(46,348)	(56,977)	(57,996)
Net cash (used in) provided by financing activities	\$ (93,630)	\$ (634,018)	\$ 394,622
Net increase (decrease) in cash, cash equivalents, and restricted cash	79,474	10,031	(19,991)
Cash, cash equivalents, and restricted cash at beginning of period	33,461	23,430	43,421
Cash, cash equivalents, and restricted cash at end of period	\$ 112,935	\$ 33,461	\$ 23,430
Supplemental Disclosure of Cash Flow Information:			
Cash paid for interest	\$ 94,691	\$ 75,318	\$ 58,003
Change in payables for residential mortgage loans purchased	\$ (6,115)	\$ —	\$ —

See accompanying notes to consolidated financial statements.

[Table of Contents](#)

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Our Company

We were incorporated in Maryland on October 20, 1997 and commenced operations on March 17, 1998. Our principal business is to invest in, finance and manage a leveraged portfolio of residential mortgage-backed securities and residential mortgage loans which presently include the following types of investments:

- *Agency mortgage-backed securities*, or Agency MBS, which include residential mortgage pass-through certificates and collateralized mortgage obligations, or CMOs, which are securities representing interests in pools of mortgage loans secured by residential property in which the principal and interest payments are guaranteed by a government-sponsored enterprise, or GSE, such as the Federal National Mortgage Association, or Fannie Mae, or the Federal Home Loan Mortgage Corporation, or Freddie Mac.
- *Non-agency mortgage-backed securities*, or Non-Agency MBS, which are securities issued by companies that are not guaranteed by federally sponsored enterprises and that are secured primarily by first-lien residential mortgage loans.
- *Residential mortgage loans*. We acquire non-Qualified Mortgage, or Non-QM, residential mortgage loans (which are described further on page 79) from independent loan originators with the intent of holding these loans for securitization. These loans are financed by a warehouse line of credit until securitization. We also hold residential mortgage loans through consolidated securitization trusts. We

finance these loans through asset-backed securities, or ABS, issued by the consolidated securitization trusts. The ABS, which are held by unaffiliated third parties, are non-recourse financing. The difference in the amount of the loans in the trusts and the amount of the ABS represents our retained net interest in the securitization trusts.

Our principal business objective is to generate net income for distribution to our stockholders primarily based upon the spread between the interest income on our mortgage assets and our borrowing costs to finance our acquisition of those assets.

We have elected to be taxed as a real estate investment trust, or REIT, under the Internal Revenue Code of 1986, as amended, or the Code. As long as we retain our REIT status, we generally will not be subject to federal or state income taxes to the extent that we distribute our taxable net income to our stockholders, and we routinely distribute to our stockholders substantially all of the taxable net income generated from our operations. In order to qualify as a REIT, we must meet various ongoing requirements under the tax law, including requirements relating to the composition of our assets, the nature of our gross income, minimum distribution requirements and requirements relating to the ownership of our stock.

At December 31, 2019, we believe we met all REIT requirements regarding the asset tests, income tests, the ownership of our common stock and the distributions of our taxable net income. Therefore, we believe that we continue to qualify as a REIT under the provisions of the Code.

Our Manager

We are externally managed and advised by Anworth Management, LLC, or our Manager. Effective as of December 31, 2011, we entered into a Management Agreement, or the Management Agreement, with our Manager, which effected the externalization of our management function, or the Externalization. Since the effective date, our day-to-day operations are being conducted by our Manager through the authority delegated to it under the Management Agreement and pursuant to the policies established by our board of directors.

[Table of Contents](#)

Our Manager is supervised and directed by our board of directors and is responsible for administering our day-to-day operations. In addition, our Manager is responsible for (i) the selection, purchase and sale of our investment portfolio; (ii) our financing and hedging activities; and (iii) providing us with portfolio management and administrative services.

Our Manager will also perform such other services and activities relating to our assets and operations as may be appropriate. In exchange for these services, our Manager receives a management fee paid monthly in arrears in an amount equal to one-twelfth of 1.20% of our Equity (as defined in the Management Agreement).

BASIS OF PRESENTATION AND CONSOLIDATION

The accompanying consolidated financial statements are prepared on the accrual basis of accounting in accordance with generally accepted accounting principles utilized in the United States of America, or GAAP. 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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Material estimates that are susceptible to change relate to the determination of the fair value of investments and derivatives, cash flow projections for and credit performance of Non-Agency MBS and residential mortgage loans, amortization of security and loan premiums, accretion of security and loan discounts, and accounting for derivatives activities. Actual results could materially differ from these estimates. In the opinion of management, all material adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation have been included.

Our consolidated financial statements include the accounts of all subsidiaries. Significant intercompany accounts and transactions have been eliminated. Our consolidated financial statements also include the consolidation of certain securitization trusts that meet the definition of a variable interest entity, or VIE, because the Company has been deemed to be the primary beneficiary of the securitization trusts. These securitization trusts hold pools of residential mortgage loans and issue series of ABS payable from the cash flows generated by the underlying pools of residential mortgage loans. These securitizations are nonrecourse financing for the residential mortgage loans held-for-investment through consolidated securitization trusts. Generally, a portion of the ABS issued by the securitization trusts are sold to unaffiliated third parties and the balance is purchased by the Company. The Company classifies the underlying residential mortgage loans owned by the securitization trusts as residential mortgage loans held-for-investment through consolidated securitization trusts in its consolidated balance sheets. The ABS issued to unaffiliated third parties are recorded as liabilities on the Company’s consolidated balance sheets. The Company records interest income on the residential mortgage loans held-for-investment through consolidated securitization trusts and interest expense on the ABS issued to third parties in the Company’s consolidated statements of operations. The Company records the initial underlying assets and liabilities of the consolidated securitization trusts at their fair value upon consolidation into the Company and, as such, no gain or loss is recorded upon consolidation. See “Note 5 - Variable Interest Entities” for additional information regarding the impact of consolidation of securitization trusts.

The consolidated securitization trusts are VIEs because the securitization trusts do not have equity that meets the definition of U.S. GAAP equity at risk. In determining if a securitization trust should be consolidated, the Company evaluates (in accordance with the Financial Accounting Standards Board, or FASB, Accounting Standards Codification, or ASC, 810-10) whether it has both (i) the power to direct the activities of the securitization trust that most significantly impact its economic performance and (ii) the right to receive benefits from the securitization trust or the obligation to absorb losses of the securitization trust that could be significant. The Company determined that it is the primary beneficiary of certain securitization trusts because it has certain delinquency and default oversight rights on residential mortgage loans. In addition, the Company owns the most subordinated class of ABS issued by the securitization trusts and has the obligation to absorb losses and right to receive benefits from the securitization trusts that could potentially be significant to the securitization trusts. The Company assesses modifications, if any, to VIEs on an ongoing basis to determine if a significant reconsideration event has occurred that would change the Company’s initial consolidation assessment.

[Table of Contents](#)

The following is a summary of our significant accounting policies:

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less, including U.S. Treasury bills. The carrying amount of cash equivalents approximates their fair value. Restricted cash includes cash pledged as collateral to counterparties on various derivative transactions.

Reverse Repurchase Agreements

We use securities purchased under agreements to resell, or reverse repurchase agreements, as a means of investing excess cash. Although legally structured as a purchase and subsequent resale, reverse repurchase agreements are treated as financing transactions under which the counterparty pledges securities (principally U.S. treasury securities) and accrued interest as collateral to secure a loan. The difference between the purchase price that we pay and the resale price that we receive represents interest paid to us and is included in “Other interest income” on our consolidated statements of operations. It is our policy to generally take possession of securities purchased under reverse repurchase agreements at the time such agreements are made.

Mortgage-Backed Securities

Agency MBS are securities that are obligations (including principal and interest) guaranteed by the U.S. government, such as Ginnie Mae, or guaranteed by federally sponsored enterprises, such as Fannie Mae or Freddie Mac. Our investment-grade Agency MBS portfolio is invested primarily in fixed-rate and adjustable-rate mortgage-backed pass-through certificates and hybrid adjustable-rate MBS. Hybrid adjustable-rate MBS have an initial interest rate that is fixed for a certain period, typically one to ten years, and then adjusts annually for the remainder of the term of the asset. We structure our investment portfolio to be diversified with a variety of prepayment characteristics, investing in mortgage assets with prepayment penalties, investing in certain mortgage security structures that have prepayment protections and purchasing mortgage assets at a premium and at a discount. A portion of our portfolio consists of Non-Agency MBS. Our principal business objective is to generate net income for distribution to our stockholders primarily based upon the spread between the interest income on our mortgage assets and our borrowing costs to finance our acquisition of those assets.

We classify our MBS as either trading investments, available-for-sale investments or held-to-maturity investments. Our management determines the appropriate classification of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. We currently classify most of our MBS as available-for-sale. We have also designated a portion of our MBS as trading investments. All assets that are classified as available-for-sale are carried at fair value and unrealized gains or losses are generally included in “Accumulated other comprehensive income (loss)” as a component of stockholders’ equity. Losses that are credit-related on securities classified as available-for-sale, which are determined by management to be other-than-temporary in nature, are reclassified from “Other comprehensive income (loss)” on the consolidated balance sheets to income (loss) on the consolidated statements of operations. Assets classified as trading investments are reported at fair value with unrealized gains and losses included in our consolidated statements of operations.

The most significant source of our revenue is derived from our investments in MBS. Interest income on Agency MBS is accrued based on the actual coupon rate and the outstanding principal amount of the underlying mortgages. Premiums and discounts are amortized or accreted into interest income over the estimated lives of the securities using the effective interest yield method, adjusted for the effects of actual and estimated prepayments based on ASC 320-10. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, street consensus prepayment speeds and current market conditions. If our estimate of prepayments is materially incorrect, as compared to the aforementioned references, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income, which could be material and adverse.

A majority of our Non-Agency MBS are accounted for under “Loans and Debt Securities Acquired with Credit Deterioration” (ASC 310-30). A debt security accounted for under ASC 310-30 is initially recorded at its purchase price (fair value). The amount of expected cash flows that exceed the initial investment represents the market yield adjustment (accretable yield), which is recognized as interest income on a level yield basis over the life of the security. The excess of total contractual cash flows over the cash flows expected at its origination is considered to be the non-accretable difference. We must periodically reassess the expected cash flows of loans accounted for under ASC 310-30 along with the cash flows received. A significant increase in expected cash flows must be accounted for as an increase in the rate of accretion over the remaining life of the security. Conversely, if expected cash flows decrease, an other-than-temporary impairment must be recognized as a charge to earnings. Adjustments to the fair value of Non-Agency MBS, accounted for as available-for-sale securities, are recorded in “Accumulated other comprehensive income,” or AOCI. The determination as to whether impairment and accretable yield exists is based on cash flow projections related to the securities. As a result, the timing and amount of impairment and accretable yield constitutes a material estimate that is susceptible to significant change.

Interest income on the Non-Agency MBS that were purchased at a discount to par value and were rated below AA at the time of purchase is recognized based on the security’s effective interest rate. The effective interest rate on these securities is based on the projected cash flows from each security, which are estimated based on our observation of current information and events and include assumptions related to interest rates, prepayment rates, and the timing and amount of credit losses. On at least a quarterly basis, we review and, if appropriate, make adjustments to our cash flow projections based on input and analysis received from external sources, internal models, and our judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the last evaluation, may result in a prospective change in the yield/interest income recognized on such securities. Actual maturities of the available-for-sale securities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of available-for-sale securities are generally shorter than stated contractual maturities. Stated contractual maturities are generally greater than ten years. There can be no assurance that our assumptions used to estimate future cash flows or the current period’s yield for each asset would not change in the near term, and the change could be material.

Based on the projected cash flows from our Non-Agency MBS purchased at a discount to par value, a portion of the purchase discount may be designated as a non-accretable difference and, therefore, not accreted into interest income. The amount designated as a non-accretable difference may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions, and other factors. If the performance of a security with a non-accretable difference is more favorable than forecasted, a portion of the amount designated as a non-accretable difference may be accreted into interest income prospectively. Conversely, if the performance of a security with a non-accretable difference is less favorable than forecasted, an impairment charge and write-down of such security to a new cost basis results.

Securities transactions are recorded on the date the securities are purchased or sold. Realized gains or losses from securities transactions are determined based on the specific identified cost of the securities.

Residential Mortgage Loans Held-for-Securitization

Residential mortgage loans held for securitization are held at our wholly-owned subsidiary, Anworth Mortgage Loans, Inc. (incorporated August 2017), with the intent to sponsor our own securitizations. Loans purchased with the intent to securitize are recorded on the trade date. Any fees associated with acquiring the loans held for securitization are deferred as well as any premium paid to acquire the loans. These are included in the loan balance and amortized using the effective interest yield method. Interest income is recorded as revenue when earned and deemed collectible or until a loan becomes more than 90 days past due, at which point the loan is placed on nonaccrual status. When a non-accrual loan has cured, meaning all delinquent principal and interest has been remitted by the borrower; the loan is placed back on accrual status. Alternatively, nonaccrual loans may be placed back on accrual status after the loan is considered re-performing, generally when the loan has been current for 6 months.

F-11

[Table of Contents](#)

The residential mortgage loans held for securitization are financed by a warehouse line of credit. The payment and performance of the obligations by Anworth Mortgage Loans under the warehouse line is guaranteed by Anworth Mortgage Asset Corporation. We may be required to remove a loan from a warehouse line of credit. We do not maintain a loan repurchase reserve, as any risk of loss due to loan repurchase would normally be covered by recourse to the companies from whom we acquired the loans. Debt issuances costs incurred in connection with this facility (such as legal costs) are deducted from the debt’s carrying amount and amortized ratably to interest expense over the term of the debt.

Residential Mortgage Loans Held-for-Investment Through Consolidated Securitization Trusts

Residential mortgage loans held-for-investment through consolidated securitization trusts are carried at unpaid principal balances net of any premiums or discounts and allowance for loan losses. We expect that we will be required to continue to consolidate the securitization trusts that hold the residential mortgage loans.

We establish an allowance for residential loan losses based on our estimate of credit losses. These estimates for the allowance for loan losses require consideration of various observable inputs including, but not limited to, historical loss experience, delinquency status, borrower credit scores, geographic concentrations and loan-to-value ratios, and are adjusted for current economic conditions as deemed necessary by our management. Many of these factors are subjective and cannot be reduced to a mathematical formula. In addition, since we have not incurred any direct losses on our portfolio, we review national historical credit performance information from external sources to assist in our analysis. Changes in our estimates can significantly impact the allowance for loan losses and provision expense. The allowance reflects management’s best estimate of the credit losses inherent in the loan portfolio at the balance sheet date. It is also possible that we will experience credit losses that are different from our current estimates or that the timing of those losses may differ from our estimates.

We recognize interest income from residential mortgage loans on an accrual basis. Any related premium or discount is amortized into interest income using the effective interest method over the estimated life of these loans. Coupon interest is recognized as revenue when earned and deemed collectable or until a loan becomes more than 90 days past due, at which point the loan is placed on non-accrual status. Interest previously accrued for loans that have been placed on non-accrual status is reversed against interest income in the period the loan is placed in non-accrual status. Residential loans delinquent more than 90 days or in foreclosure are characterized as delinquent. Cash principal and interest that are advanced from servicers after a loan becomes greater than 90 days past due are recorded as a liability due to the servicer. When a delinquent loan previously placed on non-accrual status has cured, meaning when all delinquent principal and interest have been remitted by the borrower, the loan is placed back on accrual status. Alternatively, non-accrual loans may be placed back on accrual status after the loan is considered re-performing. A restructured loan is considered re-performing when the loan has been current for at least 6 months.

Residential Properties

Residential properties are stated at cost and consist of land, buildings and improvements, including other costs incurred during their acquisition, possession and renovation. Residential properties purchased that are not subject to an existing lease are treated as asset acquisitions and, as such, are recorded at their purchase price, including acquisition and renovation costs, all of which are allocated to land and building based upon their relative fair values at the date of acquisition.

Building depreciation is computed on a straight-line basis over the estimated useful lives of the assets. We will generally use a 27.5 year estimated life with no salvage value. We will incur costs to prepare our acquired properties to be leased. These costs will be capitalized and allocated to building costs. Costs related to the restoration, renovation, or improvement of our properties that improve and extend their useful lives are capitalized and depreciated over their estimated useful lives. Expenditures for ordinary repairs and maintenance are expensed as incurred. Costs incurred by us to lease the properties will be capitalized and amortized over the life of the lease. Escrow deposits include refundable and non-refundable cash and earnest money on deposit with independent third parties for property purchases.

F-12

[Table of Contents](#)

Repurchase Agreements

We finance the acquisition of MBS primarily through the use of repurchase agreements. Under these repurchase agreements, we sell securities to a lender and agree to repurchase the same securities in the future for a price that is higher than the original sales price. The difference between the sale price that we receive and the repurchase price that we pay represents interest paid to the lender. Although structured as a sale and repurchase obligation, a repurchase agreement operates as a financing under which we pledge our

securities and accrued interest as collateral to secure a loan which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. We retain beneficial ownership of the pledged collateral. Upon the maturity of a repurchase agreement, we are required to repay the loan and concurrently receive back our pledged collateral from the lender or, with the consent of the lender, we may renew such agreement at the then-prevailing financing rate. These repurchase agreements may require us to pledge additional assets to the lender in the event the estimated fair value of the existing pledged collateral declines.

Asset-Backed Securities Issued by Securitization Trusts

Asset-backed securities issued by the securitization trusts are recorded at principal balances net of unamortized premiums or discounts. This long-term debt is collateralized only by the assets held in the trusts and is otherwise non-recourse to the Company.

Derivative Financial Instruments

Risk Management

We primarily use short-term (less than or equal to 12 months) repurchase agreements to finance the purchase of MBS. These obligations expose us to variability in interest payments due to changes in interest rates. We continuously monitor changes in interest rate exposures and evaluate various opportunities to mitigate this risk. Our objective is to limit the impact of interest rate changes on earnings and cash flows. The principal instruments we use to achieve this are interest rate swaps. Interest rate swaps effectively convert a percentage of our repurchase agreements to fixed-rate obligations over a period of up to ten years. Under interest rate swaps, we agree to pay an amount equal to a specified fixed rate of interest times a notional principal amount and to receive in return an amount equal to a specified variable-rate of interest times a notional amount, generally based on the London Interbank Offered Rate, or LIBOR. The notional amounts are not exchanged. We do not issue or hold the interest rate swaps for speculative purposes.

We also enter into To-Be-Announced, or TBA, Agency MBS as either a means of investing in and financing Agency MBS or as a means of disposing of or reducing our exposure to agency securities. Pursuant to TBA contracts, we agree to purchase or sell, for future delivery, Agency MBS with certain principal and interest terms and certain types of collateral, but the particular Agency MBS to be delivered are not identified until shortly before the TBA settlement date. We also may choose, prior to settlement, to move the settlement of these MBS out to a later date by entering into an offsetting short or long position (referred to as a “pair off”), net settling the paired off positions for cash, and simultaneously purchasing a similar TBA contract for a later settlement date. This transaction is commonly referred to as a “dollar roll.” The Agency MBS purchased or sold for a forward settlement date are typically priced at a discount to agency securities for settlement in the current month. This difference (or discount) is referred to as the “price drop.” The price drop represents compensation to us for foregoing net interest margin (interest income less repurchase agreement financing cost). TBA Agency MBS are accounted for as derivative instruments since they do not meet the exemption allowed for a “regular way” security trade under ASC 815, as either the TBA contracts do not settle in the shortest period of time possible or we cannot assess that it is probable at inception that we will take physical delivery of the security or that we will not settle on a net basis.

Accounting for Derivative and Hedging Activities

We account for derivative instruments in accordance with ASC 815, which requires recognition of all derivatives as either assets or liabilities and measurement of those instruments at fair value, which is typically based on values obtained from large financial institutions who are market makers for these types of instruments. The accounting for changes in the fair value of derivative instruments depends on whether the instruments are designated and qualify as

hedges in accordance with ASC 815. Changes in fair value related to derivatives not designated as hedges are recorded in our consolidated statements of operations as “Gain (loss) on derivatives” and specifically identified as either relating to interest rate swaps or TBA Agency MBS. For a derivative to qualify for hedge accounting, we must anticipate that the hedge will be highly “effective” as defined by ASC 815-10. A hedge of the variability of cash flows that are to be received or paid in connection with a recognized asset or liability is known as a “cash flow” hedge. Changes in the fair value of a derivative that is highly effective and that is designated as a cash flow hedge, to the extent the hedge is effective, are recorded in AOCI and reclassified to income when the forecasted transaction affects income (e.g. when periodic settlement interest payments are due on repurchase agreements). Hedge ineffectiveness, if any, is recorded in current period income. Fair value hedges protect against exposures to changes in the fair value of a recognized asset. ASC 815 requires companies to recognize in income, in the period that the changes in fair value occur, any gains or losses from any ineffectiveness in the hedging relationship.

When we discontinue hedge accounting, the gain or loss on the derivative remains in AOCI and is reclassified into income when the forecasted transaction affects income. In all situations where hedge accounting is discontinued and the derivative remains outstanding, we carry the derivative at its fair value on our balance sheet, recognizing changes in fair value in current period income. All of our interest rate swaps had historically been accounted for as cash flow hedges under ASC 815. After August 22, 2014, none of our interest rate swaps were designated for hedge accounting. As a result of discontinuing hedge accounting for our interest rate swaps, changes in the fair value of these interest rate swaps are recorded in “(Loss) on interest rate swaps, net,” which is included in “Loss (gain) on derivatives, net,” in our consolidated statements of operations rather than in AOCI. Also, net interest paid or received on these interest rate swaps, which was previously recognized in interest expense, is instead recognized in “(Loss) on interest rate swaps, net.” These continue to be reported as assets or liabilities on our consolidated balance sheets at their fair value.

As long as the forecasted transactions that were being hedged (i.e. rollovers of our repurchase agreement borrowings) are still expected to occur, the balance in AOCI from the activity in these interest rate swaps through the dates of de-designation will remain in AOCI and be recognized in our consolidated statements of operations as “interest expense” over the remaining term of these interest rate swaps.

For purposes of the consolidated statements of cash flows, cash flows hedges were classified with the cash flows from the hedged item. Cash flows from derivatives that are not hedges are classified according to the underlying nature or purpose of the derivative transaction.

For more details on the amounts and other qualitative information on all our derivative transactions, see Note 15. For more information on the fair value of our derivative instruments, see Note 9.

Credit Risk

At December 31, 2019, we had attempted to limit our exposure to credit losses on our Agency MBS by purchasing securities primarily through Freddie Mac and Fannie Mae. The payment of principal and interest on the Freddie Mac and Fannie Mae MBS are guaranteed by those respective enterprises. In September 2008, both Freddie Mac and Fannie Mae were placed in the conservatorship of the U.S. government. While it is the intent that the conservatorship will help stabilize Freddie Mac’s and Fannie Mae’s overall financial position, there can be no assurance that it will succeed or that, if necessary, Freddie Mac and Fannie Mae will be able to satisfy its guarantees of Agency MBS. There have also been concerns as to what the U.S. government will do regarding winding down the operations of Freddie Mac and Fannie Mae. There have also been concerns over the past several years regarding the credit standing of Freddie Mac, Fannie Mae, and U.S. sovereign debt. We do not know what effect any future ratings of Freddie Mac, Fannie Mae and U.S. sovereign debt may ultimately have on the U.S. economy, the value of our securities, or the ability of Freddie Mac and Fannie Mae to satisfy its guarantees of Agency MBS, if necessary.

Our adjustable-rate MBS are subject to periodic and lifetime interest rate caps. Periodic caps can limit the amount an interest rate can increase during any given period. Some adjustable-rate MBS subject to periodic payment caps may result in a portion of the interest being deferred and added to the principal outstanding.

[Table of Contents](#)

We also invest in Non-Agency MBS, which are securities that are secured by pools of residential mortgages which are not issued by government-sponsored enterprises and are not guaranteed by any agency of the U.S. government or any federally chartered corporation. Such investments carry a risk that the borrower on the underlying mortgage may default on their obligation to make full and timely payments of principal and interest.

Other-than-temporary losses on our available-for-sale MBS, as measured by the amount of decline in estimated fair value attributable to credit losses that are considered to be other-than-temporary, are charged against income, resulting in an adjustment of the cost basis of such securities. Based on the criteria in ASC 320-10, the determination of whether a security is other-than-temporarily impaired, or OTTI, involves judgments and assumptions based on both subjective and objective factors. When a security is impaired, an OTTI is considered to have occurred if (i) we intend to sell the security, (ii) it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis or (iii) we do not expect to recover its amortized cost basis (i.e., there is a credit-related loss). The following are among, but not all of, the factors considered in determining whether and to what extent an OTTI exists and the portion that is related to credit loss: (i) the expected cash flow from the investment; (ii) whether there has been an other-than-temporary deterioration of the credit quality of the underlying mortgages; (iii) the credit protection available to the related mortgage pool for MBS; (iv) any other market information available, including analysts’ assessments and statements, public statements and filings made by the debtor or counterparty; (v) management’s internal analysis of the security, considering all known relevant information at the time of assessment; and (vi) the magnitude and duration of historical decline in market prices. Because management’s assessments are based on factual information as well as subjective information available at the time of assessment, the determination as to whether an other-than-temporary decline exists and, if so, the amount considered impaired, is also subjective and therefore constitutes material estimates that are susceptible to significant change.

We also own residential mortgage loans held-for-investment through consolidated securitization trusts. As the majority of these loans (the senior tranches of the securitization trusts) are collateral for the asset-backed securities issued by the trusts, our potential credit risk is on the subordinated tranches that we own, as these tranches would be the first ones to absorb any losses resulting from defaults by the borrowers on the underlying mortgage loans.

For all interest rate swaps entered into on or after September 9, 2013, all swap participants are required by rules of the Commodities Futures Trading Commission under authority granted to it pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, or the Dodd-Frank Act, to clear interest rate swaps through a registered derivatives clearing organization, or “swap execution facility,” through standardized documents under which each swap counterparty transfers its position to another entity whereby a central clearinghouse effectively becomes the counterparty on each side of the swap. It is the intent of the Dodd-Frank Act that the clearing of interest rate swaps in this manner is designed to avoid concentration of risk in any single entity by spreading and centralizing the risk in the clearinghouse and its members.

Credit Risk Related to Residential Mortgage Loans Held-for-Securitization

Our strategy of acquiring, accumulating, and securitizing residential mortgage loans involves credit risk. We bear the risk of loss on these loans while they are being financed on warehouse lines of credit. These loans are secured by real property. Credit losses on real estate loans can occur for many reasons, including poor origination practices; fraud; poor underwriting; poor servicing practices; weak economic conditions; changes in legal protections for lenders; increases in payments required to be made by the borrowers; declines in the value or real estate; natural disaster (such as fires or earthquake), severe weather (such as flooding, hurricanes, drought, and tornados) and other acts of God; uninsured property loss; over-leveraging of the borrower; costs of remediation of environmental conditions; acts of war or terrorism; changes in legal protections for lenders and other changes in law or regulation (including lending disclosures and privacy); and personal events affecting borrowers, such as reduction in income, changes in employment status (such as job loss), divorce, or health problems. In addition, if the U.S. economy or the housing market were to weaken (and that weakening was in excess of what we anticipated), credit losses could increase beyond levels that we have anticipated. In the event of a default on any of our loans, we would bear the loss equal to the difference between the realizable value of the mortgaged property, after expenses, and the outstanding indebtedness, as well as the loss of interest.

[Table of Contents](#)

Income Taxes

We have elected to be taxed as a REIT and to comply with the provisions of the Code with respect thereto. Accordingly, we will not be subject to federal income tax to the extent that our distributions to our stockholders satisfy the REIT requirements and that certain asset, income and stock ownership tests are met.

We have no unrecognized tax benefits and do not anticipate any increase in unrecognized benefits during 2019 relative to any tax positions taken prior to January 1, 2019. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is our policy to record such accruals in our income taxes accounts; and no such accruals existed at December 31, 2019. We file REIT U.S. federal and California income tax returns. These returns are generally open to examination by the IRS and the California Franchise Tax Board for all years after 2014 and 2013, respectively.

Cumulative Convertible Preferred Stock

We classify our Series B Cumulative Convertible Preferred Stock, or Series B Preferred Stock, on our balance sheets using the guidance in ASC 480-10-S99. Our Series B Preferred Stock contains certain fundamental change provisions that allow the holder to redeem the preferred stock for cash only if certain events occur, such as a change in control. As redemption under these circumstances is not solely within our control, we have classified our Series B Preferred Stock as temporary equity.

We have analyzed whether the conversion features in our Series B Preferred Stock should be bifurcated under the guidance in ASC 815-10 and have determined that bifurcation is not necessary.

Stock-Based Expense

In accordance with ASC 718-10, any expense relating to share-based payment transactions is recognized in the consolidated financial statements. Restricted stock is expensed over the vesting period (see Note 14).

Earnings Per Share

Basic earnings per share, or EPS, is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted EPS assumes the conversion, exercise or issuance of all potential common stock equivalents (which includes stock options and convertible preferred stock) and the adding back of the Series B Preferred Stock dividends unless the effect is to reduce a loss or increase the income per share.

Accumulated Other Comprehensive Income

In accordance with ASC 220-10-55-2, total comprehensive income is divided into net income and other comprehensive income, which includes unrealized gains and losses on marketable securities classified as available-for-sale, and unrealized gains and losses on derivative financial instruments. In accordance with ASU 2013-02, we have identified, in our Statements of Comprehensive Income, items that are reclassified and included in our statements of operations.

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 disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could materially differ from those estimates.

RECENT ACCOUNTING PRONOUNCEMENTS

On February 25, 2016, the FASB issued ASU 2016-2, “Leases” (Topic 842), which is intended to improve financial reporting for lease transactions. This ASU will require organizations that lease assets, such as real estate, airplanes, and manufacturing equipment, to recognize on their balance sheet the assets and liabilities for the rights to use those assets for the lease term and obligations to make lease payments created by those leases that have terms of greater than 12 months. The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a finance or operating lease. This ASU will also require disclosures to help investors and other financial statement users better understand the amount and timing of cash flows arising from leases. These disclosures will include qualitative and quantitative requirements, providing additional information about the amounts recorded in the financial statements. This ASU became effective for public entities beginning with the quarter ended March 31, 2019 and we have adopted it at that time. This ASU did not have a material impact on our financial statements, as we do not have any finance leases and our only operating lease is for the sublease of our headquarters. Also, with respect to the small portion of our business in which we are a lessor of rental properties, this ASU is not applicable to this portion of our business, as all of our leases are for less than one year.

On June 16, 2016, the FASB issued ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” This ASU is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held-to-maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor. The scope excludes financial assets measured at fair value through net income, available-for-sale securities, loans made to participants by defined contribution employee benefit plans, policy loan receivables of an insurance company, pledge receivables of a not-for-profit entity, and receivables between entities under common control. This ASU will require entities to immediately record the full amount of credit losses that are expected in their loan portfolios and to re-evaluate at each reporting period. The income statement will reflect the credit loss provision (or expense) necessary to adjust the allowance estimate since the previous reporting date. The expected credit loss estimate should consider available information relevant to assessing the collectability of contractual cash flows including information about past events (i.e. historical loss experience), current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This ASU will become effective for public entities beginning with the quarter ending March 31, 2020. This ASU will not have a material impact on our financial statements. We also believe that when implemented, while not having a significant impact on the losses incurred over the life of the loans, it is likely that credit losses will be recognized through the allowance account sooner than previously required.

In June 2018, the FASB issued ASU 2018-07, “Compensation–Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting.” This ASU expands the scope of Topic 718, which currently only includes share-based payments issued to employees, to also include share-based payments issued to nonemployees for goods and services. Currently, nonemployee awards are measured at the fair value of the consideration received or the fair value of the equity instruments issued, whichever can be

more reliably measured. Under ASU 2018-07, equity-classified nonemployee awards within the scope of Topic 718 will be measured at grant-date fair value. This ASU became effective for public companies beginning with the quarter ended March 31, 2019, and it did not have a material impact on our financial statements.

In August 2018, the FASB issued ASU 2018-13, “Fair Value Measurement (Topic 820) – Disclosure Framework-Changes to the Disclosure Requirements for Fair Value Measurement.” The following disclosure requirements were removed: (1) The amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy; (2) The policy for timing of transfers between levels; and (3) The valuation processes for Level 3 fair value measurements. The following disclosure requirement was modified: The amendments clarify that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date. The following disclosure requirements were added: (i) The changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period; and (ii) The range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. For certain unobservable inputs, an entity may disclose other quantitative information in lieu of the weighted average if the entity determines that the other quantitative information would be a more reasonable and rational method to reflect the

[Table of Contents](#)

distribution of unobservable inputs used to develop Level 3 fair value measurements. This ASU will become effective for all entities beginning with the quarter ending March 31, 2020. This ASU will not have a material impact on our financial statements.

NOTE 2. RESTRICTED CASH

This includes cash pledged as collateral for interest rate swaps and TBA Agency MBS margin calls. The following table represents the Company’s restricted cash balances at December 31, 2019 and December 31, 2018:

	December 31, 2019	December 31, 2018
	(in thousands)	
Restricted cash - interest rate swaps and TBA Agency MBS margin calls	\$ 104,699	\$ 30,296

NOTE 3. MORTGAGE-BACKED SECURITIES (MBS)

The following tables summarize our Agency MBS and Non-Agency MBS at December 31, 2019 and December 31, 2018, which are carried at their fair value:

December 31, 2019

By Agency	Freddie Mac		Fannie Mae		Total Agency MBS ⁽¹⁾ (in thousands)	Non-Agency MBS	Total MBS
Amortized cost	\$	864,452	\$	2,590,775	\$ 3,455,227	\$ 613,576	\$ 4,068,803
Paydowns receivable ⁽²⁾		9,727		—	9,727	—	9,727
Unrealized gains		19,487		27,256	46,743	34,188	80,931
Unrealized losses		(699)		(947)	(1,646)	(4,154)	(5,800)
Fair value	\$	892,967	\$	2,617,084	\$ 3,510,051	\$ 643,610	\$ 4,153,661

By Security Type	ARMs	Hybrids	15-Year Fixed-Rate	20-Year Fixed-Rate	30-Year Fixed-Rate ⁽¹⁾ (in thousands)	Total Agency MBS	Non-Agency MBS	Total MBS
Amortized cost	\$ 473,935	\$ 296,890	\$ 47,248	\$ 193,303	\$ 2,443,851	\$ 3,455,227	\$ 613,576	\$ 4,068,803
Paydowns receivable ⁽²⁾	8,328	1,399	—	—	—	9,727	—	9,727
Unrealized gains	10,279	202	978	1,274	34,010	46,743	34,188	80,931
Unrealized losses	(69)	(1,496)	—	—	(81)	(1,646)	(4,154)	(5,800)
Fair value	\$ 492,473	\$ 296,995	\$ 48,226	\$ 194,577	\$ 2,477,780	\$ 3,510,051	\$ 643,610	\$ 4,153,661

(1) Included in the 30-year fixed-rate MBS are Trading Agency MBS. These have an amortized cost of \$655.8 million, an unrealized gain of \$1.1 million, and a fair value of \$656.9 million.

(2) Paydowns receivable on Agency MBS are generated when the Company receives notice from Freddie Mac of prepayments but does not receive the actual cash with respect to such prepayments until the 15th day of the following month.

During the year ended December 31, 2019, we received proceeds of approximately \$2.95 billion from the sales of Agency MBS and recognized gross realized losses on sales of approximately \$21.7 million and gross realized gains of approximately \$11.8 million. During the year ended December 31, 2018, we received proceeds of approximately \$781 million from the sales of Agency MBS and recognized gross realized losses on sales of approximately \$24.2 million and gross realized gains of approximately \$0.6 million. During the year ended December 31, 2019, we had gross unrealized gains on trading investments of \$17.0 million, compared to gross unrealized losses on trading investments of \$4.9 million during the year ended December 31, 2018.

F-18

[Table of Contents](#)

During the year ended December 31, 2019, we sold (including calls) approximately \$30 million of Non-Agency MBS and recognized gross gains of approximately \$310 thousand and gross losses of approximately \$234 thousand. During the year ended December 31, 2018, we sold approximately \$6 million of Non-Agency MBS and recognized gross gains of approximately \$217 thousand and gross losses of approximately \$42 thousand.

December 31, 2018

By Agency	Freddie Mac		Fannie Mae		Total Agency MBS ⁽¹⁾ (in thousands)	Non-Agency MBS	Total MBS
Amortized cost	\$	1,457,552	\$	2,127,655	\$ 3,585,207	\$ 785,640	\$ 4,370,847
Paydowns receivable ⁽²⁾		7,831		—	7,831	—	7,831
Unrealized gains		4,169		10,827	14,996	20,753	35,749
Unrealized losses		(25,155)		(34,160)	(59,315)	(11,190)	(70,505)
Fair value	\$	1,444,397	\$	2,104,322	\$ 3,548,719	\$ 795,203	\$ 4,343,922

By Security Type	ARMs	Hybrids	15-Year Fixed-Rate ⁽¹⁾	20-Year Fixed-Rate	30-Year Fixed-Rate	Total Agency MBS	Non-Agency MBS	Total MBS
					(in thousands)			
Amortized cost	\$ 854,733	\$ 689,694	\$ 917,780	\$ 374,792	\$ 748,208	\$ 3,585,207	\$ 785,640	\$ 4,370,847
Paydowns receivable ⁽²⁾	4,065	3,766	—	—	—	7,831	—	7,831
Unrealized gains	11,920	263	60	—	2,753	14,996	20,753	35,749
Unrealized losses	(1,250)	(15,786)	(25,389)	(8,290)	(8,600)	(59,315)	(11,190)	(70,505)
Fair value	\$ 869,468	\$ 677,937	\$ 892,451	\$ 366,502	\$ 742,361	\$ 3,548,719	\$ 795,203	\$ 4,343,922

- (1) Included in the 15-year fixed-rate MBS are Trading Agency MBS. These have an amortized cost of \$496.7 million, an unrealized loss of \$15.9 million, and a fair value of \$480.8 million.
- (2) Paydowns receivable on Agency MBS are generated when the Company receives notice from Freddie Mac of prepayments but does not receive the actual cash with respect to such prepayments until the 15th day of the following month.

F-19

[Table of Contents](#)

The following table presents information regarding the estimates of the contractually required principal payments, cash flows expected to be collected and estimated fair value of the Non-Agency MBS held at carrying value acquired by the Company for the year ended December 31, 2019 and cumulatively at December 31, 2019 and December 31, 2018:

	Change During the Year Ended December 31, 2019	At December 31, 2019	At December 31, 2018
		(in thousands)	
Non-Agency MBS acquired with credit deterioration:			
Contractually required principal	\$ (82,298)	\$ 738,310	\$ 820,608
Contractual principal not expected to be collected (non-accretable yield)	14,701	(318,185)	(332,886)
Expected cash flows to be collected	(67,597)	420,125	487,722
Market yield adjustment	(6,267)	130,970	137,237

Unrealized gain, net	16,965	27,393	10,428
Fair value	(56,899)	578,488	635,387
Fair value of other Non-Agency MBS (without credit deterioration)	(94,694)	65,122	159,816
Total fair value of Non-Agency MBS	<u>\$ (151,593)</u>	<u>\$ 643,610</u>	<u>\$ 795,203</u>

The following table presents the change for the years ended December 31, 2019 and December 31, 2018 of the components of the Company’s purchase discount on its Non-Agency MBS between the amount designated as the market yield adjustments and the non-accretable difference:

	For the Year Ended December 31,			
	2019		2018	
	Market Yield Adjustment	Non-Accretable	Market Yield Adjustment	Non-Accretable
	(in thousands)			
Balance at beginning of period	\$ 137,237	\$ (332,886)	\$ 147,198	\$ (332,480)
Accretion of discount	(5,948)	—	(6,633)	(100)
Purchases	—	—	(777)	(23,419)
Realized credit losses	—	16,401	—	22,018
Sales	(319)	408	1,413	—
Impairment charge	—	(2,108)	—	(2,869)
Transfer	—	—	(3,964)	3,964
Balance at end of period	<u>\$ 130,970</u>	<u>\$ (318,185)</u>	<u>\$ 137,237</u>	<u>\$ (332,886)</u>

The following table shows the gross unrealized losses and fair value of those individual securities in our MBS portfolio that have been in a continuous unrealized loss position at December 31, 2019 and December 31, 2018, aggregated by investment category and length of time:

December 31, 2019

Description of Securities	Less Than 12 Months			12 Months or More			Total		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
	(in thousands)			(in thousands)			(in thousands)		
Agency MBS	10	\$ 270,737	\$ (419)	38	\$ 168,095	\$ (1,227)	48	\$ 438,832	\$ (1,646)
Non-Agency MBS	18	\$ 49,281	\$ (1,507)	12	\$ 75,926	\$ (2,647)	30	\$ 125,207	\$ (4,154)

F-20

[Table of Contents](#)

December 31, 2018

Description of Securities	Less Than 12 Months			12 Months or More			Total		
	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses	Number of Securities	Fair Value	Unrealized Losses
	(in thousands)			(in thousands)			(in thousands)		
Agency MBS	47	\$ 859,060	\$ (6,484)	166	\$ 1,301,348	\$ (36,937)	213	\$ 2,160,408	\$ (43,421)
Non-Agency MBS	56	\$ 329,108	\$ (5,886)	12	\$ 72,514	\$ (5,304)	68	\$ 401,622	\$ (11,190)

We do not consider those available-for-sale Agency MBS, or AFS MBS, that have been in a continuous loss position for 12 months or more to be other-than-temporarily impaired. The unrealized losses on our investments in AFS MBS were caused by fluctuations in interest rates. We purchased the AFS MBS primarily at a premium relative to their face value and the contractual cash flows of those investments are guaranteed by the U.S. government or government-sponsored agencies. Since September 2008, the government-sponsored agencies have been in the conservatorship of the U.S. government. At December 31, 2019, we did not expect to sell the AFS MBS at a price less than the amortized cost basis of our investments. Because the decline in market value of the AFS MBS is attributable to changes in interest rates and not the credit quality of the AFS MBS in our portfolio, and because we did not have the intent to sell these investments nor is it more likely than not that we will be required to sell these investments before recovery of their amortized cost basis, which may be at maturity, we do not consider these investments to be other-than-temporarily impaired at December 31, 2019.

The unrealized losses on our investments in Non-Agency MBS were caused by fluctuations in interest rates. We purchased the Non-Agency MBS primarily at a discount relative to their face value. During the year ended December 31, 2019, there were several bonds that were impaired for a total of approximately \$2.1 million, as the cash flow projections were less favorable than previously forecasted. On the remainder of the Non-Agency MBS, at December 31, 2019, we did not expect to sell these Non-Agency MBS at a price less than the amortized cost basis of our investments. Because the decline in market value of these Non-Agency MBS is attributable to changes in interest rates and not the credit quality of the Non-Agency MBS in our portfolio, and because we did not have the intent to sell these investments nor is it more likely than not that we will be required to sell these investments before recovery of their amortized cost basis, which may be at maturity, we do not consider these investments to be other-than-temporarily impaired at December 31, 2019.

NOTE 4. RESIDENTIAL MORTGAGE LOANS HELD-FOR-SECURITIZATION

At December 31, 2019, we owned approximately \$152.9 million of mortgage loans. At December 31, 2018, we owned approximately \$11.7 million of mortgage loans

The following table details the carrying value for residential mortgage loans held-for-securitization at December 31, 2019 and December 31, 2018:

	December 31, 2019	December 31, 2018
	(in thousands)	
Principal balance	\$ 148,908	\$ 11,281
Unamortized premium and deferred transaction costs	4,014	379
Carrying value	<u>\$ 152,922</u>	<u>\$ 11,660</u>

[Table of Contents](#)

The following table provides a reconciliation of the carrying value of residential mortgage loans held-for-securitization at December 31, 2019 and December 31, 2018:

	Year Ended December 31,	
	2019	2018
	(in thousands)	
Balance at beginning of period	\$ 11,660	\$ —
Loan acquisitions	168,850	11,660
Premium and deferred transaction costs on new loans	3,702	—
Deductions during period:		
Collections of principal	(30,992)	—
Amortization of premium and costs	(298)	—
Balance at end of period	<u>\$ 152,922</u>	<u>\$ 11,660</u>

The following table details various portfolio characteristics of the residential mortgage loans held-for-securitization at December 31, 2019 and December 31, 2018:

	December 31, 2019	December 31, 2018
	(dollar amounts in thousands)	
Portfolio Characteristics:		
12-months bank statements	17	2
24-months bank statements	56	18
Alt documentation	97	—
Full documentation	15	2
Written Verification of Employment	115	—
Number of loans outstanding	<u>300</u>	<u>22</u>
Current principal balance	\$ 148,908	\$ 11,281
Simple Average loan balance	\$ 496	\$ 513
Net weighted average coupon rate	5.40 %	5.95 %
Weighted average FICO score	744	722
Weighted average LTV (loan-to-value)	70	77

Weighted average DTI (debt-to-income)	38	40
Performance:		
Current	\$ 146,999	\$ 11,281
30-days delinquent	1,909	—
Total	<u>\$ 148,908</u>	<u>\$ 11,281</u>

The following table summarizes the geographic concentrations of residential mortgage loans held-for-securitization at December 31, 2019 and December 31, 2018, based on principal balance outstanding:

State	December 31, 2019	December 31, 2018
California	74 %	49
Florida	7	43
New York	6	5
Other states (none greater than 5%)	13	3
Total	<u>100 %</u>	<u>100 %</u>

[Table of Contents](#)

NOTE 5. VARIABLE INTEREST ENTITIES

As discussed in Note 1, “Summary of Significant Accounting Policies,” we have determined that we are the primary beneficiary of certain securitization trusts. The following table presents a summary of the assets and liabilities of our consolidated securitization trusts as of December 31, 2019 and December 31, 2018:

	December 31, 2019	December 31, 2018
	(in thousands)	
Residential mortgage loans held-for-investment through consolidated securitization trusts	\$ 458,348	\$ 549,016
Accrued interest receivable	1,495	1,792
Total assets	<u>\$ 459,843</u>	<u>\$ 550,808</u>
Accrued interest payable	\$ 1,448	\$ 1,746
Asset-backed securities issued by securitization trusts	448,987	539,651
Total liabilities	<u>\$ 450,435</u>	<u>\$ 541,397</u>

Our risk with respect to each investment in a securitization trust is limited to our direct ownership in the securitization trust. We own the most subordinated classes on all of the trusts. The residential mortgage loans held by the consolidated securitization trusts are held solely to satisfy the liabilities of the securitization trusts and the investors in the securitization trusts have no recourse to the general credit of the Company for the ABS issued by the securitization trusts. The assets of a consolidated securitization trust can only be used to satisfy the obligations of that trust. ABS are not paid down according to any schedule but rather as payments are made on the underlying mortgages. The final distribution dates for the three trusts are all at various dates in 2045. We are not contractually required and have not provided any additional financial support to the securitization trusts for the year ended December 31, 2019.

Residential Mortgage Loans Held-for-Investment Through Consolidated Securitization Trusts

Residential mortgage loans held-for-investment through consolidated securitization trusts are carried at unpaid principal balances net of any premiums or discounts and allowances for loan losses. The residential mortgage loans are secured by first liens on the underlying residential properties. As we still retain the most subordinated tranches in these trusts, we continue to be the primary beneficiary of these trusts and believe that we are still required to consolidate these trusts. During the years ended December 31, 2019 and December 31, 2018, we did not sell any of our investment in these trusts.

The following table details the carrying value for residential mortgage loans held-for-investment through consolidated securitization trusts at December 31, 2019 and December 31, 2018:

	December 31, 2019	December 31, 2018
	(in thousands)	
Principal balance	\$ 456,768	\$ 545,881
Unamortized premium and costs	1,755	3,321

Allowance for loan losses	(175)	(186)
Carrying value	<u>\$ 458,348</u>	<u>\$ 549,016</u>

[Table of Contents](#)

The following table provides a reconciliation of the carrying value of residential mortgage loans held-for-investment through consolidated securitization trusts at December 31, 2019 and December 31, 2018:

	Year Ended December 31,	
	2019	2018
	(in thousands)	
Balance at beginning of period	\$ 549,016	\$ 639,351
Deductions during period:		
Collections of principal	(89,113)	(88,338)
Principal paydowns and other deductions	(1,566)	(2,014)
Charge-offs, net	11	17
Balance at end of period	<u>\$ 458,348</u>	<u>\$ 549,016</u>

The following table details various portfolio characteristics of the residential mortgage loans held-for-investment through consolidated securitization trusts at December 31, 2019 and December 31, 2018:

	December 31, 2019	December 31, 2018
	(dollar amounts in thousands)	
Portfolio Characteristics:		
Number of loans	704	829
Current principal balance	\$ 456,768	\$ 545,881
Average loan balance	\$ 649	\$ 658
Net weighted average coupon rate	3.87 %	3.85 %
Weighted average maturity (years)	24.3	25.3
Weighted average FICO score	762	761
Current Performance:		
Current	\$ 452,875	\$ 543,328
30 days delinquent	2,122	—
60 days delinquent	726	896
90+ days delinquent	1,045	1,066
Bankruptcy/foreclosure	—	591
Total	<u>\$ 456,768</u>	<u>\$ 545,881</u>

The following table summarizes the geographic concentrations of residential mortgage loans held-for-investment through consolidated securitization trusts at December 31, 2019 and December 31, 2018, based on principal balance outstanding:

State	December 31, 2019	December 31, 2018
California	43 %	43 %
Florida	7	7
Other states (none greater than 5%)	50	50
Total	<u>100 %</u>	<u>100 %</u>

Allowance for Loan Losses on Residential Mortgage Loans Held by Consolidated Securitization Trusts

As discussed in Note 1, “Summary of Significant Accounting Policies,” the Company establishes and maintains an allowance for loan losses on residential mortgage loans held by consolidated securitization trusts based on the Company’s estimate of credit losses.

[Table of Contents](#)

The following table summarizes the activity in the allowance for loan losses for the years ended December 31, 2019 and December 31, 2018:

	Year Ended December 31, 2019	Year Ended December 31, 2018
Balance at beginning of period	\$ 186	\$ 203
Charge-offs, net	(11)	(17)
Balance at end of period	<u>\$ 175</u>	<u>\$ 186</u>

Asset-Backed Securities Issued by Securitization Trusts

Asset-backed securities issued by securitization trusts are recorded at principal balances net of unamortized premiums and discounts. Asset-backed securities issued by securitization trusts are issued in various tranches and have a principal balance of \$449.0 million at December 31, 2019 and \$539.7 million at December 31, 2018. The investors in the asset-backed securities are not affiliated with the Company and have no recourse to the general credit of the Company.

NOTE 6. RESIDENTIAL PROPERTIES

At December 31, 2019, we owned 85 single-family residential properties which are all located in Southeastern Florida and are carried at a total cost, net of accumulated depreciation, of approximately \$13.5 million. At December 31, 2018, we owned 86 single-family residential properties that were carried at a total cost, net of accumulated depreciation, of approximately \$13.8 million. The income from these properties is included in our statements of operations as “Income on rental properties.” The expenses on these properties are included in our statements of operations in “Rental properties depreciation and expenses.” During the year ended December 31, 2019, we sold one property and realized a gain of approximately \$31 thousand.

NOTE 7. SHORT-TERM DEBT

We have entered into repurchase agreements and a warehouse line of credit with a large financial institution. The repurchase agreements that we use to finance most of our MBS are short-term borrowings that are secured by the market value of our MBS and bear fixed interest rates that have historically been based upon LIBOR. Warehouse lines of credit are short-term borrowings (generally less than 1-year) that are used to finance the residential mortgage loans that are held-for-securitization. At December 31, 2019, we had borrowed \$133.8 million against the warehouse line of credit. At December 31, 2018, no borrowing had occurred against the warehouse line of credit. The mortgage loans held-for-securitization are held as collateral for this warehouse line of credit.

[Table of Contents](#)

Repurchase Agreements

At December 31, 2019 and December 31, 2018, the repurchase agreements had the following balances (dollar amounts in thousands), weighted average interest rates, and remaining weighted average maturities:

December 31, 2019

	Agency MBS		Non-Agency MBS		Total MBS	
	Balance	Weighted Average Interest Rate	Balance	Weighted Average Interest Rate	Balance	Weighted Average Interest Rate
	(in thousands)		(in thousands)		(in thousands)	
Overnight	\$ —	— %	\$ —	— %	\$ —	— %
Less than 30 days	1,680,000	2.04	427,873	2.80	2,107,873	2.20
30 days to 90 days	1,550,000	1.89	—	—	1,550,000	1.89
Over 90 days	—	—	—	—	—	—
Demand	—	—	—	—	—	—
	<u>\$ 3,230,000</u>	<u>1.97 %</u>	<u>\$ 427,873</u>	<u>2.80 %</u>	<u>\$ 3,657,873</u>	<u>2.07 %</u>

Weighted average maturity	30 days	11 days	28 days
Weighted average interest rate after adjusting for interest rate swaps			2.13 %
Weighted average maturity after adjusting for interest rate swaps			978 days
MBS pledged as collateral under the repurchase agreements and interest rate swaps	\$ 3,419,375	\$ 535,315	\$ 3,954,690

December 31, 2018

	Agency MBS		Non-Agency MBS		Total MBS	
	Balance	Weighted Average Interest Rate	Balance	Weighted Average Interest Rate	Balance	Weighted Average Interest Rate
	(in thousands)		(in thousands)		(in thousands)	
Overnight	\$ —	— %	\$ —	— %	\$ —	— %
Less than 30 days	1,510,000	2.46	576,627	3.55	2,086,627	2.76
30 days to 90 days	1,725,000	2.57	—	—	1,725,000	2.57
Over 90 days	—	—	—	—	—	—
Demand	—	—	—	—	—	—
	<u>\$ 3,235,000</u>	<u>2.52 %</u>	<u>\$ 576,627</u>	<u>3.55 %</u>	<u>\$ 3,811,627</u>	<u>2.67 %</u>
Weighted average maturity	35 days		13 days		32 days	
Weighted average interest rate after adjusting for interest rate swaps					2.23 %	
Weighted average maturity after adjusting for interest rate swaps					1,217 days	
MBS pledged as collateral under the repurchase agreements and interest rate swaps	\$ 3,433,252		\$ 726,428		\$ 4,159,680	

For additional information about repurchase agreements, see the section in Note 1 entitled “Repurchase Agreements.”

The following tables present information about certain assets and liabilities at December 31, 2019 and December 31, 2018 that are subject to master netting arrangements (or similar agreements) only in the event of default on a

[Table of Contents](#)

contract. See Notes 1, 9, and 15 for more information on the Company’s interest rate swaps and other derivative instruments.

December 31, 2019

	Gross Amounts of Recognized Assets or Liabilities	Gross Amounts Offset in the Balance Sheets	Net Amounts of Assets or Liabilities Presented in the Balance Sheets	Gross Amounts Not Offset in the Balance Sheets ⁽¹⁾		Net Amounts
			(in thousands)	Financial Instruments	Cash Collateral Received	
Derivative assets at fair value ⁽²⁾	\$ 5,833	\$ —	\$ 5,833	\$ (5,833)	\$ 367	\$ (5,466)
Total	<u>\$ 5,833</u>	<u>\$ —</u>	<u>\$ 5,833</u>	<u>\$ (5,833)</u>	<u>\$ 367</u>	<u>\$ (5,466)</u>
Repurchase agreements ⁽³⁾	\$ 3,657,873	\$ —	\$ 3,657,873	\$ (3,657,873)	\$ —	\$ —
Warehouse line of credit	133,811	—	133,811	(133,811)	—	—
Derivative liabilities at fair value ⁽²⁾	52,197	—	52,197	(52,197)	—	—
Total	<u>\$ 3,843,881</u>	<u>\$ —</u>	<u>\$ 3,843,881</u>	<u>\$ (3,843,881)</u>	<u>\$ —</u>	<u>\$ —</u>

December 31, 2018

	Gross Amounts of Recognized Assets or Liabilities	Gross Amounts Offset in the Balance Sheets	Net Amounts of Assets or Liabilities Presented in the Balance Sheets	Gross Amounts Not Offset in the Balance Sheets ⁽¹⁾		Net Amounts
			(in thousands)	Financial Instruments	Cash Collateral Received	
Derivative assets at fair value ⁽²⁾	\$ 46,207	\$ —	\$ 46,207	\$ (46,207)	\$ —	\$ —
Total	\$ 46,207	\$ —	\$ 46,207	\$ (46,207)	\$ —	\$ —
Repurchase agreements ⁽³⁾	\$ 3,811,627	\$ —	\$ 3,811,627	\$ (3,811,627)	\$ —	\$ —
Derivative liabilities at fair value ⁽²⁾	15,901	—	15,901	(15,901)	—	—
Total	\$ 3,827,528	\$ —	\$ 3,827,528	\$ (3,827,528)	\$ —	\$ —

- (1) Amounts presented are limited to collateral pledged sufficient to reduce the related net amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.
- (2) At December 31, 2019, we had paid approximately \$104.7 million on swap and TBA Agency MBS margin calls (included in “restricted cash”) and we had received cash from counterparties of approximately \$367 thousand, which is shown as “Derivative counterparty margin” on our consolidated balance sheets. Our swap derivatives were approximately \$5.3 million in derivative assets and approximately \$52.2 million in derivative liabilities at December 31, 2019. At December 31, 2018, we had paid approximately \$30.3 million on swap and TBA Agency MBS margin calls (included in “restricted cash”). Our swap derivatives were approximately \$40.2 million in derivative assets and approximately \$15.9 million in derivative liabilities at December 31, 2018.
- (3) At December 31, 2019, we had pledged approximately \$3.42 billion in Agency MBS and approximately \$535 million of Non-Agency MBS as collateral on our repurchase agreements. At December 31, 2018, we had pledged approximately \$3.43 billion in Agency MBS and approximately \$726.4 million of Non-Agency MBS as collateral on our repurchase agreements.

NOTE 8. JUNIOR SUBORDINATED NOTES

On March 15, 2005, we issued \$37,380,000 of junior subordinated notes to a newly-formed statutory trust, Anworth Capital Trust I, organized by us under Delaware law. The trust issued \$36,250,000 in trust preferred securities to unrelated third party investors. Both the notes and the trust preferred securities require quarterly payments and bear interest at the prevailing three-month LIBOR rate plus 3.10%, reset quarterly. The first interest payments were made on June 30, 2005. Both the notes and the trust preferred securities will mature in 2035 and are currently redeemable, at our

option, in whole or in part, without penalty. We used the net proceeds of this private placement to invest in Agency MBS. We have reviewed the structure of the transaction under ASC 810-10 and concluded that Anworth Capital Trust I does not meet the requirements for consolidation. As of the date of this filing, we have not redeemed any of the notes or trust preferred securities.

NOTE 9. FAIR VALUES OF FINANCIAL INSTRUMENTS

As defined in ASC 820-10, fair value is the price that would be received from the sale of an asset or paid to transfer or settle a liability in an orderly transaction between market participants in the principal (or most advantageous) market for the asset or liability. ASC 820-10 establishes a fair value hierarchy that ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value are classified and disclosed in one of the three following categories:

- Level 1: Quoted market prices in active markets for identical assets or liabilities.
- Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data. This includes those financial instruments that are valued using models or other valuation methodologies where substantially all of the assumptions are observable in the marketplace, can be derived from observable market data or are supported by observable levels at which transactions are executed in the marketplace. The valuation techniques, including the judgments or assumptions that are used by us in arriving at the fair value of our MBS and derivative instruments, are as follows:
 - The fair values for Agency MBS and TBA Agency MBS are based primarily on independent broker pricing quotes and independent third-party pricing service quotes, which are deemed indicative of market activity. The brokers and third-party pricing services use commonly used market pricing methodology that generally incorporate such factors as coupons, primary and secondary mortgage rates, rate reset period, issuer, loan age, collateral type, periodic and life cap, geography, and prepayment speeds. We evaluate the pricing information we receive taking into account factors such as coupon, prepayment experience, fixed/adjustable rate, coupon index, time to reset and issuing agency, among other factors. Based on these factors and our market knowledge and expertise, bond prices are compared to prices of similar securities and our own observations of trading activity in the marketplace.
 - The fair values for Non-Agency MBS are based primarily on prices from independent well-known major financial brokers that make markets in these instruments and pricing from independent pricing services. We understand that these market participants use pricing models that not only consider the characteristics of the type of security and its underlying collateral from observable market data but also consider the historical performance data of the underlying collateral of the security, including loan delinquency, loan losses, and credit enhancement. To validate the prices the Company obtains, we consider and review a number of observable market data points including trading activity in the marketplace, and current market intelligence on all major markets, including benchmark security

evaluations and bid list results from various sources. We compare the prices received from brokers against the prices received from pricing services and vice-versa and also against our own internal models for reasonableness and make inquiries to the brokers and pricing services about the prices received from these parties and their methods.

For derivative instruments, the fair value is determined as follows: For all centrally cleared interest rate swaps (those entered into after September 9, 2013) pricing is provided by the central counterparty (large central clearing exchanges such as the Chicago Mercantile Exchange, or the CME, and LCH). These entities use pricing models that reference the underlying rates including the overnight index swap rate and LIBOR forward rate to produce the daily settlement price. To validate the prices for all interest rate swaps, we compare to other sources such as Bloomberg. At December 31, 2019, we did not have any non-centrally cleared swaps.

Level 3: Unobservable inputs that are not corroborated by market data. This is comprised of financial instruments whose fair value is estimated based on internally developed models or methodologies utilizing significant inputs that are generally less readily observable from objective sources.

At December 31, 2019 and December 31, 2018, fair value measurements on a recurring basis were as follows:

December 31, 2019

	Level 1	Level 2	Level 3	Total
	(in thousands)			
Assets:				
Agency MBS ⁽¹⁾	\$ —	\$ 3,510,051	\$ —	\$ 3,510,051
Non-Agency MBS ⁽¹⁾	\$ —	\$ 643,610	\$ —	\$ 643,610
Derivative instruments ⁽²⁾	\$ —	\$ 5,833	\$ —	\$ 5,833
Liabilities:				
Derivative instruments ⁽²⁾	\$ —	\$ 52,197	\$ —	\$ 52,197

December 31, 2018

	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Total</u>
	(in thousands)			
Assets:				
Agency MBS ⁽¹⁾	\$ —	\$ 3,548,719	\$ —	\$ 3,548,719
Non-Agency MBS ⁽¹⁾	\$ —	\$ 795,203	\$ —	\$ 795,203
Derivative instruments ⁽²⁾	\$ —	\$ 46,207	\$ —	\$ 46,207
Liabilities:				
Derivative instruments ⁽²⁾	\$ —	\$ 15,901	\$ —	\$ 15,901

(1) For more detail about the fair value of our MBS by agency and type of security, see Notes 1 and 3.
(2) Derivative instruments include discontinued hedges under ASC 815-10. For more detail about our derivative instruments, see Notes 1 and 15.

At December 31, 2019 and December 31, 2018, cash and cash equivalents, investments in U.S. Treasury bills, restricted cash, interest receivable, repurchase agreements, reverse repurchase agreements, warehouse line of credit, and interest payable are reflected in our consolidated financial statements at cost, which approximate fair value because of the nature and short term of these instruments.

Junior subordinated notes are variable-rate debt and, as we believe the spread would be consistent with the expectations of market participants as of December 31, 2019 and December 31, 2018, the carrying value approximates fair value.

The following table presents the carrying value and estimated fair value of the Company’s financial instruments that are not carried at fair value on the consolidated balance sheets at December 31, 2019 and December 31, 2018:

	December 31, 2019		December 31, 2018	
	Carrying Value	Estimated Fair Value	Carrying Value	Estimated Fair Value
	(in thousands)			
Financial Assets:				
Residential mortgage loans held-for-investment through consolidated securitization trusts	\$ 458,348	\$ 461,606	\$ 549,016	\$ 538,362

Residential mortgage loans held-for-securitization	\$	152,922	\$	154,442	\$	11,660	\$	11,660
Financial Liabilities:								
Asset-backed securities issued by securitization trusts	\$	448,987	\$	450,501	\$	539,651	\$	528,045

The residential mortgage loans held-for-investment through consolidated securitization trusts or held-for-securitization are carried at unpaid principal balances net of any premiums or discounts and allowances for loan losses. Asset-backed securities issued by securitization trusts are carried at principal balances net of unamortized premiums or

discounts. For both of these items, fair values are obtained by an independent broker and/or independent pricing services and are considered Level 2 in the fair value hierarchy.

NOTE 10. INCOME TAXES

We have elected to be taxed as a REIT and to comply with the provisions of the Code with respect thereto. Accordingly, we will not be subject to federal or state income taxes to the extent that our distributions to stockholders satisfy the REIT requirements and certain asset, income and stock ownership tests are met. We believe we currently meet all REIT requirements regarding the ownership of our common stock and the distribution of our taxable net income. Therefore, we believe that we continue to qualify as a REIT under the provisions of the Code.

Income tax expense (benefit) for the years ended December 31, 2019, 2018, and 2017 was zero. None of the components of income tax expense are significant on a separately stated basis.

At December 31, 2019 and December 31, 2018, there were no significant deferred tax assets and deferred tax liabilities.

The tables below present tax information regarding our dividend distributions for the fiscal year ended December 31, 2019:

8.625% Series A Cumulative Preferred Stock (CUSIP 03747 20 0)

Declaration Date	Record Date	Payable Date	2019 Total Distribution Per Share	2019 Ordinary Income	2019 Return of Capital	Short-Term Capital Gains	Carry-Over to 2020
11/06/18	12/31/18	01/15/19	\$ 0.539063	\$ 0.539063	\$ —	\$ —	\$ —
02/28/19	03/29/19	04/15/19	0.539063	0.539063	—	—	—
05/07/19	06/28/19	07/15/19	0.539063	0.539063	—	—	—
08/06/19	09/30/19	10/15/19	0.539063	0.539063	—	—	—
11/06/19	12/31/19	01/15/20	0.539063	—	—	—	0.539063
Total			<u>\$ 2.695315</u>	<u>\$ 2.156252</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 0.539063</u>

6.25% Series B Cumulative Convertible Preferred Stock (CUSIP 03747 30 9)

Declaration Date	Record Date	Payable Date	2019 Total Distribution Per Share ⁽¹⁾	2019 Ordinary Income	2019 Return of Capital	Short-Term Capital Gains	Carry-Over to 2020
11/06/18	12/31/18	01/15/19	\$ 0.395857	\$ 0.395857	\$ —	\$ —	\$ —
02/28/19	03/29/19	04/15/19	0.396315	0.396315	—	—	—
05/07/19	06/28/19	07/15/19	0.394509	0.394509	—	—	—
08/06/19	09/30/19	10/15/19	0.394301	0.394301	—	—	—
11/06/19	12/31/19	01/15/20	0.390625	—	—	—	0.390625
Total			<u>\$ 1.971607</u>	<u>\$ 1.580982</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 0.390625</u>

(1) The Series B Preferred Stock is convertible into shares of our common stock. The conversion rate is adjusted per a stated formula when distributions are made to our common stockholders. The value of any conversion rate increase is a deemed distribution for tax purposes and is taxable to holders of our Series B Preferred Stock to the extent supported by earnings and profits and is included in the table above. See Forms 8937 on our Company website for additional details.

[Table of Contents](#)

7.625% Series C Cumulative Redeemable Preferred Stock (CUSIP 03747 40 8)

Declaration Date	Record Date	Payable Date	2019 Total Distribution Per Share	2019 Ordinary Income	2019 Return of Capital	Short-Term Capital Gains	Carry-Over to 2020
11/06/18	12/31/18	01/15/19	\$ 0.476563	\$ 0.476563	\$ —	\$ —	\$ —
02/28/19	03/29/19	04/15/19	0.476563	0.476563	—	—	—
05/07/19	06/28/19	07/15/19	0.476563	0.476563	—	—	—
08/06/19	09/30/19	10/15/19	0.476563	0.476563	—	—	—
11/06/19	12/31/19	01/15/20	0.476563	—	—	—	0.476563
Total			<u>\$ 2.382815</u>	<u>\$ 1.906252</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 0.476563</u>

Common Stock (CUSIP 03747 10 1)

Declaration Date	Record Date	Payable Date	2019 Total Distribution Per Share	2019 Ordinary Income	2019 Return of Capital	Short-Term Capital Gains	Carry-Over to 2020
12/14/18	12/31/18	01/29/19	\$ 0.130000	\$ 0.091521	\$ 0.038479	\$ —	\$ —
03/14/19	03/29/19	04/29/19	0.130000	0.091521	0.038479	—	—
06/13/19	06/28/19	07/29/19	0.110000	0.077441	0.032559	—	—
09/17/19	09/30/19	10/29/19	0.100000	0.070401	0.029599	—	—
12/17/19	12/31/19	01/29/20	0.090000	—	—	—	0.090000
Total			<u>\$ 0.560000</u>	<u>\$ 0.330884</u>	<u>\$ 0.139116</u>	<u>\$ —</u>	<u>\$ 0.090000</u>

NOTE 11. SERIES B CUMULATIVE CONVERTIBLE PREFERRED STOCK

Our Series B Preferred Stock has a par value of \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The holders of our Series B Preferred Stock receive dividends at a rate of 6.25% per year on the \$25.00 liquidation preference before holders of our common stock are entitled to receive any dividends. Our Series B Preferred Stock is senior to our common stock and on parity with our Series A Preferred Stock and Series C Preferred Stock with respect to the payment of distributions and amounts, upon liquidation, dissolution or winding up. So long as any shares of our Series B Preferred Stock remain outstanding, we will not, without the affirmative vote or consent of the holders of at least two-thirds of the shares of our Series B Preferred Stock outstanding at the time, authorize or create, or increase the authorized or issued amount of, any class or series of capital stock ranking senior to our Series B Preferred Stock with respect to payment of dividends or the distribution of assets upon liquidation, dissolution, or winding up.

Our Series B Preferred Stock has no maturity date, is not redeemable and is convertible at the then-current conversion rate into shares of our common stock per \$25.00 liquidation preference. The conversion rate is adjusted in any fiscal quarter in which the cash dividends paid to common stockholders results in an annualized common stock dividend yield that is greater than 6.25%. The conversion ratio is also subject to adjustment upon the occurrence of certain specific events such as a change in control. Our Series B Preferred Stock is convertible into shares of our common stock at the option of the holder(s) of Series B Preferred Stock at any time at the then-prevailing conversion rate. At December 31, 2019, the conversion rate was 5.5379. On or after January 25, 2012, we may, at our option, under certain circumstances, convert each share of Series B Preferred Stock into a number of shares of our common stock at the then-prevailing conversion rate. We may exercise this conversion option only if our common stock price equals or exceeds 130% of the then-prevailing conversion price of our Series B Preferred Stock for at least twenty (20) trading days in a period of thirty (30) consecutive trading days (including the last trading day of such period) ending on the trading day immediately prior to our issuance of a press release announcing the exercise of the conversion option.

[Table of Contents](#)

During the year ended December 31, 2019, we did not, at our option, convert any shares of Series B Preferred Stock. Our Series B Preferred Stock contains certain fundamental change provisions that allow the holder to redeem our Series B Preferred Stock for cash if certain events occur, such as a change in control. Our Series B Preferred Stock generally does not have voting rights, except if dividends on the Series B Preferred Stock are in arrears for six or more quarterly periods (whether or not consecutive). Under such circumstances, the holders of Series B Preferred Stock, together with the holders of Series A Preferred Stock and Series C Preferred Stock, would be entitled to elect two additional directors to our board of directors to serve until all unpaid dividends have been paid or declared and set aside for payment. In addition, certain material and adverse changes to the terms of our Series B Preferred Stock may not be taken without the affirmative vote of at least two-thirds of the outstanding shares of Series B Preferred Stock, Series A Preferred Stock and Series C Preferred Stock voting together as a single class. Through December 31, 2019, we have declared and set aside for payment the required dividends for our Series B Preferred Stock.

During the year ended December 31, 2019, there were no transactions to convert shares of our Series B Preferred Stock.

NOTE 12. PUBLIC OFFERINGS AND CAPITAL STOCK

At December 31, 2019, our authorized capital included 200,000,000 shares of common stock, of which 98,849,383 shares were issued and outstanding.

At December 31, 2019, our authorized capital included 20,000,000 shares of \$0.01 par value preferred stock, of which 5,150,000 shares had been designated 8.625% Series A Cumulative Preferred Stock (liquidation preference \$25.00 per share), 3,150,000 shares had been designated 6.25% Series B Cumulative Convertible Preferred Stock (liquidation preference \$25.00 per share), and 5,000,000 shares had been designated 7.625% Series C Cumulative Redeemable Preferred Stock (liquidation preference \$25.00 per share), or Series C Preferred Stock. The undesignated shares of preferred stock may be issued in one or more classes or series, with such distinctive designations, rights and preferences as determined by our board of directors. At December 31, 2019, there were 1,919,378 shares of Series A Preferred Stock issued and outstanding, 779,743 shares of Series B Preferred Stock issued and outstanding, and 2,010,278 shares of Series C Preferred Stock issued and outstanding.

On January 27, 2015, we completed a public offering of 300,000 shares of our Series C Preferred Stock at a public offering price of \$24.50 per share and received net proceeds of approximately \$7 million. The shares were sold pursuant to the Company's effective shelf registration statement on Form S-3. The Series C Preferred Stock has no maturity date and is not subject to any sinking fund or mandatory redemption. On or after January 27, 2020, we may, at our option, redeem the Series C Preferred Stock for cash, in whole or from time to time in part, at a redemption price of \$25.00 per share plus accrued and unpaid dividends, if any, to the redemption date.

On August 10, 2016, we entered into an At Market Issuance Sales Agreement, or the FBR Sales Agreement, with FBR Capital Markets & Co., or FBR, pursuant to which we may offer and sell from time to time through FBR, as our agent, up to \$196,615,000 maximum aggregate amount of our common stock, Series B Preferred Stock, and Series C Preferred Stock, in such amounts as we may specify by notice to FBR, in accordance with the terms and conditions set forth in the FBR Sales Agreement. During the year ended December 31, 2019, we did not sell any shares of Series C Preferred Stock under the FBR Sales Agreement. At December 31, 2019, there was approximately \$152.7 million available for sale and issuance under the FBR Sales Agreement.

On October 3, 2011, we announced that our Board authorized a share repurchase program which permits us to acquire up to 2,000,000 shares of our common stock. The shares are expected to be acquired at prevailing prices through open market transactions. The manner, price, number and timing of share repurchases will be subject to market conditions and applicable SEC rules. Our Board also authorized the Company to purchase an amount of our common stock up to the amount of common stock sold through our 2015 Dividend Reinvestment and Stock Purchase Plan. Subsequently, our Board authorized the Company to acquire an aggregate of an additional 45,000,000 shares (pursuant to six separate authorizations) between December 13, 2013 and January 22, 2016. In December 2019, our Board decided to no longer include the amount of common stock sold through our Dividend Reinvestment and Stock Purchase Plan as

[Table of Contents](#)

stock available for repurchase. During the year ended December 31, 2019, we did not repurchase any shares of our common stock under our share repurchase program.

Our Dividend Reinvestment and Stock Purchase Plan allows stockholders and non-stockholders to purchase shares of our common stock and to reinvest dividends therefrom to acquire additional shares of our common stock. On March 15, 2018, we filed a shelf registration statement on Form S-3 with the SEC, which was declared effective on March 26, 2018, registering up to 15,303,119 shares of our common stock for our 2018 Dividend Reinvestment and Stock Purchase Plan, or the 2018 DRP Plan. During the year ended December 31, 2019, we issued an aggregate of 346,335 shares of our common stock at a weighted average price of \$3.92 per share under the 2018 DRP Plan, resulting in net proceeds to us of approximately \$1.36 million.

On April 4, 2019, we filed a shelf registration statement on Form S-3 with the SEC, offering up to \$490,236,182 maximum offering price of our capital stock. The registration statement was declared effective on April 19, 2019. At December 31, 2019, approximately \$490.2 million of our capital stock was available for future issuance under the registration statement.

On August 5, 2014, we filed a registration statement on Form S-8 with the SEC to register an aggregate of up to 2,000,000 shares of our common stock to be issued pursuant to the Anworth Mortgage Asset Corporation 2014 Equity Compensation Plan, or the 2014 Equity Plan. During the year ended December 31, 2019, we issued an aggregate of 8,000 restricted stock units (or phantom shares) under the 2014 Equity Plan.

NOTE 13. TRANSACTIONS WITH AFFILIATES

Management Agreement and Externalization

Effective as of December 31, 2011, we entered into the Management Agreement with our Manager, pursuant to which our day-to-day operations are being conducted by our Manager. Our Manager is supervised and directed by our board of directors and is responsible for (i) the selection, purchase and sale of our investment portfolio; (ii) our financing and hedging activities; and (iii) providing us with portfolio management and administrative services. Our Manager will also perform such other services and activities relating to our assets and operations as may be appropriate. In exchange for services, our Manager receives a management fee, paid monthly in arrears, in an amount equal to one-twelfth of 1.20% of our Equity (as defined in the Management Agreement).

On the effective date of the Management Agreement, the employment agreements with our executives were terminated, our employees became employees of our Manager, and we took such other actions as we believed were reasonably necessary to implement the Management Agreement and externalize our management function.

As of December, 31, 2019, Mr. Lloyd McAdams, a director and our former Chairman of the Board, beneficially owns 47.4% of the outstanding membership interests of our Manager; Mr. Joseph E. McAdams, our Chairman, Chief Executive Officer and President, and the Chief Investment Officer of our Manager, beneficially owns 47.4% of the outstanding membership interests of our Manager; and Ms. Heather U. Baines, an Executive Vice President of our Manager, beneficially owns 5.2% of the outstanding membership interests of our Manager.

The Management Agreement may only be terminated without cause, as defined in the agreement, after the expiration of any annual renewal term. We are required to provide 180-days prior notice of non-renewal of the Management Agreement and must pay a termination fee on the last day of any automatic renewal term equal to three times the average annual management fee earned by our Manager during the prior 24-month period immediately preceding the most recently completed month prior to the effective date of termination. We may only not renew the Management Agreement with or without cause with the consent of the majority of our independent directors. These provisions make it difficult to terminate the Management Agreement and increase the effective cost to us of not renewing the Management Agreement.

Certain of our former officers were previously granted restricted stock and other equity awards (see Note 14), including dividend equivalent rights, in connection with their service to us, and certain of our former officers had

[Table of Contents](#)

agreements under which they would receive payments if the Company is subject to a change in control (discussed later in this Note 13). In connection with the Externalization, certain of the agreements under which our officers were granted equity awards and would be paid payments in the event of a change in control were modified so that such agreements will continue with respect to our former officers and employees after they became officers and employees of our Manager. In addition, as officers and employees of our Manager, they will continue to be eligible to receive equity awards under equity compensation plans in effect now or in the future.

Messrs. Joseph E. McAdams, Charles J. Siegel, John T. Hillman, and Ms. Heather U. Baines and others are officers and employees of PIA Farmland, Inc. and its external manager, PIA, where they devote a portion of their time. PIA Farmland, Inc., a privately-held real estate investment trust investing in U.S. farmland properties to lease to independent farm operators, was incorporated in February 2013. These officers and employees are under no contractual obligations to PIA Farmland, Inc., its external manager, PIA, or to Anworth or its external manager, Anworth Management, LLC, as to their time commitment.

Change in Control and Arbitration Agreements

We entered into Change in Control and Arbitration Agreements with Mr. Charles J. Siegel, our Chief Financial Officer, and with various officers of our Manager including Ms. Bistra Pashamova, a Senior Vice President and Portfolio Manager of our Manager. These agreements provide that should a change in control (as defined in the agreements) occur, each of these officers will receive certain severance and other benefits valued as of December 31, 2011. Under these agreements, in the event that a change in control occurs, each of these officers will receive a lump sum payment equal to (i) 12 months annual base salary in effect on December 31, 2011, plus (ii) the average annual incentive compensation received for the two complete fiscal years prior December 31, 2011, plus (iii) the average annual bonus received for the two complete fiscal years prior to December 31, 2011, as well as other benefits. For Mr. Brett Roth, a Senior Vice President and Portfolio Manager of our Manager, in the event that a change in control occurs, he will receive a lump sum payment equal to (i) 12 months annual base salary paid by the Manager in effect on September 18, 2014 plus (ii) \$350,000, as well as other benefits. The Change in Control and Arbitration Agreements also provide for accelerated vesting of equity awards granted to these officers upon a change in control.

Agreements with Pacific Income Advisers, Inc.

On January 26, 2012, we entered into a sublease agreement that became effective on July 1, 2012 with PIA. Under the sublease agreement, we lease, on a pass-through basis, 7,300 square feet of office space from PIA at the same location and pay rent at an annual rate equal to PIA’s obligation, which is currently \$71.50 per square foot. The base monthly rental for us is \$43,497.47, which will be increased by 3% per annum on July 1, 2020. The sublease agreement runs through June 30, 2022 unless earlier terminated pursuant to the master lease. During the years ended December 31, 2019, 2018, and 2017, we expensed \$565 thousand, \$557 thousand, and \$528 thousand, respectively, in rent and related expenses to PIA under this sublease agreement.

At December 31, 2019, the future minimum lease commitment is as follows:

	2020	2021	2022	Total Commitment
Commitment (undiscounted cash flows)	\$ 529,800	\$ 545,697	\$ 276,882	\$ 1,352,379
Discounted cash flows on the lease commitment ⁽¹⁾	\$ 513,143	\$ 515,623	\$ 257,305	\$ 1,286,071

(1) The difference between the total commitment amount and the amount on the consolidated balance sheets is due to the amortization of the lease asset and lease liability being done on a straight-line basis rather than by the discounted cash flows.

Under our administrative services agreement with PIA, it provides administrative services and equipment to us including human resources, operational support and information technology, and we pay an annual fee of 5 basis points on the first \$225 million of stockholders’ equity and 2.25 basis points thereafter (paid quarterly in arrears) for those

[Table of Contents](#)

services. The administrative services agreement had an initial term of one year and renews for successive one-year terms thereafter unless either party gives notice of termination no less than 30 days before the expiration of the then-current annual term. We may also terminate the administrative services agreement upon 30 days’ prior written notice for any reason and immediately if there is a material breach by PIA. During the years ended December 31, 2019, 2018, and 2017, we paid fees of \$181 thousand, \$181 thousand, and \$154 thousand, respectively, to PIA in connection with this agreement.

NOTE 14. EQUITY COMPENSATION PLAN

2014 Equity Compensation Plan

At our annual meeting of stockholders held on May 22, 2014, our stockholders approved the adoption of the 2014 Equity Compensation Plan, or the 2014 Equity Plan, which replaced the Anworth Mortgage Asset Corporation 2004 Equity Compensation Plan, or the 2004 Equity Plan, due to its expiration. We filed a registration statement on Form S-8 on August 5, 2014 to register up to an aggregate of 2,000,000 shares of our common stock to be issued pursuant to the 2014 Equity Plan. The 2014 Equity Plan decreases the aggregate share reserve from 3,500,000 shares that were available under the 2004 Equity Plan to 2,000,000 shares of our registered common stock available under the 2014 Equity Plan. The 2014 Equity Plan authorizes our board of directors, or a committee of our board of directors, to grant DERs or phantom shares, which qualify as performance-based awards under Section 162(m) of the Code. Unlike the 2004 Equity Plan, however, the 2014 Equity Plan does not provide for automatic increases in the aggregate share reserve or the number of shares remaining available for grant and only provides for the granting of DERs or phantom shares. During the year ended December 31, 2019, we issued to our independent directors an aggregate of 8,000 restricted stock units (or phantom shares) with associated grants of 8,000 DERs in the aggregate under the 2014 Equity Plan. These restricted stock units (or phantom shares) do not vest until our independent directors terminate their service on our Board.

In August 2016, we granted to various officers and employees an aggregate of 146,552 performance-based restricted stock units (or phantom shares) with no associated grants of DERs. During the period commencing on the day immediately following the three-year anniversary of the grant date and ending on the ten-year anniversary of the grant date, the restricted stock units will vest on the last day of any month when the total return to stockholders (meaning the aggregate of our common stock price appreciation and dividends declared, assuming full reinvestment of such dividends) exceeds 10% per annum. During the period commencing on the grant date and ending on the last day of the calendar month after the three-year anniversary of the grant date, the restricted stock units will vest immediately upon the grantee’s involuntary termination of service for any reason other than for cause. The closing price of the Company’s common stock on the grant date was \$4.96. The amount expensed on these grants during 2019 was approximately \$62 thousand. At December 31, 2019, these grants have been fully expensed.

In December 2017, we issued to various officers and employees an aggregate of 162,613 performance-based restricted stock units (or phantom shares) with no associated grants of DERs. During the period commencing on the day immediately following the three-year anniversary of the grant date and ending on the ten-year anniversary of the grant date, the restricted stock units shall vest on the last day of any month when the total return to stockholders (meaning the aggregate of our common stock price appreciation and dividends declared, assuming full reinvestment of such dividends) exceeds 10% per annum. During the period commencing on the grant date and ending on the last day of the calendar month after the three-year anniversary of the grant date, the restricted stock units will vest immediately upon the grantee’s involuntary termination of service for any reason other than for cause. The closing price of the Company’s common stock on the grant date was \$5.66. During the year ended December 31, 2019, the amount expensed on these grants was approximately \$16 thousand. The unrecognized stock expense on these grants at December 31, 2019 was approximately \$136 thousand.

Certain of our former officers have previously been granted restricted stock and other equity incentive awards, including dividend equivalent rights, in connection with their service to us. In connection with the Externalization, certain of the agreements under which our former officers have been granted equity awards were modified so that such agreements will continue with respect to our former officers after they became officers and employees of our Manager. As a result, these awards and any future grants will be accounted for as non-employee awards. In addition, as officers and employees of our Manager, they will continue to be eligible to receive equity incentive awards under equity

[Table of Contents](#)

incentive plans in effect now or in the future. In accordance with the Externalization effective as of December 31, 2011, the DERs previously granted to all of our officers were terminated under the 2007 Dividend Equivalent Rights Plan and were reissued under the 2004 Equity Plan with the same amounts, terms and conditions. The 2004 Equity Plan was subsequently replaced by the 2014 Equity Plan.

There have been no stock option transactions that are outstanding under the 2014 Equity Plan during 2019, 2018, and 2017.

The following table summarizes information about restricted stock units transactions during the year ended December 31, 2019:

Grant Date Fair Value	Unvested Units at December 31, 2018	Restricted Units Granted	Units Vested in 2019	Units Forfeited	Unvested Units at December 31, 2019	Weighted Average Remaining Contractual Life (Years)
\$ 4.96	154,552	—	—	146,552	8,000	1
\$ 5.66	162,613	—	—	—	162,613	8
	317,165	—	—	146,552	170,613	

The fair value of the aforementioned stock-based award was estimated using the Black-Scholes model with the following weighted-average assumptions:

	2016 Grant	2017 Grant
Assumptions:		
Dividend yield	13.1 %	13.1 %
Expected volatility	27.7 %	27.7 %
Risk-free interest rate	3.8 %	3.8 %
Expected lives	3 years	10 years

We recognize the expense related to restricted stock units over a vesting period ranging from three to ten years. During the years ended December 31, 2019, 2018, and 2017, we expensed approximately \$78 thousand, \$98 thousand, and \$82 thousand, respectively, related to the restricted stock units grants.

At our May 24, 2007 annual meeting of stockholders, our stockholders adopted the Anworth Mortgage Asset Corporation 2007 Dividend Equivalent Rights Plan, or the 2007 DER Plan. A dividend equivalent right, or DER, is a right to receive amounts equal in value to the dividend distributions paid on a share of our common stock. DERs are paid in either cash or shares of our common stock, whichever is specified by our Compensation Committee at the time of grant, at such times as dividends are paid on shares of our common stock during the period between the date a DER is issued and the date the DER expires or earlier terminates. The Compensation Committee may impose such other conditions to the grant of DERs as it may deem appropriate. The maximum term for DERs is ten years from the date of grant. On December 17, 2019, our Board approved a grant of 114,178 DERs to replace an equal amount of DERs that were scheduled to expire in December 2019, which were issued under the 2014 Equity Plan. This grant has only a one-year term, whereas all of the prior grants have a five-year term from the date of the grant. These DERs are not attached to any stock and only have the right to receive the same cash distribution per common share distributed to our common stockholders during the term of the grant. At December 31, 2019, there were 746,611 DERs issued and outstanding, which are held by the directors and officers of our Company and employees of our Manager. During the years ended December 31, 2019, 2018, and 2017, we paid or accrued \$301 thousand, \$392 thousand, and \$430 thousand, respectively, related to DERs granted.

NOTE 15. DERIVATIVE INSTRUMENTS

The table below presents the fair value of our derivative instruments as well as their classification in our

[Table of Contents](#)

consolidated balance sheets as of December 31, 2019 and December 31, 2018:

Derivative Instruments	Balance Sheet Location	December 31, 2019	December 31, 2018
		(in thousands)	
Interest rate swaps	Derivative Assets	\$ 5,302	\$ 40,192
TBA Agency MBS	Derivative Assets	531	6,015
		<u>\$ 5,833</u>	<u>\$ 46,207</u>
Interest rate swaps	Derivative Liabilities	52,197	15,901
		<u>\$ 52,197</u>	<u>\$ 15,901</u>
<i>Interest Rate Swap Agreements</i>			

At December 31, 2019, we were a counterparty to interest rate swaps, which are derivative instruments as defined by ASC 815-10, with an aggregate notional amount of \$2.5 billion and a weighted average maturity of approximately 48 months. We utilize interest rate swaps to manage interest rate risk relating to our repurchase agreements and do not anticipate entering into derivative transactions for speculative or trading purposes. In accordance with the swap agreements, we will pay a fixed-rate of interest during the term of the swap agreements (ranging from 1.411% to 3.2205%) and receive a payment that varies with the three-month LIBOR rate. During the year ended December 31, 2019, 36 swap agreements with an aggregate notional amount of \$1.84 billion matured or were terminated, and we entered into 26 new swap agreements with an aggregate notional amount of \$1.035 billion and terms of up to ten years.

At December 31, 2019, the amount in AOCI relating to interest rate swaps was approximately \$7.6 million. The estimated net amount of the existing losses that were reported in AOCI at December 31, 2019 that is expected to be reclassified into earnings within the next twelve months is approximately \$3.3 million.

At December 31, 2019 and December 31, 2018, our interest rate swaps had the following notional amounts, weighted average fixed rates, and remaining terms:

Maturity	December 31, 2019			December 31, 2018		
	Notional Amount	Weighted Average Fixed Rate	Remaining Term in Months	Notional Amount	Weighted Average Fixed Rate	Remaining Term in Months
	(in thousands)			(in thousands)		
Less than 1 year	\$ 541,000	1.70 %	7	\$ 725,000	1.60 %	7
1 year to 2 years	190,000	1.63	21	591,000	1.70	19
2 years to 3 years	335,000	1.65	34	400,000	1.96	30
3 years to 4 years	295,000	1.71	45	220,000	1.92	43
4 years to 5 years	550,000	2.18	61	205,000	2.27	57
5 years to 7 years	390,000	2.51	85	475,000	2.41	73
7 years to 10 years	200,000	2.94	103	690,000	2.83	104
	<u>\$ 2,501,000</u>	2.02 %	48	<u>\$ 3,306,000</u>	2.10 %	47

Swap Agreements by Counterparty

	December 31, 2019	December 31, 2018
	(in thousands)	
Central clearing houses ⁽¹⁾	<u>\$ 2,501,000</u>	<u>\$ 3,306,000</u>

(1) For all swap agreements entered into after September 9, 2013, the counterparty will be central clearing houses, such as the Chicago Mercantile Exchange or LCH, regardless of who the trading party is. See the section entitled “Derivative Financial Instruments – Risk Management” in Note 1 for additional details.

[Table of Contents](#)

TBA Agency MBS

We also enter into TBA contracts and will recognize a gain or loss on the sale of the contracts or dollar roll income. See the section in Note 1 on “Derivative Financial Instruments – TBA Agency MBS” for more information on TBA Agency MBS. During the year ended December 31, 2019, we recognized a gain on derivatives-TBA Agency MBS, net of derivative income, of approximately \$14.2 million. During the year ended December 31, 2018, we recognized a loss on derivatives-TBA Agency MBS, net of derivative income, of approximately \$8.7 million. The types of securities involved in these TBA contracts are Fannie Mae 15-year and 30-year fixed-rate securities with coupons generally ranging from 3.0% to 4.5%. At December 31, 2019, the notional amount of the TBA Agency MBS was \$250 million. At December 31, 2018, the notional amount of the TBA Agency MBS was \$900 million.

For more information on our accounting policies, the objectives and risk exposures relating to derivatives and hedging agreements, see the section on “Derivative Financial Instruments” in Note 1. For more information on the fair value of our derivative instruments, see Note 9.

NOTE 16. COMMITMENTS AND CONTINGENCIES

Lease Commitment and Administrative Services Commitment — We sublease office space and use administrative services from PIA, as more fully described in Note 13.

NOTE 17. EARNINGS PER SHARE

The computation of EPS for the years ended December 31, 2019, 2018, and 2017 are as follows:

Net (Loss) Income	(Loss)
-------------------	--------

	to Common Stockholders	Average Shares	Earnings per Share
	(in thousands)		
For the year ended December 31, 2019			
Basic EPS	\$ (64,608)	98,739	\$ (0.65)
Effect of dilutive securities	—	—	—
Diluted EPS	<u>\$ (64,608)</u>	<u>98,739</u>	<u>\$ (0.65)</u>
For the year ended December 31, 2018			
Basic EPS	\$ (15,677)	98,314	\$ (0.16)
Effect of dilutive securities	—	—	—
Diluted EPS	<u>\$ (15,677)</u>	<u>98,314</u>	<u>\$ (0.16)</u>
For the year ended December 31, 2017			
Basic EPS	\$ 46,199	96,764	\$ 0.48
Effect of dilutive securities	1,188	3,715	(0.01)
Diluted EPS	<u>\$ 47,387</u>	<u>100,479</u>	<u>\$ 0.47</u>

For the years ended December 31, 2019, 2018, and 2017, there were no options outstanding to purchase shares of our common stock.

NOTE 18. SUMMARIZED QUARTERLY RESULTS (UNAUDITED)

The following tables summarize quarterly results for the years ended December 31, 2019 and December 31, 2018. Earnings per share amounts for each quarter and the full years have been calculated separately. Accordingly, quarterly amounts may not add to the annual amounts because of substantial differences in the average shares outstanding during each period and, with regard to diluted earnings per share amounts, they may also differ because of the inclusion of the effect of potentially dilutive securities only in the periods in which such effect would have been dilutive. Dilutive EPS assumes the conversion, exercise, or issuance of all potential common stock equivalents (which includes stock options and convertible preferred stock) and adding back the Series B Preferred Stock dividends, unless the effect is to reduce a loss or increase the income per share.

[Table of Contents](#)

For the year ended December 31, 2019 (in thousands, except per share amounts):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Interest and other income:				
Interest-Agency MBS	\$ 25,711	\$ 24,137	\$ 20,335	\$ 19,990
Interest-Non-Agency MBS	10,466	9,659	9,299	8,614
Interest-residential mortgage loans	5,368	5,259	5,049	4,767
Interest-residential mortgage loans held-for-securitization	86	1,036	1,574	1,618
Other interest income	19	20	679	253
	<u>41,650</u>	<u>40,111</u>	<u>36,936</u>	<u>35,242</u>
Interest expense:				
Interest expense on repurchase agreements	27,136	25,979	21,132	18,489
Interest expense on asset-backed securities	5,200	5,091	4,880	4,600
Interest expense of warehouse line of credit	234	1,057	1,381	1,477
Interest expense on junior subordinated notes	547	542	520	492
	<u>33,117</u>	<u>32,669</u>	<u>27,913</u>	<u>25,058</u>
Net interest income	<u>8,533</u>	<u>7,442</u>	<u>9,023</u>	<u>10,184</u>
Total operating expenses	<u>(3,046)</u>	<u>(3,113)</u>	<u>(3,258)</u>	<u>(3,263)</u>
Other (loss) income:				
Income-rental properties	436	453	469	441
Realized net (loss) gain on sale of available-for-sale MBS	(6,147)	444	214	1,338
Realized net (loss) gain on sale of Agency MBS held as trading investments	(7,363)	234	—	1,342
Impairment charge on Non-Agency MBS	—	(606)	(1,145)	(357)

Unrealized (loss) gain on Agency MBS held as trading investments	14,906	989	1,939	(798)
Gain on sales of residential properties	—	—	—	31
Gain (loss) on derivatives, net	(27,289)	(53,543)	(24,734)	20,824
Total other (loss) income	(25,457)	(52,029)	(23,257)	22,821
Net (loss) income	\$ (19,970)	\$ (47,700)	\$ (17,492)	\$ 29,742
Dividends on preferred stock	(2,297)	(2,297)	(2,297)	(2,297)
Net (loss) income to common stockholders	\$ (22,267)	\$ (49,997)	\$ (19,789)	\$ 27,445
Basic (loss) earnings per common share	\$ (0.23)	\$ (0.51)	\$ (0.20)	\$ 0.28
Diluted (loss) earnings per common share	\$ (0.23)	\$ (0.51)	\$ (0.20)	\$ 0.27
Basic weighted average number of shares outstanding	98,537	98,635	98,739	98,823
Diluted weighted average number of shares outstanding	98,537	98,635	98,739	103,141

F-39

[Table of Contents](#)

For the year ended December 31, 2018 (in thousands, except per share amounts):

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Interest and other income:				
Interest-Agency MBS	\$ 24,044	\$ 24,814	\$ 23,578	\$ 23,208
Interest-Non-Agency MBS	10,021	9,902	10,377	10,445
Interest-residential mortgage loans	6,238	5,955	5,750	5,519
Other interest income	28	44	20	29
	40,331	40,715	39,725	39,201
Interest expense:				
Interest expense on repurchase agreements	19,093	22,028	24,027	25,362
Interest expense on asset-backed securities	6,070	5,797	5,581	5,351
Interest expense on junior subordinated notes	447	504	519	526
	25,610	28,329	30,127	31,239
Net interest income	14,721	12,386	9,598	7,962
Total operating expenses	(3,233)	(3,395)	(3,199)	(3,675)
Other (loss) income:				
Income-rental properties	451	445	436	428
(Loss) gain on sale of MBS	(11,987)	—	799	(999)
Realized gain (loss) on Agency MBS held as trading investments	(7,327)	—	(231)	(3,871)
Impairment charge on Non-Agency MBS	—	(1,757)	(141)	(971)
Unrealized loss on sales of Agency MBS held as trading investments	(8,890)	(2,677)	(3,017)	9,674
Gain (loss) on sales of residential properties	—	—	30	23
Gain (loss) on derivatives, net	13,412	9,930	13,090	(44,504)
Recovery on Non-Agency MBS	—	1	—	—
Total other (loss) income	\$ (14,341)	5,942	10,966	(40,220)
Net (loss) income	(2,853)	\$ 14,933	\$ 17,365	\$ (35,933)
Dividends on preferred stock	\$ (2,297)	(2,297)	(2,297)	(2,297)
Net income to common stockholders	\$ (5,150)	\$ 12,636	\$ 15,068	\$ (38,230)
Basic (loss) earnings per common share	\$ (0.05)	\$ 0.13	\$ 0.15	\$ (0.39)
Diluted (loss) earnings per common share	\$ (0.05)	\$ 0.13	\$ 0.15	\$ (0.39)
Basic weighted average number of shares outstanding	98,185	98,271	98,353	98,444
Diluted weighted average number of shares outstanding	98,185	102,205	102,331	98,444

NOTE 19. SUBSEQUENT EVENTS

On January 2, 2020, the conversion rate of our Series B Preferred Stock increased from 5.5379 to 5.5992 shares of our common stock based upon the common stock dividend of \$0.09 per share that was declared on December 17, 2019.

[Table of Contents](#)

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

SCHEDULE IV – MORTGAGE LOANS ON REAL ESTATE
As of December 31, 2019
(dollar amounts in thousands)

Asset Type/Description	Number of Loans	Interest Rate ⁽¹⁾	Final Maturity Date ⁽²⁾	Periodic Payment Terms ⁽³⁾	Prior Liens	Face Amount	Carrying Amount	Principal Amount Subject to Delinquent Principal or Interest ⁽⁴⁾
Residential Mortgage Loans Held-for-Investment Through Consolidated Securitization Trusts								
By Product Type:								
30-year fixed-rate loans	635	3.93 %	2045	P&I	—	\$ 406,064	\$ 406,064	\$ 1,045
20-year fixed-rate loans	1	4.00	2045	P&I	—	733	733	—
15-year fixed-rate loans	51	3.13	2045	P&I	—	26,520	26,520	—
5-year to 10-year hybrid ARMs	17	3.33	2045	P&I	—	12,544	12,544	—
Application of December payments						10,907	10,907	
Unamortized premium, net of discount						1,755	1,755	
Allowance for loan losses						(175)	(175)	
	704	3.87 %				\$ 458,348	\$ 458,348	\$ 1,045
By Original Balance Stratification:								
\$100,000 - \$300,000	12	3.93 %	2045	P&I	—	\$ 2,846	\$ 2,846	\$ —
\$300,001 - \$500,000	197	3.84	2045	P&I	—	85,239	85,239	454
\$500,001 - \$700,000	294	3.90	2045	P&I	—	176,065	176,065	—
\$700,001 - \$900,000	132	3.87	2045	P&I	—	103,286	103,286	591
> \$900,000	69	3.81	2045	P&I	—	78,425	78,425	—
Application of December payments						10,907	10,907	
Unamortized premium, net of discount						1,755	1,755	—
Allowance for loan losses						(175)	(175)	—
	704	3.87 %				\$ 458,348	\$ 458,348	\$ 1,045

(1) This represents the weighted average net coupon rate.
(2) Represents the Final Maturity Date of the securitization trusts.
(3) Principal and interest (“P&I”) is generally payable at level amounts over life to maturity.
(4) Does not include any amounts that are delinquent less than 90 days.

NOTE TO SCHEDULE IV – RECONCILIATION OF MORTGAGE LOANS ON REAL ESTATE

Year Ended
December 31,
2019

Residential Mortgage Loans Held-for-Investment Through Consolidated Securitization Trusts	(in thousands)	
Balance at beginning of period	\$	549,016
Deductions during period:		
Collections of principal		(89,113)
Amortization of premium		(1,566)
Charge-offs, net		11
Balance at end of period	\$	458,348

[Table of Contents](#)

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

SCHEDULE IV – MORTGAGE LOANS ON REAL ESTATE

As of December 31, 2019

(dollar amounts in thousands)

Asset Type/Description	Number of Loans	Interest Rate ⁽¹⁾	Final Maturity Date ⁽²⁾	Periodic Payment Terms ⁽³⁾	Prior Liens	Face Amount	Carrying Amount	Principal Amount Subject to Delinquent Principal or Interest ⁽⁴⁾
Residential Mortgage Loans Held-for-Securitization								
By Product Type:								
30-year fixed-rate loans	69	5.61 %	2048	P&I	—	\$ 23,635	\$ 23,635	\$ —
20-year fixed-rate loans	—	—	—	P&I	—	—	—	—
15-year fixed-rate loans	2	5.38	2033	P&I	—	507	507	—
5-year to 10-year hybrid ARMs	229	5.36	2048	P&I	—	124,766	124,766	—
Unamortized premium and deferred transaction costs						4,014	4,014	
	300	5.40 %				\$ 152,922	\$ 152,922	\$ —
By Original Balance Stratification:								
\$10,000 - \$160,000	29	5.89 %	2048	P&I	—	\$ 3,348	\$ 3,348	\$ —
\$160,001 - \$360,000	93	5.55	2048	P&I	—	23,635	23,635	—
\$360,001 - \$560,000	86	5.30	2048	P&I	—	39,158	39,158	—
\$560,001 - \$760,000	47	5.35	2048	P&I	—	29,757	29,757	—
\$760,001 - \$960,000	16	5.59	2048	P&I	—	13,906	13,906	—
> \$960,001	29	5.33	2048	P&I	—	39,104	39,104	—
Unamortized premium and deferred transaction costs						4,014	4,014	
	300	5.40 %				\$ 152,922	\$ 152,922	\$ —

(1) This represents the weighted average net coupon rate.

(2) Represents the Final Average Maturity Date of the loans, based on the Weighted Average Remaining Term to Maturity.

(3) Principal and interest (“P&I”) is generally payable at level amounts over life to maturity.

(4) Does not include any amounts that are delinquent less than 90 days.

NOTE TO SCHEDULE IV – RECONCILIATION OF MORTGAGE LOANS ON REAL ESTATE

Year Ended
December 31,
2019

(in thousands)

Balance at beginning of period	\$	11,660
Additions during period:		
New loans		168,850
Premium and deferred transaction costs on new loans		3,702
Deductions during period:		
Collections of principal		(30,992)
Amortization of premium and costs		(298)
Balance at end of period	\$	152,922

[THIS PAGE INTENTIONALLY LEFT BLANK]

([Back To Top](#))

Section 2: EX-4.9 (EX-4.9)

Exhibit 4.9

DESCRIPTION OF SECURITIES
REGISTERED UNDER SECTION 12 OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED

The description of our securities registered under Section 12 of the Securities Exchange Act of 1934, as amended, set forth below does not purport to be complete and is qualified in its entirety by reference to our Amended Articles of Incorporation, including each of the respective articles supplementary establishing our preferred stock, as amended and/or supplemented (which we refer to as our “charter”), and our By-Laws, as amended (which we refer to as our “bylaws”), each of which is incorporated by reference herein and filed as an exhibit to our Annual Report on Form 10-K of which this Exhibit 4.9 is a part.

Authorized Capital Stock

Our authorized capital stock consists of (i) 200,000,000 shares of common stock, par value \$0.01 per share, and (ii) 20,000,000 shares of preferred stock, par value \$0.01 per share, issuable in one or more series.

Common Stock

General

The statements below describing our common stock are in all respects subject to and qualified in their entirety by reference to the Maryland General Corporation Law, our charter, and our bylaws. The outstanding shares of our common stock are duly authorized, fully paid and nonassessable. Our common stock is listed and traded on the New York Stock Exchange under the symbol “ANH”.

Ranking

Our common stock ranks junior to our Series A Preferred Stock, Series B Preferred Stock, Series C Preferred Stock, and any other future senior securities that we may establish and issue from time to time, with respect to the payments of distributions and amounts, and rights to payment upon liquidation, dissolution or winding up.

Dividends

Holders of our common stock (which we refer to as “Common Stockholders”) are entitled to receive dividends when, as and if declared by our board of directors out of legally available funds. The right of Common Stockholders to receive dividends is subordinate to the rights of the holders of our Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock, and any other future senior preferred securities that we may establish and issue from time to time. Common Stockholders will not be entitled to receive dividends paid on any dividend payment date if such shares were not issued and outstanding on the record date for such dividend.

Liquidation

If we liquidate, dissolve or wind up, Common Stockholders will share ratably in all of our assets remaining after the payment of all of our liabilities and the payment of all liquidation and other preference amounts to the holders of our Series A Preferred Stock, Series B Preferred Stock and Series C Preferred Stock, and any other future senior preferred securities that we may establish and issue from time to time.

Voting Rights

Common stockholders are entitled to one vote for each share of common stock held of record on each matter submitted to a vote of Common Stockholders. Meetings of our stockholders are to be held annually and special meetings may be called by a majority of our board of directors, the chairman of our board of directors or our president. Special meetings shall be called by our secretary at the written request of our stockholders entitled to cast at least a majority of all the votes entitled to be cast at a meeting.

Other Rights

Common Stockholders have no preemptive or other subscription rights, and there are no conversion or exchange rights, or redemption or sinking fund provisions, relating to our common stock.

Transfer Agent

The transfer agent, registrar and dividend disbursing agent for our common stock is American Stock Transfer & Trust Company.

Series A Preferred Stock

General

The statements below describing our 8.625% Series A Cumulative Preferred Stock, par value \$0.01 per share with a liquidation preference of \$25.00 per share (which we refer to as our “Series A Preferred Stock”), are in all respects subject to and qualified in their entirety by reference to the Maryland General Corporation Law, our charter (including the Articles Supplementary for Series A Cumulative Preferred Stock), and our bylaws. Our Series A Preferred Stock is listed and traded on the New York Stock Exchange under the symbol “ANHPRA”.

Ranking

The Series A Preferred Stock ranks senior to our common stock with respect to the payments of distributions and rights to payment upon liquidation, dissolution or winding up. The Series A Preferred Stock ranks on parity with all other series of preferred stock that we may issue ranking on par with the Series A Preferred Stock, including our Series B Preferred Stock and Series C Preferred Stock, with respect to the payments of distributions and amounts, and rights to payment upon liquidation, dissolution or winding up. We refer to such series of parity preferred stock as “Parity Preferred”.

Dividends

Holders of Series A Preferred Stock (which we refer to as “Series A Preferred Stockholders”) are entitled to receive, when and as authorized by our board of directors, out of funds legally available for payment of dividends, cash dividends at the rate of 8.625% per annum on the \$25.00 liquidation preference (equivalent to \$2.15625 per annum per share). Such dividends are payable quarterly on the 15th day of January, April, July and October of each year or, if not a business day, the next succeeding business day. Any dividend payable on the Series A Preferred Stock for any partial dividend period will be computed on the basis of twelve 30-day months and a 360-day year. Dividends will be payable in arrears to holders of record as they appear on our records at the close of business on the last day of each of March, June, September and December, as the case may be, immediately preceding the applicable dividend payment date. Series A Preferred Stockholders will not be entitled to receive any dividends in excess of cumulative dividends on the Series A Preferred Stock. No interest will be paid in respect of any dividend payment or payments on the Series A Preferred Stock that may be in arrears.

When dividends are not paid in full upon the Series A Preferred Stock or any other series of Parity Preferred, or a sum sufficient for such payment is not set apart, all dividends declared upon the Series A Preferred Stock and any other series of Parity Preferred shall be declared ratably in proportion to the respective amounts of dividends accumulated, accrued and unpaid on the Series A Preferred Stock and accumulated, accrued and unpaid on such Parity Preferred. Except as set forth in the preceding sentence, unless dividends on the Series A Preferred Stock equal to the full amount of accumulated, accrued and unpaid dividends have been or contemporaneously are declared and paid, or declared and a sum sufficient for the payment thereof set apart for such payment for all past dividend periods, no dividends shall be declared or paid or set aside for payment by us with respect to any series of Parity Preferred. Unless full cumulative dividends on the Series A Preferred Stock have been paid or declared and set apart for payment for all past dividend periods, no dividends (other than dividends paid in shares junior in rank to the Series A Preferred Stock or options, warrants or rights to subscribe for or purchase such junior stock) shall be declared or paid or set apart for payment by us with respect to any junior stock, nor shall any junior stock or Parity

2

Preferred be redeemed, purchased or otherwise acquired (except for purposes of an employee benefit plan) for any consideration, or any monies be paid to or made available for a sinking fund for the redemption of any junior stock or Parity Preferred (except by conversion or exchange for junior stock, or options, warrants or rights to subscribe for or purchase junior stock), nor shall any other cash or property be paid or distributed to or for the benefit of holders of junior stock. Notwithstanding the foregoing, we shall not be prohibited from (i) declaring or paying or setting apart for payment any dividend or distribution on any Parity Preferred, or (ii) redeeming, purchasing or otherwise acquiring any stock, in each case, if such declaration, payment, redemption, purchase or other acquisition is necessary to maintain our qualification as a real estate investment trust (which we refer to as a “REIT”).

No dividends on Series A Preferred Stock shall be authorized by our board of directors or declared or paid or set apart for payment at such time as the terms and provisions of any agreement, including any agreement relating to our indebtedness, prohibits such declaration, payment or setting apart for payment or provides that such declaration, payment or setting apart for payment would constitute a breach thereof or a default thereunder, or if such declaration or payment shall be restricted or prohibited by law.

In determining whether a distribution (other than upon voluntary or involuntary liquidation, dissolution or winding up of our company), by dividend, redemption or otherwise, is permitted, amounts that would be needed, if we were to be dissolved at the time of the distribution, to satisfy the liquidation preference of the Series A Preferred Stock (as discussed below) will not be added to our total liabilities.

Liquidation Preference

Upon any voluntary or involuntary liquidation, dissolution or winding up of our company, before any payment or distribution shall be made to or set apart for the holders of any junior stock, the Series A Preferred Stockholders will be entitled to receive a liquidation preference of \$25.00 per share, plus an amount equal to all accumulated, accrued and unpaid dividends (whether or not earned or declared) to the date of final distribution to such holders; but such holders shall not be entitled to any further payment. Until the Series A Preferred Stockholders have been paid the liquidation preference in full, plus an amount equal to all accumulated, accrued and unpaid dividends (whether or not earned or declared) to the date of final distribution to such holders, no payment shall be made to any holder of junior stock upon the liquidation, dissolution or winding up of our company. If upon any liquidation, dissolution or winding up of our company, our assets, or proceeds thereof, distributable among the Series A Preferred Stockholders shall be insufficient to pay in full the above described preferential amount and liquidating payments on any other shares of any series of Parity Preferred, then such assets, or the proceeds thereof, shall be distributed among the Series A Preferred Stockholders and any such other Parity Preferred ratably in the same proportion as the respective amounts that would be payable on such Series A Preferred Stock and any such other Parity Preferred if all amounts payable thereon were paid in full. Our voluntary or involuntary liquidation, dissolution or winding up shall not include our consolidation or merger with or into one or more entities, a sale or transfer of all or substantially all of our assets or a statutory stock exchange.

Upon any liquidation, dissolution or winding up of our company, after payment shall have been made in full to the Series A Preferred Stockholders and holders of any Parity Preferred, any other series or class or classes of junior stock shall be entitled to receive any and all assets remaining to be paid or distributed, and the Series A Preferred Stockholders and holders of any Parity Preferred shall not be entitled to share therein.

Redemption

We may redeem any Series A Preferred Stock, in whole or from time to time in part, at a cash redemption price equal to 100% of the liquidation preference plus all accrued and unpaid dividends to the date fixed for redemption. The redemption date shall be selected by us and shall not be less than 30 days nor more than 60 days after the date we send notice of redemption. If full cumulative dividends on all outstanding shares of Series A Preferred Stock have not been paid or declared and set apart for payment, no Series A Preferred Stock may be redeemed unless all outstanding Series A Preferred Stock are simultaneously redeemed; provided, however, that we shall not be prevented from purchasing Series A Preferred Stock pursuant to our charter or otherwise in order to ensure that we remain qualified as a REIT under the tax code. Additionally, unless full cumulative dividends on all outstanding shares of Series A Preferred Stock have been paid or declared or set apart for payment, we may not purchase or otherwise acquire directly or indirectly for any consideration, nor shall any monies be paid to or made

3

available for a sinking fund for the redemption of, any shares of Series A Preferred Stock (except by conversion into or exchange for junior stock); provided, however, that we shall not be prevented from purchasing any Series A Preferred Stock pursuant to our charter or otherwise in order to ensure that we remain qualified as a REIT under the tax code.

Notice of redemption of the Series A Preferred Stock shall be mailed to each holder of record of the shares to be redeemed by first class mail, postage prepaid at such holder’s address as the same appears on our stock records. Any notice which was mailed as described above shall be conclusively presumed to have been duly given on the date mailed whether or not the holder receives the notice. In addition to any information required by law or by the applicable rules of the exchange upon which the Series A Preferred Stock may be listed or admitted to trading, each notice shall state: (i) the redemption date; (ii) the redemption price; (iii) the number of shares of Series A Preferred Stock to be redeemed; and (iv) the place or places where certificates for such shares of Series A Preferred Stock are to be surrendered for cash. Any such redemption may be made conditional on such factors as may be determined by our board of directors and as set forth in the notice of redemption. From and after the redemption date, dividends on the Series A Preferred Stock to be redeemed will cease to accrue, such shares shall no longer be deemed to be outstanding and all rights of the holders thereof shall cease (except the right to receive the cash payable upon such redemption).

The Series A Preferred Stock has no stated maturity and will not be subject to any sinking fund or mandatory redemption provisions except as provided under “—Restrictions on Ownership and Transfer” below.

Subject to applicable law and the limitation on purchases when dividends on the Series A Preferred Stock are in arrears, we may, at any time and from time to time, purchase Series A Preferred Stock in the open market, by tender or by private agreement.

Any shares of Series A Preferred Stock redeemed, purchased or otherwise acquired by us in any manner whatsoever shall become our authorized but unissued and unclassified preferred stock and may be reissued or reclassified by us in accordance with the applicable provisions of our charter.

Voting Rights

Series A Preferred Stockholders do not have any voting rights, except as set forth below.

Whenever dividends on any shares of Series A Preferred Stock are in arrears for six or more quarterly periods (whether or not consecutive), the number of directors then constituting our board of directors shall be increased by two, and the Series A Preferred Stockholders (voting together as a single class with all other series of Parity Preferred which are entitled to similar voting rights) will be entitled to vote for the election of the two additional directors at any annual meeting of stockholders or at a special meeting of the Series A Preferred Stockholders and of any other voting preferred stock called for that purpose. We must call such special meeting upon the request of the holders of record of 10% or more of the Series A Preferred Stock. Whenever dividends in arrears on outstanding Series A Preferred Stock and any other voting preferred stock shall have been paid and dividends thereon for the current quarterly dividend period shall have been paid or declared and set apart for payment, then the right of the Series A Preferred Stockholders to elect such additional two directors shall cease and the terms of office of such directors shall terminate, and the number of directors constituting the board of directors shall be reduced accordingly.

The affirmative vote or consent of at least 66⅔% of the votes entitled to be cast by the Series A Preferred Stockholders and the holders of all other series of preferred stock entitled to vote on such matters, voting as a single class, in addition to any other vote required by our charter or Maryland law, will be required to: (i) authorize the creation of, the increase in the authorized amount of, or the issuance of any shares of any class of stock ranking senior to the Series A Preferred Stock or any security convertible into shares of any class of such senior stock, or (ii) amend, alter or repeal any provision of, or add any provision to, our charter, including the articles supplementary establishing the Series A Preferred Stock, if such action would materially adversely affect the powers, rights or preferences of the Series A Preferred Stockholders. An amendment of our charter to authorize, create, or increase the authorized amount of junior stock or any shares of any series of Parity Preferred, including additional Series A Preferred Stock, will not be deemed to materially adversely affect the voting powers, rights or preferences of the

Series A Preferred Stockholders. No such vote of the Series A Preferred Stockholders as described above will be required if provision is made to redeem all Series A Preferred Stock at or prior to the time such amendment, alteration or repeal is to take effect, or when the issuance of any such shares or convertible securities is to be made, as the case may be.

With respect to the exercise of the above described voting rights, each share of Series A Preferred Stock shall have one vote per share, except that when any other series of preferred stock shall have the right to vote with the Series A Preferred Stock as a single class, then the Series A Preferred Stock and such other series shall have one vote per \$25.00 of stated liquidation preference.

Conversion

The Series A Preferred Stock is not convertible into or exchangeable for any of our other securities or property.

Transfer and Dividend Paying Agent

American Stock Transfer & Trust Company is the transfer and dividend paying agent and registrar in respect of the Series A Preferred Stock.

Series B Preferred Stock

General

The statements below describing our 6.25% Series B Cumulative Convertible Preferred Stock, par value \$0.01 per share with a liquidation preference of \$25.00 per share (which we refer to as our “Series B Preferred Stock”), are in all respects subject to and qualified in their entirety by reference to the Maryland General Corporation Law, our charter (including the Articles Supplementary for Series B Cumulative Convertible Preferred Stock), and our bylaws. Our Series B Preferred Stock is listed and traded on the New York Stock Exchange under the symbol “ANHPRB”.

Ranking

The Series B Preferred Stock ranks senior to our common stock with respect to the payments of distributions and rights to payment upon liquidation, dissolution or winding up. The Series B Preferred Stock ranks on parity with all other series of preferred stock that we may issue ranking on par with the Series B Preferred Stock, including our Series A Preferred Stock and Series C Preferred Stock, with respect to the payments of distributions and amounts, and rights to payment upon liquidation, dissolution or winding up. We refer to such series of parity preferred stock as “Parity Preferred”.

Dividends

Holders of the Series B Preferred Stock (which we refer to as “Series B Preferred Stockholders”) are entitled to receive, when and as authorized by our board of directors, out of funds legally available for the payment of dividends, cumulative preferential cash dividends at the rate of 6.25% per annum of the \$25.00 liquidation preference (equivalent to \$1.5625 per share). Such dividends are payable quarterly in arrears on the 15th day of January, April, July and October of each year or, if not a business day, the next succeeding business day (each, a “Series B Dividend Payment Date”). Series B Preferred Stockholders will not be entitled to receive dividends paid on any Series B Dividend Payment Date if such shares were not issued and outstanding on the record date for such dividend.

Any dividend payable on the Series B Preferred Stock for any partial dividend period will be computed on the basis of a 360-day year consisting of twelve 30-day months. Dividends will be payable to holders of record as they appear on our records at the close of business on the last day of each of March, June, September and December, as the case may be, immediately preceding the applicable Series B Dividend Payment Date (each, a “Series B Dividend

5

Record Date”). Series B Preferred Stockholders will not be entitled to receive any dividends in excess of cumulative dividends on the Series B Preferred Stock. No interest will be paid in respect of any dividend payment or payments on the Series B Preferred Stock that may be in arrears.

No dividends on shares of Series B Preferred Stock will be declared by us or paid or set apart for payment by us at such time as the terms and provisions of any of our agreements, including any agreement relating to our indebtedness, prohibit such declaration, payment or setting apart for payment or provide that such declaration, payment or setting apart for payment would constitute a breach thereof or a default thereunder, or if such declaration or payment will be restricted or prohibited by law.

Notwithstanding the foregoing, dividends on the Series B Preferred Stock will accrue whether or not we have earnings, whether or not there are funds legally available for the payment of such dividends and whether or not such dividends are declared. Accrued and unpaid dividends on the Series B Preferred Stock will accumulate as of the Series B Dividend Payment Date on which they first become payable.

Except as set forth in the next paragraph, unless full cumulative dividends on the Series B Preferred Stock have been or contemporaneously are declared and paid or declared and a sum sufficient for such full payment is set apart for payment for all past dividend periods and the then current dividend period, no dividends (other than dividends in shares of common stock or dividends in shares of any series of preferred stock that we may issue ranking junior to the Series B Preferred Stock as to dividends and upon liquidation) will be declared or paid or set aside for payment. Nor will any other distribution be declared or made upon shares of our common stock or preferred stock that we may issue ranking junior to or on par with the Series B Preferred Stock as to dividends or upon liquidation. In addition, any shares of our common stock or preferred stock that we may issue ranking junior to or on par with the Series B Preferred Stock as to dividends or upon liquidation will not be redeemed, purchased or otherwise acquired for any consideration (or any moneys be paid to or made available for a sinking fund for the redemption of any such shares) by us (except by conversion into or exchange for our other capital stock that we may issue ranking junior to the Series B Preferred Stock as to dividends and upon liquidation and except for transfers made pursuant to the provisions of our charter relating to restrictions on ownership and transfers of our capital stock).

If dividends are not paid in full (or a sum sufficient for such full payment is not so set apart) upon the Series B Preferred Stock and the shares of any other series of Parity Preferred, all dividends declared upon the Series B Preferred Stock and the shares of any other series of Parity Preferred will be declared pro rata so that the amount of dividends declared per share of the Series B Preferred Stock and the shares of any other series of Parity Preferred will in all cases bear to each other the same ratio that accrued dividends per share on the Series B Preferred Stock and the shares of any other series of Parity Preferred (which will not include any accrual in respect of unpaid dividends for prior dividend periods if such preferred stock does not have a cumulative dividend) bear to each other. No interest, or sum of money in lieu of interest, will be payable in respect of any dividend payment or payments on the Series B Preferred Stock which may be in arrears.

Series B Preferred Stockholders will not be entitled to any dividend, whether payable in cash, property or stock, in excess of full cumulative dividends on the Series B Preferred Stock as provided above. Any dividend payment made on shares of the Series B Preferred Stock will first be credited against the earliest accrued and unpaid dividend due with respect to such shares which remains payable.

Liquidation Preference

Upon any voluntary or involuntary liquidation, dissolution or winding up of our affairs, the Series B Preferred Stockholders are entitled to be paid out of our assets that are legally available for distribution to our stockholders a liquidation preference of \$25.00 per share, plus an amount equal to any accrued and unpaid dividends (whether or not declared) to the date of payment, before any distribution of assets is made to our Common Stockholders or to holders of any series of our preferred stock that we may issue that ranks junior to the Series B Preferred Stock as to liquidation rights.

In the event that, upon any such voluntary or involuntary liquidation, dissolution or winding up, our available assets are insufficient to pay the amount of the liquidating distributions on all outstanding shares of Series B

6

Preferred Stock and the corresponding amounts payable on all shares of other series of Parity Preferred, then the Series B Preferred Stockholders and stockholders of such series of Parity Preferred will share ratably in any such distribution of assets in proportion to the full liquidating distributions to which they would otherwise be respectively entitled.

Series B Preferred Stockholders will be entitled to written notice of any such liquidation. After payment of the full amount of the liquidating distributions to which they are entitled, the Series B Preferred Stockholders will have no right or claim to any of our remaining assets. The consolidation or merger of us with or into any other corporation, trust or entity or of any other corporation with or into us, or the sale, lease or conveyance of all or substantially all of our assets or business, will not be deemed to constitute a liquidation, dissolution or winding up of us.

Voting Rights

The Series B Preferred Stockholders do not have any voting rights, except as set forth below.

Whenever dividends on any shares of Series B Preferred Stock are in arrears for six or more quarterly periods (whether or not consecutive) (which we refer to as a “Series B Preferred Dividend Default”), the number of directors then constituting our board of directors will be increased by two (if not already increased by two by reason of the election of directors by the holders of other series of Parity Preferred), and the Series B Preferred Stockholders (voting separately as a class with all other series of Parity Preferred upon which like voting rights have been conferred and are exercisable) will be entitled to elect the two additional members of our board of directors (which we refer to as “Preferred Stock Directors”) at a special meeting called by the holders of record of at least 10% of the Series B Preferred Stock or any other series of Parity Preferred so in arrears (unless such request is received less than 90 days before the date fixed for the next annual or special meeting of the stockholders) or at the next annual meeting of stockholders, and at each subsequent annual meeting until all dividends accumulated on such shares of Series B Preferred Stock for the past dividend periods and the dividends for all dividend periods during the two most recently completed quarterly periods have been fully paid or declared and sums sufficient for the payments thereof have been set aside for payment.

If and when all accumulated dividends and the dividend for the then current dividend period on the Series B Preferred Stock have been paid in full or set aside for payment in full, the Series B Preferred Stockholders will be divested of the foregoing voting rights (subject to revesting in the event of each and every subsequent Series B Preferred Dividend Default) and, if all accumulated dividends and the dividends for all dividend periods during the two most recently completed quarterly periods have been paid in full or set aside for payment in full on all series of Parity Preferred upon which like voting rights have been conferred and are exercisable, the term of office of each Preferred Stock Director so elected will terminate and the number of directors on the board of directors will decrease by two. Any Preferred Stock Director may be removed at any time with or without cause by, and will not be removed otherwise than by the vote of, the holders of record of a majority of the outstanding shares of the Series B Preferred Stock when they have the voting rights described above (voting separately as a class with all series of Parity Preferred that we may issue upon which like voting rights have been conferred and are exercisable). So long as a Series B Preferred Dividend Default continues, any vacancy in the office of a Preferred Stock Director may be filled by the written consent of the Preferred Stock Directors remaining in office, or if none remains in office, by a vote of the holders of record of a majority of the outstanding shares of Series B Preferred Stock when they have the voting rights described above (voting separately as a class with all series of Parity Preferred that we may issue upon which like voting rights have been conferred and are exercisable). The Preferred Stock Directors will each be entitled to one vote per director on any matter.

So long as any shares of Series B Preferred Stock remain outstanding, we will not, without the affirmative vote or consent of the holders of at least two-thirds of the shares of the Series B Preferred Stock outstanding at the time, given in person or by proxy, either in writing or at a meeting (voting separately as a class with all series of Parity Preferred that we may issue upon which like voting rights have been conferred and are exercisable), (i) authorize or create, or increase the authorized or issued amount of, any class or series of capital stock ranking senior to the Series B Preferred Stock with respect to payment of dividends or the distribution of assets upon liquidation, dissolution or winding up or reclassify any of our authorized capital stock into such shares, or create, authorize or issue any obligation or security convertible into or evidencing the right to purchase any such shares; or

7

(ii) amend, alter or repeal the provisions of our charter, whether by merger, consolidation or otherwise (which we refer to as an “Event”), so as to materially and adversely affect any right, preference, privilege or voting power of the Series B Preferred Stock; provided, however, with respect to the occurrence of any Event set forth in (ii) above, so long as the Series B Preferred Stock remains outstanding with the terms thereof materially unchanged, the occurrence of any such Event will not be deemed to materially and adversely affect such rights, preferences, privileges or voting power of Series B Preferred Stockholders and, provided further, that any increase in the amount of the authorized preferred stock, including the Series B Preferred Stock, or the creation or issuance of any additional Series B Preferred Stock or other series of preferred stock that we may issue, or any increase in the amount of authorized shares of such series, in each case ranking on a parity with or junior to the Series B Preferred Stock that we may issue with respect to payment of dividends or the distribution of assets upon liquidation, dissolution or winding up, will not be deemed to materially and adversely affect such rights, preferences, privileges or voting powers.

Maturity

The Series B Preferred Stock has no maturity date and is not subject to any sinking fund or mandatory redemption. Accordingly, the Series B Preferred Stock will remain outstanding indefinitely unless a Series B Preferred Stockholder or we decide to convert it or a Series B Preferred Stockholder elects to have us purchase it upon a fundamental change. See “—Conversion Rights”, “—Company Conversion Option”, and “—Purchase of Series B Preferred Stock Upon a Fundamental Change” below.

Redemption

We may not redeem the Series B Preferred Stock. We have the right, in certain circumstances, to require Series B Preferred Stockholders to convert their shares of Series B Preferred Stock to shares of our common stock. See “—Company Conversion Option” below.

Conversion Rights

Series B Preferred Stockholders may, at their option, convert some or all of their outstanding shares of Series B Preferred Stock at a conversion rate of a number of shares of our common stock per \$25.00 liquidation preference (which we refer to as the “Series B Conversion Rate”). The Series B Conversion Rate may increase, ultimately increasing the number of shares of our common stock received upon conversion. Shares of our Series B Preferred Stock will only be convertible into shares of our common stock.

We will not issue fractional shares of common stock upon the conversion of Series B Preferred Stock. Instead, we will pay the cash value of such fractional shares based upon the closing sale price of shares of our common stock on the trading day immediately prior to the Series B Conversion Date (as defined below).

Series B Preferred Stockholders are not entitled to any rights of a Common Stockholder until such Series B Preferred Stockholder has converted its Series B Preferred Stock, and only to the extent that the shares of Series B Preferred Stock are deemed to have been converted to common stock under the articles supplementary establishing the Series B Preferred Stock.

Company Conversion Option

We may, at our option, require the Series B Preferred Stockholders to convert the Series B Preferred Stock into that number of shares of our common stock that are issuable at the then prevailing Series B Conversion Rate (we refer to this option as the “Company Conversion Option”). We may exercise the Company Conversion Option only if our common stock price equals or exceeds 130% of the then prevailing conversion price of the Series B Preferred Stock for at least 20 trading days in a period of 30 consecutive trading days (including the last trading day of such period) ending on the trading day immediately prior to our issuance of a press release announcing the exercise of the Company Conversion Option as described below.

8

To exercise the Company Conversion Option described above, we must issue a press release for publication on Dow Jones & Company, Inc., Business Wire or Bloomberg Business News (or, if such organizations are not in existence at the time of issuance of such press release, such other news or press organization as is reasonably calculated to broadly disseminate the relevant information to the public) prior to the opening of business on the first trading day following any date on which the conditions described in the preceding paragraph are met, announcing such conversion. We will also give notice by mail or by publication (with subsequent prompt notice by mail) to our Series B Preferred Stockholders (not more than four (4) trading days after the date of the press release) of the exercise of the Company Conversion Option announcing our intention to convert the Series B Preferred Stock. The conversion date (which we refer to as the “Company Conversion Option Date”) will be the date that is five (5) trading days after the date on which we issue such press release.

In addition to any information required by applicable law or regulation, the press release and notice of the exercise of the Company Conversion Option will state, as appropriate:

- the Company Conversion Option Date;
- the number of shares of our common stock to be issued upon conversion of each Series B Preferred Stock;
- the number of shares of Series B Preferred Stock to be converted; and
- that dividends on the Series B Preferred Stock to be converted will cease to accrue on the Company Conversion Option Date.

Conversion Procedures

Series B Preferred Stockholders may convert some or all of their shares by surrendering to us at our principal office or at the office of our transfer agent, as may be designated by our board of directors, the certificate or certificates for the Series B Preferred Stock to be converted accompanied by a written notice stating that the Series B Preferred Stockholder elects to convert all or a specified whole number of those shares and specifying the name or names in which the Series B Preferred Stockholder wishes the certificate or certificates for the shares of common stock to be issued. In case the notice specifies a name or names other than the Series B Preferred Stockholder’s name, the notice must be accompanied by payment of all transfer taxes payable upon the issuance of shares of common stock in that name or names. Other than those taxes, we will pay any documentary, stamp or similar issue or transfer taxes that may be payable in respect of any issuance or delivery of shares of common stock upon conversion of the Series B Preferred Stock. As promptly as practicable after the surrender of that certificate or certificates and the receipt of the notice relating to the conversion and payment of all required transfer taxes, if any, or the demonstration to our satisfaction that those taxes have been paid, we will deliver or cause to be delivered (i) certificates representing the number of full shares of validly issued, fully paid and non-assessable common stock to which the Series B Preferred Stockholder, or the Series B Preferred Stockholder’s transferee, will be entitled, and (ii) if less than the full number of Series B Preferred Stock evidenced by the surrendered certificate or certificates is being converted, a new certificate or certificates, of like tenor, for the number of shares evidenced by the surrendered certificate or certificates, less the number of shares being converted. This conversion will be deemed to have been made at the close of business on the date of giving the notice and of surrendering the certificate or certificates representing the shares of the Series B Preferred Stock to be converted (which we refer to as the “Series B Conversion Date”), so that the Series B Preferred Stockholder’s rights as to the shares being converted will cease except for the right to receive the conversion value, and, if applicable, the person entitled to receive common shares will be treated for all purposes as having become the record holder of those shares of common stock at that time.

In lieu of the foregoing procedures, if the shares of Series B Preferred Stock are held in global certificate form, the Series B Preferred Stockholder must comply with the procedures of The Depository Trust Company (which we refer to as “DTC”) to convert the Series B Preferred Stockholder’s beneficial interest in respect of the Series B Preferred Stock evidenced by a global stock certificate of the Series B Preferred Stock.

9

Series B Preferred Stockholders are not eligible to exercise any rights of a Common Stockholder until they have converted their Series B Preferred Stock into common stock.

In case any shares of Series B Preferred Stock are to be converted pursuant to the Company Conversion Option, a Series B Preferred Stockholder’s right to voluntarily convert those shares of Series B Preferred Stock will terminate if we have not received such Series B Preferred Stockholder’s conversion notice by 5:00 p.m., New York City time, on the trading day immediately preceding the date fixed for conversion pursuant to the Company Conversion Option.

If more than one share of Series B Preferred Stock is surrendered for conversion by the same stockholder at the same time, the number of shares of full common stock issuable on conversion of those Series B Preferred Stock will be computed on the basis of the total number of Series B Preferred Stock so surrendered.

We will at all times reserve and keep available, free from preemptive rights out of our authorized but unissued shares of capital stock, for issuance upon the conversion of Series B Preferred Stock, a number of our authorized but unissued shares of common stock that will from time to time be sufficient to permit the conversion of all outstanding Series B Preferred Stock.

Before the delivery of any securities upon conversion of the Series B Preferred Stock, we will comply with all applicable federal and state laws and regulations. All common stock delivered upon conversion of the Series B Preferred Stock will upon delivery be duly authorized, validly issued, fully paid and non-assessable, free of all liens and charges and not subject to any preemptive rights.

If a Series B Preferred Stockholder has exercised its right to require us to repurchase shares of Series B Preferred Stock as described under “—Purchase of Series B Preferred Stock Upon a Fundamental Change,” the Series B Preferred Stockholder’s conversion rights with respect to the Series B Preferred Stock so subject to repurchase will expire if we have not received their conversion notice by 5:00 p.m., New York City time, on the trading day immediately preceding the repurchase date, unless we default on the payment of the purchase price. If a Series B Preferred Stockholder has submitted any such shares for repurchase, such shares may be converted only if the Series B Preferred Stockholder submits a notice of withdrawal or complies with applicable DTC procedures.

Payment of Dividends Upon Conversion

Optional Conversion

General. If a Series B Preferred Stockholder exercises its conversion rights, upon delivery of the Series B Preferred Stock for conversion, those shares of Series B Preferred Stock will cease to cumulate dividends as of the end of the day immediately preceding the Series B Conversion Date and the Series B Preferred Stockholder will not receive any cash payment representing accrued and unpaid dividends on the Series B Preferred Stock, except in those limited circumstances discussed below. Except as provided below, we will make no payment for accrued and unpaid dividends, whether or not in arrears, on Series B Preferred Stock converted at the Series B Preferred Stockholder’s election, or for dividends on the common stock issued upon such conversion.

Conversion On or Before a Series B Dividend Record Date. If we receive a conversion notice before the close of business on a Series B Dividend Record Date, the Series B Preferred Stockholder will not be entitled to receive any portion of the dividend payable on such converted stock on the corresponding Series B Dividend Payment Date.

Conversion After a Record Date and Prior to a Series B Dividend Payment Date. If we receive a conversion notice after the Series B Dividend Record Date but prior to the corresponding Series B Dividend Payment Date, the Series B Preferred Stockholder on the Series B Dividend Record Date will receive on that Series B Dividend Payment Date accrued dividends on those shares of Series B Preferred Stock, notwithstanding the conversion of those shares of Series B Preferred Stock prior to that Series B Dividend Payment Date, because that Series B Preferred Stockholder will have been the Series B Preferred Stockholder of record on the corresponding Series B Dividend Record Date. At the time that such Series B Preferred Stockholder surrenders Series B Preferred Stock for

10

conversion, however, it must pay to us an amount equal to the dividend that has accrued and that will be paid on the related Series B Dividend Payment Date.

Conversion On or After a Series B Dividend Payment Date. If the Series B Preferred Stockholder is a Series B Preferred Stockholder on a Series B Dividend Record Date who converts such shares of Series B Preferred Stock into shares of common stock on or after the corresponding Series B Dividend Payment Date such Series B Preferred Stockholder will be entitled to receive the dividend payable on such shares of Series B Preferred Stock on such Series B Dividend Payment Date, and the Series B Preferred Stockholder will not need to include payment of the amount of such dividend upon surrender for conversion of shares of the Series B Preferred Stock.

Company Conversion Option

General. If we convert a Series B Preferred Stockholder’s shares pursuant to the Company Conversion Option, whether prior to, on, or after the Series B Dividend Record Date for the current period, all unpaid dividends that are in arrears as of the Company Conversion Option Date will be payable to the Series B Preferred Stockholder.

Conversion Before a Series B Dividend Record Date. If we exercise the Company Conversion Option and the effective date of the conversion of the Series B Preferred Stock is a date that is prior to the close of business on any Series B Dividend Record Date, the Series B Preferred Stockholder will not be entitled to receive any portion of the dividend payable for such period on such converted shares on the corresponding Series B Dividend Payment Date.

Conversion On or After a Series B Dividend Record Date and Prior to a Series B Dividend Payment Date. If we exercise the Company Conversion Option and the effective date of the conversion of the Series B Preferred Stock is a date that is on or after the close of business on any Series B Dividend Record Date and prior the close of business on the corresponding Series B Dividend Payment Date, all dividends, including accrued and unpaid dividends, whether or not in arrears, with respect to the Series B Preferred Stock called for a conversion on such date, will be payable on such Series B Dividend Payment Date to the Series B Preferred Stockholder if the Series B Preferred Stockholder is the record holder of such shares on such record date.

Conversion Rate Adjustments

We will adjust the Series B Conversion Rate if any of the following events occur:

- 1.We issue shares of our common stock as a dividend or distribution to all or substantially all of our Common Stockholders (other than pursuant to our current dividend reinvestment and share purchase plan or any future dividend reinvestment and share purchase plan we adopt which is not materially adverse to Series B Preferred Stockholders and in any case which is without duplication subject to an adjustment under 6 below);
- 2.We subdivide, combine or reclassify our common stock;
- 3.We distribute to all or substantially all of our Common Stockholders certain rights or warrants to subscribe for or purchase, for a period expiring within 60 days, common stock, or securities convertible into or exchangeable or exercisable for our common stock, at less than the closing sale price of our common stock on the trading day immediately preceding the date of the announcement of such distribution, provided that the Series B Conversion Rate will be readjusted to the extent that such rights or warrants are not exercised prior to the expiration;
- 4.We distribute to all or substantially all of our Common Stockholders shares of our capital stock or issue evidence of our indebtedness or assets, including securities, but excluding:
 - dividends or distributions referred to in 1 above;
 - rights or warrants referred to in 3 above;

11

- dividends and distributions in connection with a reclassification, change, consolidation, merger, combination, sale or conveyance resulting in a change in the conversion consideration described below; and

- cash dividends or cash distributions referred to in 6 below;
- 5.We distribute to all or substantially all of our Common Stockholders capital stock of one of our subsidiaries, with such adjustment, if any, based on the market value of the subsidiary capital stock so distributed relative to the market value of our common stock, in each case over a measurement period following the distribution;
- 6.We pay any cash dividend or cash distribution during any quarterly fiscal period to all or substantially all of our Common Stockholders in an aggregate amount that, together with other cash dividends or cash distributions made during such quarterly fiscal period, results in an annualized common stock dividend yield which is greater than 6.25% (which we refer to as the “Dividend Threshold Amount”);

The Series B Conversion Rate will be adjusted based on the following formula:

$$CR(1) = CRo + ((\$25.00 \times (CSY - 6.25\%)/4)/SP)$$

where,

CRo = the Series B Conversion Rate in effect immediately prior to the record date for such distribution;

CR(1) = the Series B Conversion Rate in effect immediately after the record date for such distribution;

SP = the average of the closing sale price per share of common stock over the ten (10) consecutive trading day period prior to the trading day immediately preceding the earlier of the record date or the ex-dividend date of such cash excess dividend or distribution;

CSY = the annualized common stock dividend yield, calculated as all cash dividends and cash distributions paid to our Common Stockholders during the fiscal quarter, multiplied by four (4), divided by SP;

\$25.00 = the liquidation preference of our Series B Preferred Stock;

6.25% = the dividend rate of our Series B Preferred Stock; or

- 7.We make payments in respect of a tender offer or exchange offer for our common stock by us or any of our subsidiaries to the extent that the cash and fair market value of any other consideration included in the payment per stock exceeds the closing price of our common stock on the trading day following the last date on which tenders or exchanges may be made pursuant to such tender offer or exchange offer.

To the extent we have a rights plan in effect upon conversion of the Series B Preferred Stock into common stock, the Series B Preferred Stockholders will receive, in addition to the common stock, the rights under the rights plan unless the rights have separated from the common stock prior to the time of conversion, in which case the Series B Conversion Rate will be adjusted at the time of separation as if we made a distribution referred to in 4 above (without regard to any of the exceptions there).

In the case of the following events (each, a “Business Combination”):

- any recapitalization, reclassification or change of our common stock (other than changes resulting from a subdivision or combination);
- a consolidation, merger or combination involving us;
- a sale, conveyance or lease to another corporation of all or substantially all of our property and assets (other than to one or more of our subsidiaries); or
- a statutory share exchange;

in each case, as a result of which our Common Stockholders are entitled to receive stock, other securities, other property or assets (including cash or any combination thereof) with respect to or in exchange for our common stock, a Series B Preferred Stockholder will be entitled thereafter to convert such Series B Preferred Stock into the kind and amount of stock, other securities or other property or assets (including cash or any combination thereof) which the Series B Preferred Stockholder would have owned or been entitled to receive upon such Business Combination, except that the Series B Preferred Stockholder will not receive a make whole premium if the Series B Preferred Stockholder does not convert its Series B Preferred Stock in connection with the relevant fundamental change. In the event that our Common Stockholders have the opportunity to elect the form of consideration to be received in such Business Combination, we will make adequate provision whereby the Series B Preferred Stockholders shall have a reasonable opportunity to determine the form of consideration into which all of the Series B Preferred Stock, treated as a single class, shall be convertible from and after the effective date of such Business Combination. Such determination shall be based on the weighted average of elections made by the Series B Preferred Stockholders who participate in such determination, shall be subject to any limitations to which all of our Common Stockholders are subject, such as pro rata reductions applicable to any portion of the consideration payable in such Business Combination, and shall be conducted in such a manner as to be completed by the date which is the earliest of (i) the deadline for elections to be made by our Common Stockholders, and (ii) two trading days prior to the anticipated effective date of the Business Combination.

We will provide notice of the opportunity to determine the form of such consideration, as well as notice of the determination made by our Series B Preferred Stockholders (and the weighted average of elections), by posting such notice with DTC and providing a copy of such notice to the transfer agent. If the effective date of a Business Combination is delayed beyond the initially anticipated effective date, the Series B Preferred Stockholders will be given the opportunity to make subsequent similar determinations in regard to

such delayed effective date. We may not become a party to any such transaction unless its terms are consistent with the preceding. None of the foregoing provisions shall affect the Series B Preferred Stockholder’s right to convert the Series B Preferred Stockholder’s shares into our common stock prior to the effective date.

To the extent permitted by law, we may, from time to time, increase the Series B Conversion Rate for a period of at least 20 days if our board of directors determines that such an increase would be in our best interests. Any such determination by our board of directors will be conclusive. In addition, we may increase the Series B Conversion Rate if our board of directors deems it advisable to avoid or diminish any income tax to Common Stockholders resulting from any distribution of common stock or similar event. We will give the Series B Preferred Stockholders at least 15 trading days’ notice of any increase in the Series B Conversion Rate.

We will not adjust the Series B Conversion Rate pursuant to these provisions to the extent that the adjustments would reduce the conversion price below \$0.01. Nor will we be required to make an adjustment in the Series B Conversion Rate unless the adjustment would require a change of at least one percent (1%) in the Series B Conversion Rate. However, any adjustments that are not required to be made because they would have required an increase or decrease of less than one percent (1%) will be carried forward and taken into account in any subsequent adjustment of the Series B Conversion Rate. Except as described above in this section, we will not adjust the Series B Conversion Rate for any issuance of our common stock or any securities convertible into or exchangeable or exercisable for our common stock or rights to purchase our common stock or such convertible, exchangeable or exercisable securities.

A Series B Preferred Stockholder may, in some circumstances, including the distribution of cash dividends to stockholders, be deemed to have received a distribution or dividend subject to U.S. federal income tax as a result of an adjustment or the nonoccurrence of an adjustment to the Series B Conversion Rate. See “Additional Federal Income Tax Considerations” below.

Purchase of Series B Preferred Stock Upon a Fundamental Change

In the event of a fundamental change described below, a Series B Preferred Stockholder will have the right to require us to purchase for cash all or any part of its Series B Preferred Stock at a purchase price equal to 100% of the liquidation preference of the Series B Preferred Stock to be purchased plus accrued and unpaid dividends (including additional dividends, if any) to, but not including, the fundamental change purchase date.

Within 30 days after the occurrence of a fundamental change, we will provide to the Series B Preferred Stockholder and the transfer agent a notice of the occurrence of the fundamental change and of the resulting repurchase right. Such notice will state:

- the events constituting the fundamental change;
- the date of the fundamental change;
- the last date on which the Series B Preferred Stockholder may exercise the repurchase right;
- the repurchase price;
- the repurchase date;
- the name and address of the paying agent and the conversion agent;
- the Series B Conversion Rate and any adjustment to the Series B Conversion Rate that will result from the fundamental change;
- that the Series B Preferred Stock with respect to which a repurchase notice is given by the Series B Preferred Stockholder may be converted, if otherwise convertible, only if the repurchase notice has been properly withdrawn; and
- the procedures that the Series B Preferred Stockholder must follow to exercise the repurchase rights.

Simultaneously with providing the Series B Preferred Stockholder such notice, we will publish a notice containing this information in a newspaper of general circulation in the City of New York or through such other public medium as we may use at that time and publish such information on our corporate website.

To exercise the purchase right, a Series B Preferred Stockholder must deliver, on or before the twentieth trading day after the date of our notice of a fundamental change (subject to extension to comply with applicable law), the Series B Preferred Stock to be purchased, duly endorsed for transfer, together with a written purchase notice and the form entitled “Form of Fundamental Change Purchase Notice” on the reverse side of the Series B Preferred Stock duly completed, to the paying agent. The purchase notice will state:

- the relevant purchase date;
- the portion of the liquidation preference of Series B Preferred Stock to be purchased, in integral multiples of \$25.00; and
- that the Series B Preferred Stock are to be purchased by us pursuant to the applicable provisions of the Series B Preferred Stock.

If the Series B Preferred Stock are not in certificated form, its purchase notice must comply with applicable DTC procedures.

14

A Series B Preferred Stockholder may withdraw any purchase notice (in whole or in part) by a written notice of withdrawal delivered to the paying agent prior to the close of business on the trading day prior to the fundamental change purchase date. The notice of withdrawal shall state:

- the liquidation preference of the withdrawn Series B Preferred Stock, in integral multiples of \$25.00;
- if certificated Series B Preferred Stock have been issued, the certificate numbers of the withdrawn Series B Preferred Stock; and
- the liquidation preference, if any, which remains subject to the purchase notice.

If the shares of Series B Preferred Stock are not in certificated form, a Series B Preferred Stockholder’s notice of withdrawal must comply with applicable DTC procedures.

We will be required to purchase the Series B Preferred Stock no less than 30 days nor more than 45 days after the date of our notice of the occurrence of the relevant fundamental change, subject to extension to comply with applicable law. The Series B Preferred Stockholder will receive payment of the fundamental change purchase price promptly following the later of the fundamental change purchase date or the time of book-entry transfer or delivery of the Series B Preferred Stock. If the paying agent holds cash sufficient to pay the fundamental change purchase price of the Series B Preferred Stock on the trading day following the fundamental change purchase date, then:

- the Series B Preferred Stock will cease to be outstanding and dividends (including additional dividends, if any) will cease to accrue (whether or not book-entry transfer of the Series B Preferred Stock is made or whether or not the Series B Preferred Stock Certificate is delivered to the paying agent); and
- all of the Series B Preferred Stockholder’s other rights will terminate (other than the right to receive the fundamental change purchase price upon delivery or transfer of the Series B Preferred Stock).

A “fundamental change” will be deemed to occur upon a change of control or a termination of trading. A “change of control” will be deemed to have occurred at such time after the original issuance of the Series B Preferred Stock when the following has occurred:

- 1.any “person” or “group” (as such terms are used in Sections 13(d) and 14(d) of the Exchange Act) acquires the beneficial ownership, directly or indirectly, through a purchase, merger or other acquisition transaction or series of transactions, of 50% or more of the total voting power of our total outstanding voting stock other than an acquisition by us or any of our subsidiaries;
- 2.we consolidate with, or merge with or into, another person or convey, transfer, lease or otherwise dispose of all or substantially all of our assets to any person, or any person consolidates with or merges with or into us, other than:
(a) any transaction (i) that does not result in any reclassification, exchange, or cancellation of outstanding shares of our capital stock, and (ii) pursuant to which our capital stockholders immediately prior to the transaction have the entitlement to exercise, directly or indirectly, 50% or more of the total voting power of all shares of our capital stock entitled to vote generally in the election of directors of the continuing or surviving person immediately after the transaction; or (b) any merger solely for the purpose of changing our jurisdiction of formation and resulting in a reclassification, conversion or exchange of outstanding shares of common stock solely into shares of common stock of the surviving entity; or
- 3.we approve a plan of liquidation or dissolution.

A “termination of trading” is deemed to occur if our common stock (or other common stock into which the Series B Preferred Stock is then convertible) is neither listed for trading on a United States national securities exchange nor approved for trading on an established automated over the-counter trading market in the United States. Notwithstanding the foregoing, it will not constitute a change of control if 100% of the consideration for our common stock (excluding cash payments for fractional shares and cash payments made in respect of dissenters’

15

appraisal rights) in the transaction or transactions constituting the change of control consists of common stock traded on a United States national securities exchange (including the Nasdaq Global Market), or which will be so traded or quoted when issued or exchanged in connection with the change of control, and as a result of such transaction or transactions the Series B Preferred Stock become convertible solely into such common stock.

The definition of fundamental change includes a phrase relating to the conveyance, transfer, sale, lease or other disposition of “all or substantially all” of our assets. There is no precise, established definition of the phrase “substantially all” under the laws of the State of Maryland, which govern the Series B Preferred Stock, and our formation. Accordingly, the Series B Preferred Stockholder’s ability to require us to repurchase our Series B Preferred Stock as a result of a conveyance, transfer, sale, lease or other disposition of less than all of our assets may be uncertain.

In connection with the acquisition of the Series B Preferred Stock as a result of a fundamental change, we will comply with all U.S. federal and state securities laws in connection with any offer by us to purchase the Series B Preferred Stock upon such fundamental change.

This fundamental change purchase feature may make it more difficult or discourage a party from taking over our company and removing incumbent management. We are not aware, however, of any specific effort to accumulate our capital stock with the intent to obtain control of our company by means of a merger, tender offer, solicitation or otherwise. In addition, the fundamental change purchase feature is not part of a plan by management to adopt a series of anti-takeover provisions. Instead, the fundamental change purchase feature is a result of negotiations between our company and the underwriters.

We could, in the future, enter into certain transactions, including recapitalizations that would not constitute a fundamental change but would increase the amount of debt outstanding or otherwise adversely affect a Series B Preferred Stockholder. The incurrence of significant amounts of additional debt could adversely affect our ability to service our debt, and to satisfy our obligation to repurchase the Series B Preferred Stock upon a fundamental change.

Our ability to repurchase Series B Preferred Stock upon the occurrence of a fundamental change is subject to important limitations. If a fundamental change were to occur, we may not have sufficient funds, or be able to arrange financing, to pay the fundamental change purchase price for the Series B Preferred Stock tendered by a Series B Preferred Stockholder. In addition, we may in the future incur debt that has similar fundamental change provisions that permit holders of such debt to accelerate or require us to purchase such debt upon the occurrence of events similar to a fundamental change. In addition, our ability to repurchase Series B Preferred Stock for cash may be limited by restrictions on our ability to obtain funds.

We will not be required to make an offer to purchase the Series B Preferred Stock upon a fundamental change if a third party (i) makes an offer to purchase the Series B Preferred Stock in the manner, at the times and otherwise in compliance with the requirements applicable to an offer made by us to purchase Series B Preferred Stock upon a fundamental change, and (ii) purchases all of the Series B Preferred Stock validly delivered and not withdrawn under such offer to purchase Series B Preferred Stock.

Transfer and Dividend Paying Agent

American Stock Transfer & Trust Company is the transfer and dividend paying agent and registrar in respect of the Series B Preferred Stock.

Series C Preferred Stock

General

The statements below describing our 7.625% Series C Cumulative Redeemable Preferred Stock, par value \$0.01 per share with a liquidation preference of \$25.00 per share (which we refer to as our “Series C Preferred Stock”), are in all respects subject to and qualified in their entirety by reference to the Maryland General

16

Corporation Law, our charter (including the Articles Supplementary for Series C Cumulative Redeemable Preferred Stock), and our bylaws. Our Series C Preferred Stock is listed and traded on the New York Stock Exchange under the symbol “ANHPRC”.

Ranking

The Series C Preferred Stock ranks senior to our common stock with respect to the payments of distributions and rights to payment upon liquidation, dissolution or winding up. The Series C Preferred Stock ranks on parity with all other series of preferred stock that we may issue ranking on par with the Series C Preferred Stock, including our Series A Preferred Stock and Series B Preferred Stock, with respect to the payments of distributions and amounts, and rights to payment upon liquidation, dissolution or winding up. We refer to such series of parity preferred stock as “Parity Preferred”.

Dividends

Holders of the Series C Preferred Stock (which we refer to as “Series C Preferred Stockholders”) are entitled to receive, when and as authorized by our board of directors, out of funds legally available for the payment of dividends, cumulative preferential cash dividends at the rate of 7.625% per annum of the \$25.00 liquidation preference (equivalent to \$1.90625 per share). Such dividends are payable quarterly in arrears on the 15th day of January, April, July and October of each year or, if not a business day, the next succeeding business day (each, a “Series C Dividend Payment Date”). Series C Preferred Stockholders will not be entitled to receive dividends paid on any Series C Dividend Payment Date if such shares were not issued and outstanding on the record date for such dividend.

Any dividend payable on the Series C Preferred Stock for any partial dividend period will be computed on the basis of a 360-day year consisting of twelve 30-day months. Dividends will be payable to holders of record as they appear on our records at the close of business on the last day of each of March, June, September and December, as the case may be, immediately preceding the applicable Series C Dividend Payment Date (each, a “Series C Dividend Record Date”). Series C Preferred Stockholders will not be entitled to receive any dividends in excess of cumulative dividends on the Series C Preferred Stock. No interest will be paid in respect of any dividend payment or payments on the Series C Preferred Stock that may be in arrears.

No dividends on shares of Series C Preferred Stock will be declared by us or paid or set apart for payment by us at such time as the terms and provisions of any of our agreements, including any agreement relating to our indebtedness, prohibit such declaration, payment or setting apart for payment or provide that such declaration, payment or setting apart for payment would constitute a breach thereof or a default thereunder, or if such declaration or payment will be restricted or prohibited by law.

Notwithstanding the foregoing, dividends on the Series C Preferred Stock will accrue whether or not we have earnings, whether or not there are funds legally available for the payment of such dividends and whether or not such dividends are declared. Accrued and unpaid dividends on the Series C Preferred Stock will accumulate as of the Series C Dividend Payment Date on which they first become payable.

Except as set forth in the next paragraph, unless full cumulative dividends on the Series C Preferred Stock have been or contemporaneously are declared and paid or declared and a sum sufficient for such full payment is set apart for payment for all past dividend periods and the then current dividend period, no dividends (other than dividends in shares of common stock or dividends in shares of any series of preferred stock that we may issue ranking junior to the Series C Preferred Stock as to dividends and upon liquidation) will be declared or paid or set aside for payment. Nor will any other distribution be declared or made upon shares of our common stock or preferred stock that we may issue ranking junior to or on par with the Series C Preferred Stock as to dividends or upon liquidation. In addition, any shares of our common stock or preferred stock that we may issue ranking junior to or on par with the Series C Preferred Stock as to dividends or upon liquidation will not be redeemed, purchased or otherwise acquired for any consideration (or any moneys be paid to or made available for a sinking fund for the redemption of any such shares) by us (except by conversion into or exchange for our other capital stock that we may issue ranking junior to the Series C Preferred Stock as to dividends and upon liquidation and except for transfers

made pursuant to the provisions of our charter relating to restrictions on ownership and transfers of our capital stock).

If dividends are not paid in full (or a sum sufficient for such full payment is not so set apart) upon the Series C Preferred Stock and the shares of any other series of Parity Preferred, all dividends declared upon the Series C Preferred Stock and the shares of any other series of Parity Preferred will be declared pro rata so that the amount of dividends declared per share of the Series C Preferred Stock and the shares of any other series of Parity Preferred will in all cases bear to each other the same ratio that accrued dividends per share on the Series C Preferred Stock and the shares of any other series of Parity Preferred (which will not include any accrual in respect of unpaid dividends for prior dividend periods if such preferred stock does not have a cumulative dividend) bear to each other. No interest, or sum of money in lieu of interest, will be payable in respect of any dividend payment or payments on the Series C Preferred Stock which may be in arrears.

Series C Preferred Stockholders will not be entitled to any dividend, whether payable in cash, property or stock, in excess of full cumulative dividends on the Series C Preferred Stock as provided above. Any dividend payment made on shares of the Series C Preferred Stock will first be credited against the earliest accrued and unpaid dividend due with respect to such shares which remains payable.

Liquidation Preference

Upon any voluntary or involuntary liquidation, dissolution or winding up of our affairs, the Series C Preferred Stockholders are entitled to be paid out of our assets that are legally available for distribution to our stockholders a liquidation preference of \$25.00 per share, plus an amount equal to any accrued and unpaid dividends (whether or not declared) to the date of payment, before any distribution of assets is made to our Common Stockholders or to holders of any series of our preferred stock that we may issue that ranks junior to the Series C Preferred Stock as to liquidation rights.

In the event that, upon any such voluntary or involuntary liquidation, dissolution or winding up, our available assets are insufficient to pay the amount of the liquidating distributions on all outstanding shares of Series C Preferred Stock and the corresponding amounts payable on all shares of other series of Parity Preferred, then the Series C Preferred Stockholders and stockholders of such series of Parity Preferred will share ratably in any such distribution of assets in proportion to the full liquidating distributions to which they would otherwise be respectively entitled.

Series C Preferred Stockholders will be entitled to written notice of any such liquidation. After payment of the full amount of the liquidating distributions to which they are entitled, the Series C Preferred Stockholders will have no right or claim to any of our remaining assets. The consolidation or merger of us with or into any other corporation, trust or entity or of any other corporation with or into us, or the sale, lease or conveyance of all or substantially all of our assets or business, will not be deemed to constitute a liquidation, dissolution or winding up of us.

Voting Rights

The Series C Preferred Stockholders do not have any voting rights, except as set forth below.

Whenever dividends on any shares of Series C Preferred Stock are in arrears for six or more quarterly periods (whether or not consecutive) (which we refer to as a “Series C Preferred Dividend Default”), the number of directors then constituting our board of directors will be increased by two (if not already increased by two by reason of the election of directors by the holders of other series of Parity Preferred), and the Series C Preferred Stockholders (voting separately as a class with all other series of Parity Preferred upon which like voting rights have been conferred and are exercisable) will be entitled to elect the two additional members of our board of directors (which we refer to as “Preferred Stock Directors”) at a special meeting called by the holders of record of at least 10% of the Series C Preferred Stock or any other series of Parity Preferred so in arrears (unless such request is received less than 90 days before the date fixed for the next annual or special meeting of the stockholders) or at the next annual meeting of stockholders, and at each subsequent annual meeting until all dividends accumulated on such shares of

Series C Preferred Stock for the past dividend periods and the dividends for all dividend periods during the two most recently completed quarterly periods have been fully paid or declared and sums sufficient for the payments thereof have been set aside for payment.

If and when all accumulated dividends and the dividends for all dividend periods during the two most recently completed quarterly periods on the Series C Preferred Stock have been paid in full or set aside for payment in full, the Series C Preferred Stockholders will be divested of the foregoing voting rights (subject to revesting in the event of each and every subsequent Series C Preferred Dividend Default) and, if all accumulated dividends and the dividends for all dividend periods during the two most recently completed quarterly periods have been paid in full or set aside for payment in full on all series of Parity Preferred upon which like voting rights have been conferred and are exercisable, the term of office of each Preferred Stock Director so elected will terminate and the number of directors on the board of directors will decrease by two. Any Preferred Stock Director may be removed at any time with or without cause by, and will not be removed otherwise than by the vote of, the holders of record of a majority of the outstanding shares of the Series C Preferred Stock when they have the voting rights described above (voting separately as a class with all series of Parity Preferred that we may issue upon which like voting rights have been conferred and are exercisable). So long as a Series C Preferred Dividend Default continues, any vacancy in the office of a Preferred Stock Director may be filled by the written consent of the Preferred Stock Directors remaining in office, or if none remains in office, by a vote of the holders of record of a majority of the outstanding shares of Series C Preferred Stock when they have the voting rights described above (voting separately as a class with all series of Parity Preferred that we may issue upon which like voting rights have been conferred and are exercisable). The Preferred Stock Directors will each be entitled to one vote per director on any matter.

So long as any shares of Series C Preferred Stock remain outstanding, we will not, without the affirmative vote or consent of the holders of at least two-thirds of the shares of the Series C Preferred Stock outstanding at the time, given in person or by proxy, either in writing or at a meeting (voting separately as a class with all series of Parity Preferred that we may issue upon which like voting rights have been conferred and are exercisable), (i) authorize or create, or increase the authorized or issued amount of, any class or series of capital stock ranking senior to the Series C Preferred Stock with respect to payment of dividends or the distribution of assets upon liquidation, dissolution or winding up or reclassify any of our authorized capital stock into such shares, or create, authorize or issue any obligation or security convertible into or evidencing the right to purchase any such shares; or (ii) amend, alter or repeal the provisions of our charter, whether by merger, consolidation or otherwise (which we refer to as an “Event”), so as to materially and adversely affect any right, preference, privilege or voting power of the Series C Preferred Stock; provided, however, with respect to the occurrence of any Event set forth in (ii) above, so long as the Series C Preferred Stock remains outstanding with the terms thereof materially unchanged, the occurrence of any such Event will not be deemed to materially and adversely affect such rights, preferences, privileges or voting power of Series C Preferred Stockholders and, provided further, that any increase in the amount of the authorized preferred stock, including the Series C Preferred Stock, or the creation or issuance of any additional Series C Preferred Stock or other series of preferred stock that we may issue, or any increase in the amount of authorized shares of such series, in each case ranking on a parity with or junior to the Series C Preferred Stock that we may issue with respect to payment of dividends or the distribution of assets upon liquidation, dissolution or winding up, will not be deemed to materially and adversely affect such rights, preferences, privileges or voting powers.

Maturity

The Series C Preferred Stock has no maturity date and is not subject to any sinking fund or mandatory redemption. Accordingly, the Series C Preferred Stock will remain outstanding indefinitely unless we redeem it pursuant to the circumstances described under “—Redemption—Optional Redemption” or “—Special Optional Redemption” below, or, if we do not redeem it, you elect to convert it following a Change of Control pursuant to the circumstances described under “—Conversion Rights of Series C Preferred Stockholders” below.

Redemption

Except as described below under “—Special Optional Redemption”, the Series C Preferred Stock is not redeemable prior to January 27, 2020.

19

Optional Redemption

On and after January 27, 2020, we may, at our option, upon not less than 30 nor more than 60 days’ written notice, redeem the Series C Preferred Stock, in whole or in part, at any time or from time to time, for cash at a redemption price of \$25.00 per share, plus any accrued and unpaid dividends thereon to, but not including, the date fixed for redemption. If we elect to redeem any shares of Series C Preferred Stock as described in this paragraph, we may use any available cash to pay the redemption price, and we will not be required to pay the redemption price only out of the proceeds from the issuance of other equity securities or any other specific source.

Special Optional Redemption

Upon the occurrence of a Change of Control (as defined below), we may, at our option, upon not less than 30 nor more than 60 days’ written notice, redeem the Series C Preferred Stock, in whole or in part, within 120 days after the first date on which such Change of Control occurred, for cash at a redemption price of \$25.00 per share, plus any accrued and unpaid dividends thereon to, but not including, the date fixed for redemption. If we elect to redeem any shares of the Series C Preferred Stock as described in this paragraph, we may use any available cash to pay the redemption price, and we will not be required to pay the redemption price only out of the proceeds from the issuance of other equity securities or any other specific source.

If, prior to the Change of Control Conversion Date (as defined below under “—Conversion Rights of Series C Preferred Stockholders—Certain Definitions”), we have provided notice of our election to redeem some or all of the shares of Series C Preferred Stock (whether pursuant to our optional redemption right described above under “—Optional Redemption” above or this special optional redemption right), the Series C Preferred Stockholders will not have the Change of Control Conversion Right (as defined and described below under “—Conversion Rights of Series C Preferred Stockholders”) with respect to the shares of Series C Preferred Stock called for redemption.

A “Change of Control” is deemed to occur when, after the original issuance of the Series C Preferred Stock, the following have occurred and are continuing:

- 1.(a)any “person” or “group” (as such terms are used in Sections 13(d) and 14(d) of the Exchange Act) acquires the beneficial ownership, directly or indirectly, through a purchase, merger or other acquisition transaction or series of transactions, of 50% or more of the total voting power of our total outstanding voting stock other than an acquisition by us or any of our subsidiaries;
- (b)we consolidate with, or merge with or into, another person or convey, transfer, lease or otherwise dispose of all or substantially all of our assets to any person, or any person consolidates with or merges with or into us, other than: (a) any transaction (i) that does not result in any reclassification, exchange, or cancellation of outstanding shares of our capital stock and (ii) pursuant to which our capital stockholders immediately prior to the transaction have the entitlement to exercise, directly or indirectly, 50% or more of the total voting power of all shares of our capital stock entitled to vote generally in the election of directors of the continuing or surviving person immediately after the transaction; or (b) any merger solely for the purpose of changing our jurisdiction of formation and resulting in a reclassification, conversion or exchange of outstanding shares of common stock solely into shares of common stock of the surviving entity; or
- (c)we approve a plan of liquidation or dissolution; and
- 2.following the closing of any transaction referred to in (1) above, neither we nor the acquiring or surviving entity has a class of common securities listed for trading on a United States national securities exchange (including the Nasdaq Stock Market).

The definition of “Change of Control” includes a phrase relating to the conveyance, transfer, sale, lease or other disposition of “all or substantially all” of our assets. There is no precise, established definition of the phrase “substantially all” under the laws of the State of Maryland, which govern the Series C Preferred Stock, and our

20

formation. Accordingly, our ability to redeem all or part of the Series C Preferred Stock as a result of a conveyance, transfer, sale, lease or other disposition of less than all of our assets may be uncertain.

Redemption Procedures

In the event we elect to redeem Series C Preferred Stock, the notice of redemption will be mailed, not less than 30 nor more than 60 days prior to the redemption date, to each holder of record of Series C Preferred Stock called for redemption at such holder’s address as it appears on our stock transfer records and will state the following:

- the redemption date;

- the number of shares of Series C Preferred Stock to be redeemed (if less than all of the Series C Preferred Stock held by any Series C Preferred Stockholder are to be redeemed, the notice shall specify the number of shares of Series C Preferred Stock held by such holder to be redeemed);
- the redemption price;
- the procedure for surrendering shares of Series C Preferred Stock to be redeemed for payment of the redemption price;
- that dividends on the shares of Series C Preferred Stock to be redeemed will cease to accumulate on the redemption date;
- whether such redemption is being made pursuant to the provisions described above under “—Optional Redemption” or “—Special Optional Redemption” above;
- if applicable, that such redemption is being made in connection with a Change of Control and, in that case, a brief description of the transaction or transactions constituting such Change of Control; and
- if such redemption is being made in connection with a Change of Control, that the Series C Preferred Stockholders being so called for redemption will not be able to tender such shares of Series C Preferred Stock for conversion in connection with the Change of Control, and that each share of Series C Preferred Stock tendered for conversion that is called, prior to the Change of Control Conversion Date, for redemption will be redeemed on the related date of redemption instead of converted on the Change of Control Conversion Date.

No failure to give such notice or any defect thereto or in the mailing thereof shall affect the validity of the proceedings for the redemption of any shares of Series C Preferred Stock except as to the holder to whom notice was defective or not given. Any such redemption may be made conditional on such factors as may be determined by our board of directors and as set forth in the notice of redemption.

Series C Preferred Stockholders to be redeemed shall follow the procedures for surrendering the Series C Preferred Stock set forth in the notice of redemption and shall be entitled to the redemption price and any accrued and unpaid dividends payable upon the redemption following the surrender.

If notice of redemption of any shares of Series C Preferred Stock has been given and if we have irrevocably set aside the funds necessary for redemption in trust for the benefit of the holders of the shares of Series C Preferred Stock so called for redemption, then from and after the redemption date (unless we shall default in providing for the payment of the redemption price plus any accrued and unpaid dividends), dividends will cease to accrue on those shares of Series C Preferred Stock, those shares of Series C Preferred Stock shall no longer be deemed outstanding, and all rights of the holders of those shares will terminate, except the right to receive the redemption price plus any accrued and unpaid dividends payable upon redemption.

21

If any redemption date is not a business day, then the redemption price and any accrued and unpaid dividends payable upon redemption may be paid on the next business day and no interest, additional dividends or other sums will accrue on the amount payable for the period from and after that redemption date to that next business day.

If less than all of the outstanding Series C Preferred Stock is to be redeemed, the Series C Preferred Stock to be redeemed shall be selected pro rata (as nearly as may be practicable without creating fractional shares).

Immediately prior to any redemption of Series C Preferred Stock, we shall pay, in cash, any accrued and unpaid dividends through and including the redemption date, unless a redemption date falls after a Series C Dividend Record Date and prior to the corresponding Series C Dividend Payment Date, in which case each Series C Preferred Stockholder at the close of business on such Series C Dividend Record Date shall be entitled to the dividend payable on such shares on the corresponding Series C Dividend Payment Date notwithstanding the redemption of such shares before such Series C Dividend Payment Date. Except as provided above, we will make no payment or allowance for unpaid dividends, whether or not in arrears, on shares of the Series C Preferred Stock to be redeemed.

Unless full cumulative dividends on all shares of Series C Preferred Stock have been or contemporaneously are declared and paid or declared and a sum sufficient for the payment thereof has been or contemporaneously is set apart for payment for all past dividend periods, no shares of Series C Preferred Stock shall be redeemed unless all outstanding shares of Series C Preferred Stock are simultaneously redeemed, and we shall not purchase or otherwise acquire directly or indirectly any shares of Series C Preferred Stock (except by exchanging it for our capital stock ranking junior to the Series C Preferred Stock as to dividends and upon liquidation); provided, however, that the foregoing shall not prevent the purchase or acquisition by us of shares of Series C Preferred Stock to preserve our REIT status or pursuant to a purchase or exchange offer made on the same terms to holders of all outstanding shares of Series C Preferred Stock.

In connection with any redemption of the Series C Preferred Stock, we will comply with all U.S. federal and state securities laws in connection with any redemption by us of the Series C Preferred Stock. In addition, subject to applicable law, we may purchase shares of Series C Preferred Stock in the open market, by tender or by private agreement. Any shares of Series C Preferred Stock redeemed, purchased or otherwise acquired by us in any manner whatsoever may be retired and re-classified as authorized but unissued shares of preferred stock, without designation as to series, and may thereafter be reissued by us as any series of preferred stock in accordance with the applicable provisions of our charter.

Conversion Rights of Series C Preferred Stockholders

Upon the occurrence of a Change of Control, each Series C Preferred Stockholder will have the right (unless, prior to the Change of Control Conversion Date, we have provided notice of our election to redeem some or all of the shares of Series C Preferred Stock held by such holder as described above under “—Redemption—Optional Redemption” or “—Redemption—Special Optional Redemption” above, in which case such holder will have the right only with respect to any shares of Series C Preferred Stock that are not called for redemption) to convert some or all of the shares of Series C Preferred Stock held by such holder (which we refer to as the “Change of Control Conversion Right”) on the Change of Control Conversion Date into a number of shares of our common stock per share of Series C Preferred Stock (which we refer to as the “common stock Conversion Consideration”) equal to the lesser of:

- (i)the quotient obtained by dividing (A) the sum of the \$25.00 liquidation preference per share of Series C Preferred Stock plus the amount of any accrued and unpaid dividends thereon to, but not including, the Change of Control Conversion Date (unless the Change of Control Conversion Date is after a Series C Dividend Record Date and prior to the corresponding Series C Dividend Payment Date, in which case no additional amount for such accrued and unpaid dividends will be included in this sum) by (B) the common stock Price (as defined below); and
- (ii)9.4518 (which we refer to as the “Share Cap”), subject to certain adjustments as described below.

22

Share Cap Adjustments

The Share Cap is subject to pro rata adjustments for any share splits (including those effected pursuant to a distribution of our common stock to existing holders of our common stock), subdivisions or combinations (in each case, a “Share Split”) with respect to our common stock as follows: the adjusted Share Cap as the result of a Share Split will be the number of shares of our common stock that is equivalent to the product obtained by multiplying (i) the Share Cap in effect immediately prior to such Share Split by (ii) a fraction, the numerator of which is the number of shares of our common stock outstanding immediately after giving effect to such Share Split and the denominator of which is the number of shares of our common stock outstanding immediately prior to such Share Split.

For the avoidance of doubt, subject to the immediately succeeding sentence, the aggregate number of shares of our common stock (or equivalent Alternative Conversion Consideration (as defined below), as applicable) issuable or deliverable, as applicable, in connection with the exercise of the Change of Control Conversion Right will not exceed 2,835,540 shares of our common stock (or equivalent Alternative Conversion Consideration, as applicable) (which we refer to as the “Exchange Cap”). The Exchange Cap is subject to pro rata adjustments for any Share Splits on the same basis as the corresponding adjustment to the Share Cap.

Conversion Consideration

In the case of a Change of Control pursuant to which our common stock is or will be converted into cash, securities or other property or assets (including any combination thereof) (which we refer to as the “Alternative Form Consideration”), a Series C Preferred Stockholder will receive upon conversion of such Series C Preferred Stock the kind and amount of Alternative Form Consideration which such holder would have owned or been entitled to receive upon the Change of Control had such holder held a number of shares of our common stock equal to the common stock Conversion Consideration immediately prior to the effective time of the Change of Control (which we refer to as the “Alternative Conversion Consideration,” and we refer to the common stock Conversion Consideration or the Alternative Conversion Consideration, whichever shall be applicable to a Change of Control, as the “Conversion Consideration”).

If the holders of our common stock have the opportunity to elect the form of consideration to be received in the Change of Control, the Conversion Consideration in respect of such Change of Control will be deemed to be the kind and amount of consideration actually received by holders of a majority of the outstanding shares of our common stock that made or voted for such an election if electing between two types of consideration, or holders of a plurality of the outstanding shares of our common stock that made or voted for such an election if electing between more than two types of consideration, as the case may be, and will be subject to any limitations to which all holders of our common stock are subject, including, without limitation, pro rata reductions applicable to any portion of the consideration payable in such Change of Control.

We will not issue any fractional shares of our common stock upon the conversion of the Series C Preferred Stock in connection with a Change of Control. Instead, we will make a cash payment equal to the value of such fractional shares based upon the common stock Price used in determining the common stock Conversion Consideration for such Change of Control.

Conversion Procedures

Within 15 days following the occurrence of a Change of Control, provided that we have not then exercised our right to redeem all shares of Series C Preferred Stock pursuant to the redemption provisions described above, we will provide to the Series C Preferred Stockholders a notice of occurrence of the Change of Control that describes the resulting Change of Control Conversion Right. This notice will state the following:

- the events constituting the Change of Control;
- the date of the Change of Control;
- the last date on which the Series C Preferred Stockholders may exercise their Change of Control Conversion Right;
- the method and period for calculating the common stock Price;
- the Change of Control Conversion Date;
- that if, prior to the Change of Control Conversion Date, we have provided notice of our election to redeem any or all shares of Series C Preferred Stock, holders will not be able to convert such shares of Series C Preferred Stock called for redemption and such shares will be redeemed on the applicable redemption date, even if such shares have already been tendered for conversion pursuant to the Change of Control Conversion Right;
- if applicable, the type and amount of Alternative Conversion Consideration entitled to be received per share of Series C Preferred Stock;
- the name and address of the paying agent, transfer agent and conversion agent for the Series C Preferred Stock;

23

- the procedures that the Series C Preferred Stockholders must follow to exercise the Change of Control Conversion Right (including procedures for surrendering shares for conversion through the facilities of DTC, including the form of conversion notice to be delivered by such holders as described below; and
- the last date on which Series C Preferred Stockholders may withdraw shares surrendered for conversion and the procedures that such holders must follow to effect such a withdrawal.

Under such circumstances, we will also issue a press release containing such notice for publication on Dow Jones & Company, Inc., Business Wire, PR Newswire or Bloomberg Business News (or, if these organizations are not in existence at the time of issuance of the press release, such other news or press organization as is reasonably calculated to broadly disseminate the relevant information to the public), and post a notice on our website, in any event prior to the opening of business on the first business day following any date on which we provide the notice described above to the Series C Preferred Stockholders.

To exercise the Change of Control Conversion Right, Series C Preferred Stockholders will be required to deliver, on or before the close of business on the Change of Control Conversion Date, the shares of Series C Preferred Stock to be converted through the facilities of DTC, together with a written conversion notice in the form provided by us, duly completed, to our transfer agent. The conversion notice must comply with applicable procedures, if any, of DTC and state:

- the relevant Change of Control Conversion Date;
- the number of shares of Series C Preferred Stock to be converted; and
- that the Series C Preferred Stock is to be converted pursuant to the applicable provisions of the Series C Preferred Stock.

Series C Preferred Stockholders may withdraw any notice of exercise of a Change of Control Conversion Right (in whole or in part) by a written notice of withdrawal delivered to our transfer agent prior to the close of business on the business day prior to the Change of Control Conversion Date. The notice of withdrawal delivered by any holder must comply with applicable procedures, if any, of DTC and state:

- the number of withdrawn shares of Series C Preferred Stock; and
- the number of shares of Series C Preferred Stock, if any, which remain subject to such holder’s conversion notice.

24

Series C Preferred Stock as to which the Change of Control Conversion Right has been properly exercised and for which the conversion notice has not been properly withdrawn will be converted into the applicable Conversion Consideration in accordance with the Change of Control Conversion Right on the Change of Control Conversion Date, unless prior to the Change of Control Conversion Date we have provided notice of our election to redeem some or all of the shares of Series C Preferred Stock, as described above under “—Redemption—Optional Redemption” or “—Redemption—Special Optional Redemption,” in which case only the shares of Series C Preferred Stock properly surrendered for conversion and not properly withdrawn that are not called for redemption, if any, will be converted as aforesaid. If we elect to redeem shares of Series C Preferred Stock that would otherwise be converted into the applicable Conversion Consideration on a Change of Control Conversion Date, such shares of Series C Preferred Stock will not be so converted and the holders of such shares will be entitled to receive on the applicable redemption date the redemption price described above under “—Redemption—Optional Redemption” or “—Redemption—Special Optional Redemption”, as applicable.

We will deliver all securities, cash and any other property owing upon conversion no later than the third business day following the Change of Control Conversion Date. Notwithstanding the foregoing, the persons entitled to receive any shares of our common stock or other securities delivered on conversion will be deemed to have become the holders of record thereof as of the Change of Control Conversion Date.

In connection with the exercise of any Change of Control Conversion Right, we will comply with all federal and state securities laws and stock exchange rules in connection with any conversion of Series C Preferred Stock into shares of our common stock or other property. Notwithstanding any other provision of the Series C Preferred Stock, no Series C Preferred Stockholder will be entitled to convert such Series C Preferred Stock into shares of our common stock to the extent that receipt of such common stock would cause such holder (or any other person) to exceed the applicable share ownership limitations contained in our charter or the articles supplementary establishing the Series C Preferred Stock, unless we provide an exemption from this limitation to such holder. See “—Restrictions on Ownership and Transfer” below.

Payment of Dividends Upon Conversion

Anything in the articles supplementary establishing the Series C Preferred Stock to the contrary notwithstanding and except as otherwise required by law, the persons who are the holders of record of shares of Series C Preferred Stock at the close of business on a Series C Dividend Record Date will be entitled to receive the dividend payable on the corresponding Series C Dividend Payment Date notwithstanding the conversion of those shares after such Series C Dividend Record Date and on or prior to such Series C Dividend Payment Date, and, in such case, the full amount of such dividend shall be paid on such Series C Dividend Payment Date to the persons who were the holders of record at the close of business on such Series C Dividend Record Date. Except as provided above, we will make no allowance for unpaid dividends that are not in arrears on the shares of Series C Preferred Stock to be converted.

Certain Definitions

The “Change of Control Conversion Date” is the date the Series C Preferred Stock is to be converted, which will be a business day selected by us that is no fewer than 20 days nor more than 35 days after the date on which we provide the notice described under “—Conversion Procedures” above to the Series C Preferred Stockholders.

The “common stock Price” is (i) if the consideration to be received in the Change of Control by the holders of our common stock is solely cash, the amount of cash consideration per share of our common stock, or (ii) if the consideration to be received in the Change of Control by holders of our common stock is other than solely cash, (A) the average of the closing sale prices per share of our common stock (or, if no closing sale price is reported, the average of the closing bid and ask prices per share or, if more than one in either case, the average of the average closing bid and the average closing ask prices per share) for the ten consecutive trading days immediately preceding, but not including, the date on which such Change of Control occurred as reported on the principal United States

national securities exchange on which our common stock is then traded, or (B) the average of the last quoted bid prices for our common stock in the over-the-counter market as reported by Pink OTC Markets Inc. or another similar organization for the ten consecutive trading days immediately preceding, but not including, the date on

25

which such Change of Control occurred, if our common stock is not then listed for trading on a United States national securities exchange.

Transfer and Dividend Paying Agent

American Stock Transfer & Trust Company is the transfer and dividend paying agent and registrar in respect of the Series C Preferred Stock.

Restrictions on Ownership and Transfer

Two of the requirements of qualification for the tax benefits accorded by the REIT provisions of the tax code are that (i) during the last half of each taxable year not more than 50% in value of the outstanding shares may be owned directly or indirectly by five or fewer individuals, and (ii) there must be at least 100 stockholders on 335 days of each taxable year of 12 months.

In order that we may meet these requirements at all times, our charter prohibits any person from owning, acquiring or holding, directly or indirectly, without prior approval by our board of directors, shares of any class of our capital stock in excess of 9.8% in value of the aggregate of the outstanding shares of capital stock or shares of our common stock in excess of 9.8% (in value or in number of shares, whichever is more restrictive) of the aggregate of the outstanding shares of our common stock. For this purpose, ownership includes both beneficial ownership and constructive ownership. Beneficial ownership is defined in our charter to include interests that would be treated as owned through the application of Section 544 of the tax code, as modified by Section 856(h)(1)(B) of the tax code. Constructive ownership is defined in our charter to include interests that would be treated as owned through the application of Section 318(a) of the tax code, as modified by Section 856(d)(5) of the tax code. Subject to certain limitations, our board of directors may increase or decrease the ownership limitations or waive the limitations for individual investors.

For purposes of the 50% stockholder test discussed above, the constructive ownership provisions applicable under Section 544 of the tax code attribute ownership of securities owned by a corporation, partnership, estate or trust proportionately to its stockholders, partners or beneficiaries, attribute ownership of securities owned by family members to other members of the same family, treat securities with respect to which a person has an option to purchase as actually owned by that person, and set forth rules for application of such attribution provisions (e.g., reattribution of stock that is constructively owned). Thus, for purposes of determining whether a person holds shares of capital stock in violation of the ownership limitations set forth in our charter, many types of entities may own directly more than the 9.8% limit because such entities’ shares are attributed to its individual stockholders. On the other hand, a person will be treated as owning not only shares of capital stock actually or beneficially owned, but also any shares of capital stock attributed to such person under the attribution rules described above. Accordingly, under certain circumstances, shares of capital stock owned by a person who individually owns less than 9.8% of the shares outstanding may nevertheless be in violation of the ownership limitations set forth in our charter. Ownership of shares of capital stock through such attribution is generally referred to as constructive ownership.

If any transfer of shares of capital stock would result in any person beneficially or constructively owning capital stock in violation of our transfer or ownership limitations, then the number of shares of capital stock causing the violation (rounded to the nearest whole shares) shall be automatically transferred to a trustee of a trust for the exclusive benefit of one or more charitable beneficiaries. The intended transferee shall not acquire any rights in such shares. Shares of capital stock held by the trustee shall be issued and outstanding shares of capital stock. The intended transferee shall not benefit economically from ownership of any shares held in the trust, shall have no rights to dividends, and shall not possess any rights to vote or other rights attributable to the shares held in the trust. The trustee shall have all voting rights and rights to dividends or other distributions with respect to shares held in the trust, which rights shall be exercised for the exclusive benefit of the charitable beneficiary. Any dividend or other distribution paid to the intended transferee prior to the discovery by us that shares of capital stock have been transferred to the trustee shall be paid with respect to such shares to the trustee by the intended transferee upon demand and any dividend or other distribution authorized but unpaid shall be paid when due to the trustee. Our board of directors may, in its discretion, waive these requirements on owning shares in excess of the ownership limitations.

26

Within 20 days of receiving notice from us that shares of capital stock have been transferred to the trust, the trustee shall sell the shares held in the trust to a person, designated by the trustee, whose ownership of the shares will not violate the ownership limitations set forth in our charter. Upon such sale, the interest of the charitable beneficiary in the shares sold shall terminate and the trustee shall distribute the net proceeds of the sale to the intended transferee and to the charitable beneficiary as follows. The intended transferee shall receive the lesser of (1) the price paid by the intended transferee for the shares or, if the intended transferee did not give value for the shares in connection with the event causing the shares to be held in the trust (e.g., in the case of a gift, devise or other such transaction), the market price (as defined below) of the shares on the day of the event causing the shares to be held in the trust, and (2) the price per share received by the trustee from the sale or other disposition of the shares held in the trust. Any net sales proceeds in excess of the amount payable to the intended transferee shall be immediately paid to the charitable beneficiary. In addition, shares of capital stock transferred to the trustee shall be deemed to have been offered for sale to us, or our designee. This offer shall be at a price per share equal to the lesser of (1) the price per share in the transaction that resulted in such transfer to the trust (or, in the case of a devise or gift, the market price at the time of such devise or gift), and (2) the market price on the date we, or our designee, accepts such offer. We shall have the right to accept such offer until the trustee has sold shares held in the trust. Upon such a sale to us, the interest of the charitable beneficiary in the shares sold shall terminate and the trustee shall distribute the net proceeds of the sale to the intended transferee.

The market price shall mean the last sale price for such shares. In case no such sale takes place on such day, the market price shall be the average of the closing bid and asked prices on the New York Stock Exchange. In the event that no trading price is available for such shares, the fair market value of the shares shall be as determined in good faith by our board of directors.

Under the REIT provisions of the tax code, every owner of 5% or more in the case of 2,000 or more stockholders of record, of 1% or more in the case of more than 200 but fewer than 2,000 stockholders of record and of 0.5% or more in the case of 200 or fewer stockholders of record, of all classes or series of our stock, is required to give written notice to us in response to our written demand for such notice, which request must be made within 30 days after the end of each taxable year. They shall state their name and address, the number of shares of each class and series of our stock beneficially owned and a description of the manner in which such shares are held. Each such owner shall provide to us such additional information as we may request in order to determine the effect, if any, of such beneficial ownership on our status as a REIT and to ensure compliance with the ownership limitations.

Maryland Business Combination Act

Maryland law prohibits specified “business combinations” between a Maryland corporation and an “interested stockholder”. These business combinations include, among others, a merger, consolidation, share exchange, asset transfer or issuance or reclassification of equity securities. Interested stockholders are either:

- the beneficial owner, directly or indirectly, of 10% or more of the voting power of the then outstanding stock of the corporation; or
- an affiliate or associate of the corporation who was the beneficial owner, directly or indirectly, of 10% or more of the voting power of the then outstanding stock of the corporation at any time within the two-year period prior to the date in question.

Business combinations with a past interested stockholder are prohibited for five years after the most recent date on which the stockholder became an interested stockholder. Thereafter, any business combinations with the interested stockholder must be recommended by the board of directors of the corporation and approved by the affirmative vote of at least:

- 80% of the votes entitled to be cast by outstanding shares of the corporation’s voting shares, voting together as a single group; and
- 66⅔% of the votes entitled to be cast by all holders of the corporation’s voting shares other than voting shares held by the interested stockholder or an affiliate or associate of the interested stockholder.

27

However, these special voting requirements do not apply if the corporation’s stockholders receive a minimum price for their shares, as specified in the statute, and the consideration is received in cash or in the same form previously paid by the interested stockholder for its shares.

The business combination statute does not apply to business combinations that are approved or exempted by the corporation’s board of directors prior to the time that the interested stockholder becomes an interested stockholder. The statute also does not apply to stockholders that acquired 10% or more of the corporation’s voting shares in a transaction approved by the corporation’s board of directors. A Maryland corporation may adopt an amendment to its charter electing not to be subject to these special voting requirements. Any amendment would have to be approved by at least 80% of the votes entitled to be cast by all holders of outstanding shares of voting stock and 66⅔% of the votes entitled to be cast by holders of outstanding shares of voting stock who are not interested stockholders or affiliates or associates of interested stockholders.

The business combination statute could have the effect of discouraging offers to acquire us and of increasing the difficulty of consummating such offers, even if our acquisition would be in our stockholders’ best interests. Our board of directors has not passed such a resolution exempting us from the business combination act.

Maryland Control Share Acquisition Act

Maryland law provides that “control shares” of a Maryland corporation acquired in a “control share acquisition” have no voting rights unless approved by a vote of two-thirds of the votes entitled to be cast on the matter, excluding shares owned by the acquirer or by the corporation’s officers or directors who are employees of the corporation. Control shares are shares of voting stock which, if aggregated with all other shares of stock previously acquired, would entitle the acquirer to exercise voting power in electing directors within one of the following ranges of voting power:

- 10% or more but less than 33⅓%
- 33⅓% or more but less than a majority; or
- a majority or more of all voting power.

Control shares do not include shares of stock an acquiring person is entitled to vote as a result of having previously obtained stockholder approval. A control share acquisition generally means the acquisition of, ownership of or the power to direct the exercise of voting power with respect to, control shares.

A person who has made or proposes to make a “control share acquisition”, under specified conditions, including an undertaking to pay expenses, may require the board of directors to call a special stockholders meeting to consider the voting rights of the shares. The meeting must be held within 50 days of the demand. If no request for a meeting is made, the corporation may itself present the question at any stockholders’ meeting.

If voting rights are not approved at the meeting or if the acquiring person does not deliver an acquiring person statement as permitted by the statute, the corporation generally may redeem any or all of the control shares, except those for which voting rights have previously been approved. This redemption of shares must be for fair value, determined without regard to the absence of voting rights for the control shares as of the date of the last control share acquisition by the acquiring person or of any stockholders’ meeting at which the voting rights of the shares are considered and not approved. If voting rights for “control shares” are approved at a stockholders’ meeting and the acquirer becomes entitled to vote a majority of the shares entitled to vote, all other stockholders may exercise appraisal rights. The fair value of the stock determined for purposes of appraisal rights may not be less than the highest price per share paid by the acquiring person in the control share acquisition. Certain limitations and restrictions otherwise applicable to the exercise of dissenters’ rights do not apply in the context of a “control share acquisition”.

28

The control share acquisition statute would not apply to stock acquired in a merger, consolidation or share exchange if we were a party to the transaction, or to acquisitions previously approved or exempted by a provision in our charter or bylaws.

Our bylaws currently contain a provision exempting from the control share acquisition statute any and all acquisitions by any person of our common stock. However, our board of directors may decide to amend or eliminate this provision at any time in the future.

[\(Back To Top\)](#)

Section 3: EX-23.1 (EX-23.1)

Exhibit 23.1

Consent of Independent Registered Public Accounting Firm

We consent to the incorporation by reference in Registration Statements on Form S-3 (No. 333-230724 and No. 333-223697) and on Form S-8 (No. 333-197880) of Anworth Mortgage Asset Corporation and subsidiaries of our reports dated March 5, 2020, relating to the consolidated financial statements, the financial statement schedules and the effectiveness of internal control over financial reporting of Anworth Mortgage Asset Corporation and subsidiaries, appearing in the Annual Report on Form 10-K of Anworth Mortgage Asset Corporation and subsidiaries for the year ended December 31, 2019.

/s/ RSM US LLP
Los Angeles, California
March 5, 2020

[\(Back To Top\)](#)

Section 4: EX-31.1 (EX-31.1)

EXHIBIT 31.1

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER

I, Joseph E. McAdams, certify that:

1. I have reviewed this Annual Report on Form 10-K of Anworth Mortgage Asset Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting;

5. The registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Dated: March 5, 2020

/s/ JOSEPH E. MCADAMS

Joseph E. McAdams

Chief Executive Officer and President

(Principal Executive Officer)

(authorized officer of registrant)

[\(Back To Top\)](#)

Section 5: EX-31.2 (EX-31.2)

EXHIBIT 31.2

CERTIFICATION OF PRINCIPAL EXECUTIVE OFFICER

I, Charles J. Siegel, certify that:

1. I have reviewed this Annual Report on Form 10-K of Anworth Mortgage Asset Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant’s other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal controls over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant’s disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant’s internal control over financial reporting that occurred during the registrant’s most recent fiscal quarter (the registrant’s fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant’s internal control over financial reporting;

5. The registrant’s other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant’s ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal control over financial reporting.

Dated: March 5, 2020

/s/ CHARLES J. SIEGEL

Charles J. Siegel

Chief Financial Officer

(Principal Financial Officer)

(authorized officer of registrant)

[\(Back To Top\)](#)

Section 6: EX-32.1 (EX-32.1)

EXHIBIT 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the annual report of Anworth Mortgage Asset Corporation (the “Company”) on Form 10-K for the year ended December 31, 2019, as filed with the Securities and Exchange Commission on March 5, 2020 (the “Report”), I, Joseph E. McAdams, Chairman, President, and Chief Executive Officer (Principal Executive Officer) of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

March 5, 2020

/s/ JOSEPH E. MCADAMS

Joseph E. McAdams

Chief Executive Officer and President

(Principal Executive Officer)

(authorized officer of registrant)

[\(Back To Top\)](#)

Section 7: EX-32.2 (EX-32.2)

EXHIBIT 32.2

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the annual report of Anworth Mortgage Asset Corporation (the “Company”) on Form 10-K for the year ended December 31, 2019, as filed with the Securities and Exchange Commission on March 5, 2020 (the “Report”), I, Charles J. Siegel, Chief Financial Officer (Principal Financial Officer) of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

March 5, 2020

/s/ CHARLES J. SIEGEL

Charles J. Siegel
Chief Financial Officer
(Principal Financial Officer)
(principal accounting officer)

([Back To Top](#))