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Ellington Residential Mortgage REIT  
Form 10-Q  
August 12, 2014

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

For the quarterly period ended June 30, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 001-35896  
Ellington Residential Mortgage REIT  
(Exact Name of Registrant as Specified in Its Charter)

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|  |                                   |
|--|-----------------------------------|
| Maryland   | 46-0687599                        |
| (State or Other Jurisdiction of Incorporation)       | (IRS Employer Identification No.) |
| 53 Forest Avenue                                     |                                   |
| Old Greenwich, CT 06870                              |                                   |
| (Address of principal executive offices, zip code)   |                                   |
| (203) 698-1200                                       |                                   |
| (Registrant's Telephone Number, Including Area Code) |                                   |

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

|   |                                     |                           |                          |
|---|-------------------------------------|---------------------------|--------------------------|
| Large Accelerated Filer   | <input type="checkbox"/>            | Accelerated Filer         | <input type="checkbox"/> |
| Non-Accelerated Filer (do not check if a smaller reporting company) | <input checked="" type="checkbox"/> | Smaller Reporting Company | <input type="checkbox"/> |

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

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

|  |                               |
|--|-------------------------------|
| Class  | Outstanding at August 8, 2014 |
| Common Shares of Beneficial Interest, \$0.01 par value per share | 9,139,842                     |



ELLINGTON RESIDENTIAL MORTGAGE REIT  
FORM 10-Q

PART I. Financial Information

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## PART I. FINANCIAL INFORMATION

## Item 1. Consolidated Financial Statements (unaudited)

ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED BALANCE SHEET  
(UNAUDITED)

|  | June 30, 2014 | December 31,<br>2013 |
|--|---------------|----------------------|
| (In thousands except share amounts)  |               |                      |
| <b>ASSETS</b>  |               |                      |
| Cash and cash equivalents  | \$49,908      | \$50,112             |
| Mortgage-backed securities, at fair value  | 1,344,444     | 1,326,036            |
| Due from brokers   | 13,338        | 18,347               |
| Financial derivatives—assets, at fair value  | 10,115        | 34,963               |
| Receivable for securities sold   | 100,267       | 76,692               |
| Interest receivable  | 5,769         | 4,766                |
| Other assets   | 468           | 174                  |
| Total Assets   | \$1,524,309   | \$1,511,090          |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |               |                      |
| <b>LIABILITIES</b>   |               |                      |
| Repurchase agreements  | \$1,285,593   | \$1,310,347          |
| Payable for securities purchased   | 46,467        | 2,776                |
| Due to brokers   | 7,320         | 22,788               |
| Financial derivatives—liabilities, at fair value   | 6,807         | 1,069                |
| Dividend payable   | 5,027         | 4,570                |
| Accrued expenses   | 930           | 996                  |
| Management fee payable   | 567           | 600                  |
| Interest payable   | 605           | 764                  |
| Total Liabilities  | 1,353,316     | 1,343,910            |
| <b>SHAREHOLDERS' EQUITY</b>  |               |                      |
| Preferred shares, par value \$0.01 per share, 100,000,000 shares authorized;<br>(0 shares issued and outstanding, respectively)      | —             | —                    |
| Common shares, par value \$0.01 per share, 500,000,000 shares authorized;<br>(9,139,842 shares issued and outstanding, respectively) | 91            | 91                   |
| Additional paid-in-capital   | 181,203       | 181,147              |
| Accumulated deficit  | (10,301       | ) (14,058 )          |
| Total Shareholders' Equity   | 170,993       | 167,180              |
| Total Liabilities and Shareholders' Equity   | \$1,524,309   | \$1,511,090          |

See Notes to Consolidated Financial Statements

ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF OPERATIONS  
(UNAUDITED)

|   | Three Month<br>Period<br>Ended<br>June 30,<br>2014 | Three Month<br>Period<br>Ended<br>June 30,<br>2013 | Six Month<br>Period<br>Ended<br>June 30,<br>2014 | Six Month<br>Period<br>Ended<br>June 30,<br>2013 |
|---|--|--|--|--|
| (In thousands except per share amounts)                               |  |  |  |  |
| <b>INTEREST INCOME (EXPENSE)</b>                                      |  |  |  |  |
| Interest income   | \$11,575   | \$4,310  | \$23,534   | \$4,592  |
| Interest expense  | (1,070)  | ) (525)  | ) (2,225)  | ) (525)  |
| Total net interest income   | 10,505   | 3,785  | 21,309   | 4,067  |
| <b>EXPENSES</b>   |  |  |  |  |
| Management fees   | 567  | 703  | 1,159  | 823  |
| Professional fees   | 137  | 237  | 276  | 268  |
| Other operating expenses  | 613  | 421  | 1,276  | 466  |
| Total expenses  | 1,317  | 1,361  | 2,711  | 1,557  |
| <b>OTHER INCOME (LOSS)</b>  |  |  |  |  |
| Net realized gains (losses) on mortgage-backed securities             | 382  | (3,006)  | ) (2,643)  | ) (2,117)  |
| Net realized gains (losses) on financial derivatives                  | (11,155)   | ) 8,376  | (14,564)   | ) 8,376  |
| Change in net unrealized gains (losses) on mortgage-backed securities | 25,424   | (45,784)   | ) 43,005   | (45,629)   |
| Change in net unrealized gains (losses) on financial derivatives      | (12,789)   | ) 28,286   | (30,585)   | ) 28,286   |
| Total other income (loss)   | 1,862  | (12,128)   | ) (4,787)  | ) (11,084)                                       |
| <b>NET INCOME (LOSS)</b>  | <b>\$11,050</b>                                    | <b>\$(9,704)</b>                                   | <b>) \$13,811</b>                                | <b>\$(8,574)</b>                                 |
| <b>NET INCOME (LOSS) PER COMMON SHARE:</b>                            |  |  |  |  |
| Basic   | \$1.21   | \$(1.55)   | ) \$1.51   | \$(2.17)   |
| <b>CASH DIVIDENDS PER COMMON SHARE:</b>                               |  |  |  |  |
| Dividends declared  | \$0.55   | 0.14   | \$1.10   | \$0.14   |

See Notes to Consolidated Financial Statements

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ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY  
(UNAUDITED)

|                                     | Common<br>Shares | Common<br>Shares,<br>par value | Preferred<br>Shares | Preferred<br>Shares,<br>par value | Additional<br>Paid-in-Capital | Accumulated<br>Deficit | Total     |
|-------------------------------------|------------------|--------------------------------|---------------------|-----------------------------------|-------------------------------|------------------------|-----------|
| (In thousands except share amounts) |                  |                                |                     |                                   |                               |                        |           |
| BALANCE, December 31, 2012          | 1,633,378        | \$16                           | —                   | \$—                               | \$ 32,674                     | \$ (1,726 )            | \$30,964  |
| Issuance of common shares           | 7,500,000        | 75                             | —                   | —                                 | 149,925                       |                        | 150,000   |
| Offering costs                      |                  |                                |                     |                                   | (1,538 )                      |                        | (1,538 )  |
| Dividends declared                  |                  |                                |                     |                                   |                               | (1,279 )               | (1,279 )  |
| Net loss                            |                  |                                |                     |                                   |                               | (8,574 )               | (8,574 )  |
| BALANCE, June 30, 2013              | 9,133,378        | \$91                           | —                   | \$—                               | \$ 181,061                    | \$ (11,579 )           | \$169,573 |
| BALANCE, December 31, 2013          | 9,139,842        | \$91                           | —                   | \$—                               | \$ 181,147                    | \$ (14,058 )           | \$167,180 |
| Share based compensation            |                  |                                |                     |                                   | 56                            |                        | 56        |
| Dividends declared                  |                  |                                |                     |                                   |                               | (10,054 )              | (10,054 ) |
| Net income                          |                  |                                |                     |                                   |                               | 13,811                 | 13,811    |
| BALANCE, June 30, 2014              | 9,139,842        | \$91                           | —                   | \$—                               | \$ 181,203                    | \$ (10,301 )           | \$170,993 |

See Notes to Consolidated Financial Statements

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ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(UNAUDITED)

|  | Six Month<br>Period Ended<br>June 30, 2014 | Six Month<br>Period Ended<br>June 30, 2013 |
|--|--|--|
| (In thousands)   |  |  |
| Cash flows provided by (used in) operating activities:                               |  |  |
| Net income (loss)  | \$13,811                                   | \$(8,574)                                  |
| Reconciliation of net income to net cash provided by (used in) operating activities: |  |  |
| Net realized (gains) losses on mortgage-backed securities                            | 2,643                                      | 2,117                                      |
| Change in net unrealized (gains) losses on mortgage-backed securities                | (43,005)                                   | ) 45,629                                   |
| Net realized (gains) losses on financial derivatives                                 | 14,564                                     | (8,376)                                    |
| Change in net unrealized (gains) losses on financial derivatives                     | 30,585                                     | (28,286)                                   |
| Amortization of premiums and accretion of discounts (net)                            | 3,186                                      | 719  |
| Share based compensation   | 56   | —  |
| (Increase) decrease in assets:   |  |  |
| Due from brokers   | 5,009                                      | (41,604)                                   |
| Interest receivable  | (1,003)                                    | ) (3,904)                                  |
| Other assets   | (435)                                      | ) (367)                                    |
| Increase (decrease) in liabilities:  |  |  |
| Due to brokers   | (15,468)                                   | ) 27,887                                   |
| Accrued expenses   | 107  | (212)                                      |
| Interest payable   | (159)                                      | ) 353                                      |
| Management fees payable  | (33)                                       | ) 587                                      |
| Net cash provided by (used in) operating activities                                  | 9,858                                      | (14,031)                                   |
| Cash flows provided by (used in) investing activities:                               |  |  |
| Purchases of mortgage-backed securities  | (963,724)                                  | ) (1,596,310)                              |
| Proceeds from sale of mortgage-backed securities                                     | 958,571                                    | 266,465                                    |
| Principal repayments of mortgage-backed securities                                   | 44,051                                     | 4,663                                      |
| Proceeds from investments sold short   | 13,036                                     | 2,042                                      |
| Repurchase of investments sold short   | (13,049)                                   | ) (2,036)                                  |
| Proceeds from disposition of financial derivatives                                   | 6,989                                      | 11,437                                     |
| Purchase of financial derivatives  | (21,553)                                   | ) (3,060)                                  |
| Payments made on reverse repurchase agreements                                       | (29,129)                                   | ) (4,098)                                  |
| Proceeds from reverse repurchase agreements  | 29,129                                     | 4,098                                      |
| Net cash provided by (used in) investing activities                                  | 24,321                                     | (1,316,799)                                |
| Cash flows provided by (used in) financing activities:                               |  |  |
| Proceeds from issuance of common shares  | —  | 150,000                                    |
| Offering costs paid  | (32)                                       | ) (682)                                    |
| Dividends paid   | (9,597)                                    | ) —  |
| Borrowings under repurchase agreements   | 3,065,991                                  | 1,977,370                                  |
| Repayments of repurchase agreements  | (3,090,745)                                | ) (761,674)                                |
| Cash provided by (used in) financing activities                                      | (34,383)                                   | ) 1,365,014                                |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS                                 | (204)                                      | ) 34,184                                   |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD                                       | 50,112                                     | 18,161                                     |
| CASH AND CASH EQUIVALENTS, END OF PERIOD   | \$49,908                                   | \$52,345                                   |
| Supplemental disclosure of cash flow information:                                    |  |  |

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|               |         |       |
|---------------|---------|-------|
| Interest paid | \$2,385 | \$171 |
|---------------|---------|-------|

See Notes to Consolidated Financial Statements

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ELLINGTON RESIDENTIAL MORTGAGE REIT  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

June 30, 2014

(UNAUDITED)

1. Organization and Investment Objective

Ellington Residential Mortgage REIT, or "EARN," was formed as a Maryland real estate investment trust, or "REIT," on August 2, 2012, and commenced operations on September 25, 2012. EARN conducts its business through its wholly owned subsidiaries, EARN OP GP LLC, or the "General Partner," and Ellington Residential Mortgage LP, or the "Operating Partnership," which were formed as a Delaware limited liability company and a Delaware limited partnership, respectively, on July 31, 2012 and commenced operations on September 25, 2012. The Operating Partnership conducts its business of acquiring, investing in, and managing residential mortgage-related and real estate-related assets through its wholly owned subsidiaries.

EARN, the General Partner, the Operating Partnership, and their consolidated subsidiaries are hereafter defined as the "Company."

Ellington Residential Mortgage Management LLC, or the "Manager," serves as the Manager of the Company pursuant to the terms of the Second Amended and Restated Management Agreement effective as of March 13, 2014, or the "Management Agreement." The Manager is an affiliate of Ellington Management Group, L.L.C., or "EMG," an investment management firm that is registered as an investment adviser with a 19-year history of investing in a broad spectrum of mortgage-backed securities and related derivatives, with an emphasis on the residential mortgage-backed securities, or "RMBS," market. In accordance with the terms of the Management Agreement and the Services Agreement, as discussed in Note 10, the Manager is responsible for administering the Company's business activities and day-to-day operations, and performs certain services, subject to oversight by the Board of Trustees.

The Company was formed through an initial strategic venture among affiliates of EMG and the Blackstone Tactical Opportunity Funds, or the "Blackstone Funds." These initial investors made an aggregate investment of approximately \$31.5 million on September 25, 2012. On May 1, 2013, the Company priced an initial public offering of its common shares, pursuant to which it sold 6,450,000 shares to the public at a price of \$20.00 per share. Concurrent with the initial public offering, the Company completed a private placement of 1,050,000 common shares to its initial investors at a purchase price of \$20.00 per share which generated gross proceeds of \$21.0 million. Proceeds to the Company, net of offering costs, were approximately \$148.5 million.

The Company acquires and manages Agency and non-Agency RMBS, including Agency pools and Agency collateralized mortgage obligations, or "CMOs," and non-Agency CMOs, both investment grade and non-investment grade. The Company may also acquire and manage mortgage servicing rights, residential mortgage loans, and other mortgage- and real estate-related assets. The Company may also invest in other instruments including, but not limited to, forward-settling To-Be-Announced Agency pass-through certificates, or "TBAs," interest rate swaps and swaptions, U.S. Treasury securities, Eurodollar and U.S. Treasury futures, other financial derivatives, and cash equivalents. The Company's targeted investments may range from unrated (first loss) securities to AAA senior securities.

The Company intends to make the election to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, or "the Code" commencing with the Company's short taxable year ended December 31, 2013. As a REIT, the Company is required to distribute annually at least 90% of its taxable income. As long as the Company continues to qualify as a REIT, it will not be subject to U.S. federal or state corporate taxes on its taxable income to the extent that it distributes all of its annual taxable income to its shareholders. It is the intention of the Company to distribute at least 100% of its taxable income, after application of available tax attributes, within the limits prescribed by the Code, which may extend into the subsequent taxable year.

2. Significant Accounting Policies

(A) Basis of Presentation: The Company's unaudited interim consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America, or "U.S. GAAP." Entities in which the Company has a controlling financial interest, through ownership of the majority of the entities' voting equity interests, or through other contractual right that give the Company control, are consolidated by the Company.

All inter-company balances and transactions have been eliminated. The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and those differences could be material. Interim results are not necessarily indicative of the results that may be expected for the entire fiscal year. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

(B) Valuation: The Company applies Accounting Standards Codification, or "ASC," ASC 820-10, Fair Value Measurement and Disclosures ("ASC 820-10"), to its holdings of financial instruments. ASC 820-10 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. The three levels are defined as follows:

Level 1—inputs to the valuation methodology are observable and reflect quoted prices (unadjusted) for identical assets or liabilities in active markets,

Level 2—inputs to the valuation methodology other than quoted prices included in Level 1 are observable for the asset or liability, either directly or indirectly, and

Level 3—inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in these securities.

(C) Accounting for Mortgage-Backed Securities: Investments in mortgage-backed securities are recorded on trade date. The Company has chosen to make a fair value election pursuant to ASC 825-10, Financial Instruments, for its mortgage-backed securities portfolio. Electing the fair value option allows the Company to record changes in fair value in the Consolidated Statement of Operations, which, in management's view, more appropriately reflects the results of operations for a particular reporting period as all securities activities will be recorded in a similar manner. As such, the mortgage-backed securities are recorded at fair value on the Consolidated Balance Sheet and the period change in fair value is recorded in current period earnings on the Consolidated Statement of Operations as a component of Change in net unrealized gains (losses) on mortgage-backed securities.

Realized gains or losses on sales of mortgage-backed securities are included in Net realized gains (losses) on mortgage-backed securities on the Consolidated Statement of Operations, and are recorded at the time of disposition. The cost of positions sold is calculated based on identified cost.

(D) Interest Income: The Company accretes market discounts and amortizes market premiums on debt securities using the effective yield method. Accretion of market discount and amortization of market premiums requires the application of several assumptions including, but not limited to, prepayment assumptions and default rate assumptions, which are re-evaluated not less than quarterly and require the use of a significant amount of judgment. Principal write-offs are generally treated as realized losses. The Company's accretion of discounts and amortization of premiums for U.S. federal and other tax purposes is likely to differ from the financial accounting treatment under U.S. GAAP of these items as described above.

(E) Cash and Cash Equivalents: Cash and cash equivalents include cash and short term investments with original maturities of three months or less at the date of acquisition. Cash equivalents are recorded at cost plus accrued interest, which approximates fair value. Cash accounts are maintained with financial institutions and these balances generally exceed insured limits.

(F) Due from brokers/Due to brokers: Due from brokers and Due to brokers accounts on the Consolidated Balance Sheet include collateral paid or received from counterparties, including clearinghouses, along with receivables and payables for open and or closed derivative positions.

(G) Financial Derivatives: The Company may enter into various types of financial derivatives subject to its investment guidelines, which include restrictions associated with maintaining qualification as a REIT. The Company's derivatives are predominantly subject to bilateral collateral arrangements or clearing in accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The Company may be required to deliver or may receive cash or securities as collateral upon entering into derivative transactions. In addition, changes in the relative value of

derivative transactions may require the Company or the counterparty to post or receive additional collateral. In the case of cleared derivatives, the clearinghouse becomes the Company's counterparty and a futures commission merchant, or "FCM," acts as intermediary between the Company and the clearinghouse with respect to all facets of the related transaction, including the posting and receipt of required collateral. Collateral received by the Company is reflected on the Consolidated Balance Sheet as "Due to Brokers." Conversely, collateral posted by the Company is reflected as "Due from Brokers" on the Consolidated Balance Sheet. The types of derivatives that have been utilized by the Company to date are interest rate swaps, TBAs, swaptions, and futures.

Swaps: The Company has entered into interest rate swaps, which are contractual agreements whereby one party pays a floating rate of interest on a notional principal amount and receives a fixed rate on the same notional principal, or vice versa, for a fixed period of time.

While the Company does not intend to operate its non-Agency RMBS investment strategy on a credit hedged basis, the Company may opportunistically enter into various credit hedging transactions, such as involving credit default swaps, total return swaps, or other derivative contracts. The Company may use credit default swaps to hedge non-Agency RMBS credit risk by buying protection on a basket or index of non-Agency RMBS assets or on a single non-Agency RMBS. For credit hedging purposes the Company may also enter into credit default swaps which reference other mortgage-backed securities, or "MBS," or the corporate credit of certain corporations, or indices on the foregoing. In addition, the Company may enter into various other derivative contracts, including total return swaps. Generally, a total return swap would reference either the corporate credit or equity of certain corporations. However, the Company's ability to use credit hedges is subject to the Company's qualifying and maintaining its qualification as a REIT and maintaining its exclusion from regulation as an investment company under the Investment Company Act.

Swaps change in value with movements in interest rates or total return of the reference securities. During the term of swap contracts, changes in value are recognized as unrealized gains or losses on the Consolidated Statement of Operations. When a contract is terminated, the Company realizes a gain or loss equal to the difference between the proceeds from (or cost of) the closing transaction and the Company's basis in the contract, if any. Periodic payments or receipts required by swap agreements are recorded as unrealized gains or losses when accrued and realized gains or losses when received or paid. Upfront payments paid and/or received by the Company to open swap contracts are recorded as an asset and/or liability on the Consolidated Balance Sheet and are recorded as a realized gain or loss on the termination date.

TBA Securities: The Company has transacted in the TBA RMBS market. A TBA position is a forward contract for the purchase ("long position") or sale ("short position") of Agency RMBS at a predetermined price, face amount, issuer, coupon, and maturity on an agreed-upon future delivery date. For each TBA contract and delivery month, a uniform settlement date for all market participants is determined by the Securities Industry and Financial Markets Association. The specific Agency RMBS to be delivered into the contract at the settlement date are not known at the time of the transaction. The Company typically does not take delivery of TBAs, but rather enters into offsetting transactions and settles the associated receivable and payable balances with its counterparties. The Company primarily uses TBAs to hedge interest rate risk, but from time to time it also holds net long positions in certain TBA securities as a means of acquiring exposure to Agency RMBS.

TBAs are accounted for as financial derivatives. The difference between the contract price and the fair value of the TBA position as of the reporting date is included in Change in net unrealized gains (losses) on financial derivatives, in the Consolidated Statement of Operations. The Company estimates the fair value of TBA positions based on similar methods used to value mortgage-backed securities. Upon settlement of the TBA contract, the realized gain (loss) on the TBA contract is equal to the net cash amount received (paid).

Options: The Company has entered into swaption contracts. It may purchase or write put, call, straddle, or other similar options contracts. The Company enters into options primarily to help mitigate interest rate risk. When the Company purchases an option, the option asset is initially recorded at an amount equal to the premium paid, if any, and is subsequently marked-to-market. Premiums paid for purchasing options that expire unexercised are recognized on the expiration date as realized losses. If an option is exercised, the premium paid is subtracted from the proceeds of the sale or added to the cost of the purchase to determine whether the Company has realized a gain or loss on the related investment transaction. When the Company writes an option, the option liability is initially recorded at an amount equal to the premium received, if any, and is subsequently marked-to-market. Premiums received for writing options that expire unexercised are recognized on the expiration date as realized gains. If an option is exercised, the premium received is subtracted from the cost of the purchase or added to the proceeds of the sale to determine whether the Company has realized a gain or loss on the related investment transaction. When the Company enters into a closing transaction, the Company will realize a gain or loss depending upon whether the amount from the closing transaction is greater or less than the premiums paid or received. In general, the Company's options contain

forward-settling premiums. In this case, no money is exchanged upfront; instead, the agreed-upon premium is paid by the buyer upon expiration of the option, regardless of whether or not the option is exercised.

Financial derivative assets are included in Financial derivatives—assets, at fair value on the Consolidated Balance Sheet while financial derivative liabilities are included in Financial derivatives—liabilities, at fair value on the Consolidated Balance Sheet.

Futures Contracts: A futures contract is an exchange-traded agreement to buy or sell an asset for a set price on a future date. Initial margin deposits are made upon entering into futures contracts and can be either in the form of cash or securities. During the period the futures contract is open, changes in the value of the contract are recognized as unrealized gains or losses

by marking-to-market to reflect the current market value of the contract. Variation margin payments are made or received periodically, depending upon whether unrealized losses or gains are incurred. When the contract is closed, the Company records a realized gain or loss equal to the difference between the proceeds of the closing transaction and the Company's basis in the contract.

(H) Repurchase Agreements and Reverse Repurchase Agreements: The Company enters into repurchase agreements with third-party broker-dealers, whereby it sells securities under agreements to repurchase at an agreed upon price and date. The Company may also enter into reverse repurchase agreement transactions with third-party broker-dealers, whereby it purchases securities under agreements to resell at an agreed upon price and date. The Company accounts for repurchase agreements as collateralized borrowings, with the initial sale price representing the amount borrowed, and with the future repurchase price consisting of the amount borrowed plus interest, at the implied interest rate of the repurchase agreement, on the amount borrowed over the term of the repurchase agreement. The interest rate on a repurchase agreement or a reverse repurchase agreement is based on competitive market rates (or competitive market spreads, in the case of agreements with floating interest rates) at the time such agreement is entered into. When the Company enters into a repurchase agreement, the lender establishes and maintains an account containing cash and securities having a value not less than the repurchase price, including accrued interest, of the repurchase agreement. Repurchase and reverse repurchase agreements that are conducted with the same counterparty can be reported on a net basis if they meet the requirements under the authoritative guidance. Repurchase agreements and reverse repurchase agreements are carried at their contractual amounts, which approximate fair value.

(I) U.S. Treasury Securities: The Company may purchase or sell short U.S. Treasury securities to help mitigate the potential impact of changes in interest rates on the performance of its portfolio. The Company may borrow securities under reverse repurchase agreements to enable it to deliver U.S. Treasury securities that it has sold short.

(J) Offering Costs/Deferred Offering Costs: Offering costs are charged against shareholders' equity and typically include legal, accounting, printing, and other fees associated with the cost of raising equity capital.

(K) Share Based Compensation: The Company applies the provisions of ASC 718, Compensation—Shares Compensation ("ASC 718"), with regard to its equity incentive plans. ASC 718 covers a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. ASC 718 requires that compensation cost relating to share-based payment transactions be recognized in financial statements. The cost is measured based on the fair value of the equity or liability instruments issued.

(L) Dividends: Dividends payable are recorded on the declaration date.

(M) Earnings Per Share: In accordance with the provisions of ASC 260, Earnings per Share, the Company calculates basic income (loss) per share by dividing net income (loss) for the period by the weighted average of the Company's common shares outstanding for that period. Diluted income (loss) per share takes into account the effect of dilutive instruments, such as share options and warrants, and uses the average share price for the period in determining the number of incremental shares that are to be added to the weighted average number of shares outstanding.

(N) Share Repurchases: Common shares that are repurchased by the Company subsequent to issuance decrease the total number of shares issued and outstanding.

(O) Income Taxes: Prior to May 1, 2013, the Company, as a business trust with more than one owner, was considered a partnership for U.S. federal income tax purposes. In general, partnerships are not subject to entity-level tax on their income, but the income of a partnership is taxable to its owners on a flow-through basis. Interest, dividend, and other income realized by the Company from non-U.S. sources and capital gains realized on the sale of securities of non-U.S. issuers may be subject to entity level tax such as withholding and other taxes levied by the jurisdiction in which the income is sourced. For the periods September 25, 2012 (commencement of operations) through December 31, 2012 and January 1, 2013 through April 30, 2013, the Company filed its tax return as a partnership. Effective May 1, 2013, the Company made the election to be taxed as a corporation. In addition, the Company intends to elect to be taxed as a REIT under Sections 856 to 860 of the Code commencing with the short taxable period May 1, 2013 through December 31, 2013. To qualify as a REIT, the Company must meet certain requirements, including the distribution of at least 90% of its annual taxable income to shareholders.

The Company follows the authoritative guidance on accounting for and disclosure of uncertainty on tax positions, which requires management to determine whether a tax position of the company is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals of the litigation process, based on the technical merits of the position. For uncertain tax positions, the tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. The Company did not have any unrecognized tax benefits at December 31, 2013. In the normal course of business, the Company may be subject to examination by federal, state, local, and foreign jurisdictions, where applicable, for the current period, 2013, and 2012 (its open tax years).

The Company may take positions with respect to certain tax issues which depend on legal interpretation of facts or applicable tax regulations. Should the relevant tax regulators successfully challenge any of such positions, the Company might be found to have a tax liability that has not been recorded in the accompanying consolidated financial statements. Also, management's conclusions regarding the authoritative guidance may be subject to review and adjustment at a later date based on changing tax laws, regulations, and interpretations thereof. There were no amounts accrued for penalties or interest as of or during the periods presented in these consolidated financial statements.

(P) Recent Accounting Pronouncements: Under the Jumpstart Our Business Startups Act, or the "JOBS Act," the Company meets the definition of an "emerging growth company." The Company has elected to follow the extended transition period for complying with new or revised U.S. accounting standards pursuant to Section 107(b) of the JOBS Act. As a result, the Company will comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for non-public entities.

In June 2014, the FASB issued ASU No. 2014-11, Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures ("ASU 2014-11"). This amends ASC 860, Transfers and Servicing ("ASC 860"), to require disclosure of repurchase-to maturity transactions to be accounted for as secured borrowings rather than sales of an asset, and transfers of financial assets with a contemporaneous repo will no longer be evaluated to determine whether they should be accounted for on a combined basis as forward contracts. The new guidance also prescribes additional disclosures particularly on the nature of collateral pledged under repurchase agreements accounted for as secured borrowings. ASU 2014-11 is effective for interim and annual periods beginning after December 15, 2014. The adoption of ASC 860, as amended by ASU 2014-11 is not expected to have a material impact on the Company's consolidated financial statements.

### 3. Mortgage-Backed Securities

The following tables present details of the Company's mortgage-backed securities portfolio at June 30, 2014 and December 31, 2013, respectively. The Company's Agency RMBS include mortgage pass-through certificates and CMOs representing interests in or obligations backed by pools of residential mortgage loans issued or guaranteed by a U.S. government agency or government-sponsored enterprises, or "GSEs." The non-Agency RMBS portfolio is not issued or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or any agency of the U.S. Government and is therefore subject to greater credit risk.

By RMBS Type –

June 30, 2014:

| (\$ in thousands)            |                   |                                |                | Gross Unrealized |         |            | Weighted Average |       |   |
|------------------------------|-------------------|--------------------------------|----------------|------------------|---------|------------|------------------|-------|---|
|                              | Current Principal | Unamortized Premium (Discount) | Amortized Cost | Gains            | Losses  | Fair Value | Coupon           | Yield | Weighted Average Life(Years) <sup>(1)</sup> |
| Agency RMBS:                 |                   |                                |                |                  |         |            |                  |       |   |
| 15-year fixed rate mortgages | \$166,910         | \$7,816                        | \$174,726      | \$1,147          | \$(290) | \$175,583  | 3.36%            | 2.46% | 5.64  |
| 20-year fixed rate mortgages | 10,158            | 604                            | 10,762         | 174              | —       | 10,936     | 4.00%            | 2.71% | 7.11  |
| 30-year fixed rate mortgages | 957,162           | 52,577                         | 1,009,739      | 14,530           | (4,185) | 1,020,084  | 4.07%            | 3.27% | 9.05  |
| Adjustable rate mortgages    | 66,864            | 3,722                          | 70,586         | 152              | (198)   | 70,540     | 4.20%            | 3.52% | 7.33  |
|                              | 15,824            | 1,284                          | 17,108         | 249              | —       | 17,357     | 4.77%            | 2.48% | 4.17  |



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|                          |             |           |             |          |            |             |       |        |      |  |
|--------------------------|-------------|-----------|-------------|----------|------------|-------------|-------|--------|------|--|
| Reverse mortgages        |             |           |             |          |            |             |       |        |      |  |
| Interest only securities | n/a         | n/a       | 12,469      | 2,484    | (677 )     | 14,276      | 4.20% | 15.26% | 3.86 |  |
| Total Agency RMBS        | 1,216,918   | 66,003    | 1,295,390   | 18,736   | (5,350 )   | 1,308,776   | 4.00% | 3.27%  | 7.99 |  |
| Non-Agency RMBS          | 55,395      | (23,307 ) | 32,088      | 3,821    | (241 )     | 35,668      | 2.38% | 9.83%  | 5.97 |  |
| Total RMBS               | \$1,272,313 | \$42,696  | \$1,327,478 | \$22,557 | \$(5,591 ) | \$1,344,444 | 3.94% | 3.43%  | 7.91 |  |

Average lives of RMBS are generally shorter than stated contractual maturities. Average lives are affected by the (1) contractual maturities of the underlying mortgages, scheduled periodic payments of principal, and unscheduled prepayments of principal.

For the three month and six month periods ended June 30, 2014, the weighted average holdings of RMBS investments based on amortized cost were \$1.350 billion and \$1.362 billion, respectively.

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December 31, 2013:

(\$ in thousands)

|                              | Current Principal | Unamortized Premium (Discount) | Amortized Cost | Gross Unrealized |            | Fair Value  | Weighted Average |        |   |
|------------------------------|-------------------|--------------------------------|----------------|------------------|------------|-------------|------------------|--------|---|
|                              |                   |                                |                | Gains            | Losses     |             | Coupon           | Yield  | Weighted Average Life(Years) <sup>(1)</sup> |
| Agency RMBS:                 |                   |                                |                |                  |            |             |                  |        |   |
| 15-year fixed rate mortgages | \$179,906         | \$7,153                        | \$187,059      | \$65             | \$(3,252)  | \$183,872   | 3.09%            | 2.52%  | 5.76  |
| 30-year fixed rate mortgages | 1,029,629         | 41,565                         | 1,071,194      | 490              | (28,111)   | 1,043,573   | 3.79%            | 3.30%  | 9.80  |
| Adjustable rate mortgages    | 43,525            | 2,647                          | 46,172         | 46               | (103)      | 46,115      | 4.72%            | 3.24%  | 3.79  |
| Reverse mortgages            | 7,581             | 673                            | 8,254          | 16               | (2)        | 8,268       | 4.85%            | 2.90%  | 3.41  |
| Interest only securities     | n/a               | n/a                            | 10,718         | 2,841            | (32)       | 13,527      | 3.97%            | 11.79% | 5.02  |
| Total Agency RMBS            | 1,260,641         | 52,038                         | 1,323,397      | 3,458            | (31,500)   | 1,295,355   | 3.75%            | 3.26%  | 8.67  |
| Non-Agency RMBS              | 50,006            | (21,327)                       | 28,679         | 2,196            | (194)      | 30,681      | 2.84%            | 9.12%  | 5.54  |
| Total RMBS                   | \$1,310,647       | \$30,711                       | \$1,352,076    | \$5,654          | \$(31,694) | \$1,326,036 | 3.72%            | 3.38%  | 8.56  |

Average lives of RMBS are generally shorter than stated contractual maturities. Average lives are affected by the (1) contractual maturities of the underlying mortgages, scheduled periodic payments of principal, and unscheduled prepayments of principal.

For the year ended December 31, 2013, the weighted average holdings of RMBS investments based on amortized cost was \$879.9 million.

By Estimated Weighted Average Life –  
As of June 30, 2014:

| (\$ in thousands)                                   | Agency RMBS |                |                         | Agency Interest Only Securities |                |                         | Non-Agency RMBS |                |                         |
|---|-------------|----------------|-------------------------|---------------------------------|----------------|-------------------------|-----------------|----------------|-------------------------|
|   | Fair Value  | Amortized Cost | Weighted Average Coupon | Fair Value                      | Amortized Cost | Weighted Average Coupon | Fair Value      | Amortized Cost | Weighted Average Coupon |
| Less than three years                               | \$8,284     | \$8,192        | 4.85 %                  | \$3,938                         | \$4,534        | 3.31 %                  | \$3,325         | \$2,313        | 3.03 %                  |
| Greater than three years and less than seven years  | 264,835     | 263,343        | 3.83 %                  | 10,338                          | 7,935          | 4.97 %                  | 16,467          | 15,935         | 2.38 %                  |
| Greater than seven years and less than eleven years | 1,021,381   | 1,011,386      | 4.02 %                  | —                               | —              | — %                     | 14,082          | 13,053         | 1.33 %                  |
| Greater than eleven years                           | —           | —              | — %                     | —                               | —              | — %                     | 1,794           | 787            | 7.69 %                  |
| Total   | \$1,294,500 | \$1,282,921    | 3.98 %                  | \$14,276                        | \$12,469       | 4.20 %                  | \$35,668        | \$32,088       | 2.38 %                  |

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As of December 31, 2013:

| (\$ in thousands)                                   | Agency RMBS |                |                         | Agency Interest Only Securities |                |                         | Non-Agency RMBS |                |                         |
|---|-------------|----------------|-------------------------|---------------------------------|----------------|-------------------------|-----------------|----------------|-------------------------|
|   | Fair Value  | Amortized Cost | Weighted Average Coupon | Fair Value                      | Amortized Cost | Weighted Average Coupon | Fair Value      | Amortized Cost | Weighted Average Coupon |
| Estimated Weighted Average Life                     |             |                |                         |                                 |                |                         |                 |                |                         |
| Less than three years                               | \$5,554     | \$5,518        | 5.68 %                  | \$955                           | \$762          | 6.48 %                  | \$1,715         | \$1,216        | 2.38 %                  |
| Greater than three years and less than seven years  | 243,120     | 246,342        | 3.48 %                  | 7,643                           | 6,198          | 3.31 %                  | 16,488          | 15,950         | 3.42 %                  |
| Greater than seven years and less than eleven years | 1,031,552   | 1,059,223      | 3.79 %                  | 4,929                           | 3,758          | 4.91 %                  | 11,656          | 10,708         | 1.43 %                  |
| Greater than eleven years                           | 1,602       | 1,596          | 4.50 %                  | —                               | —              | — %                     | 822             | 805            | 7.69 %                  |
| Total   | \$1,281,828 | \$1,312,679    | 3.73 %                  | \$13,527                        | \$10,718       | 3.97 %                  | \$30,681        | \$28,679       | 2.84 %                  |

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The following table illustrates components of interest income on the Company's RMBS for the three and six month periods ended June 30, 2014:

| (\$ in thousands) | Three Month Period Ended June 30, 2014 |                  |                 | Six Month Period Ended June 30, 2014 |                  |                 |
|-------------------|--|------------------|-----------------|--------------------------------------|------------------|-----------------|
|                   | Coupon Interest                        | Net Amortization | Interest Income | Coupon Interest                      | Net Amortization | Interest Income |
| Agency RMBS       | \$13,052                               | \$(2,287)        | \$10,765        | \$26,069                             | \$(4,043)        | \$22,026        |
| Non-Agency RMBS   | 338                                    | 468              | 806             | 644                                  | 857              | 1,501           |
| Total             | \$13,390                               | \$(1,819)        | \$11,571        | \$26,713                             | \$(3,186)        | \$23,527        |

The following table illustrates components of interest income on the Company's RMBS for the three and six month periods ended June 30, 2013:

| (\$ in thousands) | Three Month Period Ended June 30, 2013 |                  |                 | Six Month Period Ended June 30, 2013 |                  |                 |
|-------------------|--|------------------|-----------------|--------------------------------------|------------------|-----------------|
|                   | Coupon Interest                        | Net Amortization | Interest Income | Coupon Interest                      | Net Amortization | Interest Income |
| Agency RMBS       | \$4,914                                | \$(1,043)        | \$3,871         | \$4,914                              | \$(1,043)        | \$3,871         |
| Non-Agency RMBS   | 253                                    | 185              | 438             | 396                                  | 324              | 720             |
| Total             | \$5,167                                | \$(858)          | \$4,309         | \$5,310                              | \$(719)          | \$4,591         |

#### 4. Valuation

The Company applies ASC 820-10 to its holdings of financial instruments. ASC 820-10 establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. Financial instruments include securities and derivatives. A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in these securities. The following is a description of the valuation methodologies used for financial instruments:

Level 1—valuation methodologies include the observation of quoted prices (unadjusted) for identical assets or liabilities in active markets, often received from widely recognized data providers.

Level 2—valuation methodologies include the observation of (i) quoted prices for similar assets or liabilities in active markets, (ii) inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves) in active markets and (iii) quoted prices for identical or similar assets or liabilities in markets that are not active.

The Company's Agency RMBS, exclusive of Agency interest only securities, or "Agency IOs," are classified as Level 2 assets. Fair value for Agency RMBS, excluding Agency IOs is determined using inputs considered to be observable including multiple indicative quotes from broker-dealers and recent trading activity for similar securities.

Level 3—valuation methodologies include (i) the solicitation of valuations from third parties (typically, pricing services and broker-dealers), (ii) the use of proprietary models that require the use of a significant amount of judgment and the application of various assumptions including, but not limited to, prepayment assumptions and default rate assumptions, and (iii) the assessment of observable or reported recent trading activity. The Company utilizes such information to assign a good faith fair value (the estimated price that would be received to sell an asset or paid to transfer a liability in an orderly transaction at the valuation date) to each such financial instrument. The Company's non-Agency RMBS and Agency IOs are classified as Level 3 assets.

The Company seeks to obtain at least one third-party indicative valuation for each instrument, and often obtains multiple indicative valuations when available. Third-party valuation providers often utilize proprietary models that are highly subjective and also require the use of a significant amount of judgment and the application of various assumptions including, but not limited to, prepayment assumptions and default rate assumptions. The Company has been able to obtain third-party valuations on the vast majority of its assets, and the Company expects to continue to solicit third-party valuations on substantially all of its assets in the future to the extent practical. The Company generally values each financial instrument at the average of third-party valuations received and not rejected as described below. Third-party valuations are not binding on the Company and while the Company generally does not adjust valuations it receives, it may challenge or reject a valuation when, based on validation criteria, the Company

determines that such valuation is unreasonable or erroneous. Furthermore, the Company may determine, based on validation criteria, that for a given instrument the average of the third-party valuations received does not result in what

the Company believes to be fair value, and in such circumstances the Company may override this average with its own good faith valuation. The validation criteria include the use of the Company's own models, recent trading activity in the same or similar instruments, and valuations received from third parties. The Company's valuation process, including the application of validation criteria, is overseen by a valuation committee. Because of the inherent uncertainty of valuation, these estimated values may differ significantly from the values that would have been used had a ready market for the financial instruments existed, and the differences could be material to the consolidated financial statements.

The following tables present the Company's financial instruments measured at fair value on:

June 30, 2014:

(In thousands)

| Description  | Level 1 | Level 2     | Level 3  | Total       |
|--|---------|-------------|----------|-------------|
| Assets:  |         |             |          |             |
| Mortgage-backed securities, at fair value:                                       |         |             |          |             |
| Agency RMBS:   |         |             |          |             |
| 15-year fixed rate mortgages   | \$—     | \$175,583   | \$—      | \$175,583   |
| 20-year fixed rate mortgages   | —       | 10,936      | —        | 10,936      |
| 30-year fixed rate mortgages   | —       | 1,020,084   | —        | 1,020,084   |
| Adjustable rate mortgages  | —       | 70,540      | —        | 70,540      |
| Reverse mortgages  | —       | 17,357      | —        | 17,357      |
| Interest only securities   | —       | —           | 14,276   | 14,276      |
| Non-Agency RMBS  | —       | —           | 35,668   | 35,668      |
| Mortgage-backed securities, at fair value  | —       | 1,294,500   | 49,944   | 1,344,444   |
| Financial derivatives—assets, at fair value:                                     |         |             |          |             |
| TBAs   | —       | 385         | —        | 385         |
| Fixed payer interest rate swaps  | —       | 9,730       | —        | 9,730       |
| Total financial derivatives—assets, at fair value                                | —       | 10,115      | —        | 10,115      |
| Total mortgage-backed securities and financial derivatives—assets, at fair value | \$—     | \$1,304,615 | \$49,944 | \$1,354,559 |
| Liabilities:   |         |             |          |             |
| Financial derivatives—liabilities, at fair value:                                |         |             |          |             |
| TBAs   | \$—     | \$(3,347)   | \$—      | \$(3,347)   |
| Fixed payer interest rate swaps  | —       | (2,536)     | —        | (2,536)     |
| Fixed payer swaptions  | —       | (924)       | —        | (924)       |
| Total financial derivatives—liabilities, at fair value                           | \$—     | \$(6,807)   | \$—      | \$(6,807)   |

There were no transfers of financial instruments between Levels 1, 2, or 3 of the fair value hierarchy during the six month period ended June 30, 2014.

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December 31, 2013:

(In thousands)

| Description  | Level 1 | Level 2      | Level 3   | Total        |
|--|---------|--------------|-----------|--------------|
| Assets:  |         |              |           |              |
| Mortgage-backed securities, at fair value:                                       |         |              |           |              |
| Agency RMBS:   |         |              |           |              |
| 15-year fixed rate mortgages   | \$—     | \$ 183,872   | \$—       | \$ 183,872   |
| 30-year fixed rate mortgages   | —       | 1,043,573    | —         | 1,043,573    |
| Adjustable rate mortgages  | —       | 46,115       | —         | 46,115       |
| Reverse mortgages  | —       | 8,268        | —         | 8,268        |
| Interest only securities   | —       | —            | 13,527    | 13,527       |
| Non-Agency RMBS  | —       | —            | 30,681    | 30,681       |
| Mortgage-backed securities, at fair value  | —       | 1,281,828    | 44,208    | 1,326,036    |
| Financial derivatives—assets, at fair value:                                     |         |              |           |              |
| TBAs   | —       | 2,263        | —         | 2,263        |
| Fixed payer interest rate swaps  | —       | 32,700       | —         | 32,700       |
| Total financial derivatives—assets, at fair value                                | —       | 34,963       | —         | 34,963       |
| Total mortgage-backed securities and financial derivatives—assets, at fair value | \$—     | \$ 1,316,791 | \$ 44,208 | \$ 1,360,999 |
| Liabilities:   |         |              |           |              |
| Financial derivatives—liabilities, at fair value:                                |         |              |           |              |
| TBAs   | \$—     | \$(28)       | \$—       | \$(28)       |
| Fixed payer interest rate swaps  | —       | (956)        | —         | (956)        |
| Fixed payer swaptions  | —       | (85)         | —         | (85)         |
| Total financial derivatives—liabilities, at fair value                           | \$—     | \$(1,069)    | \$—       | \$(1,069)    |

There were no transfers of financial instruments between Levels 1, 2, or 3 of the fair value hierarchy during the year ended December 31, 2013.

The following tables present additional information about the Company's investments which are measured at fair value for which the Company has utilized Level 3 inputs to determine fair value:

Three month period ended June 30, 2014:

| (In thousands)                          | Non-Agency RMBS | Agency RMBS |
|---|-----------------|-------------|
| Beginning balance as of March 31, 2014  | \$ 32,045       | \$ 15,924   |
| Transfers:                              |                 |             |
| Transfers into level 3                  | —               | —           |
| Transfers out of level 3                | —               | —           |
| Purchases                               | 4,504           | —           |
| Proceeds from sales                     | (1,993)         | —           |
| Principal repayments                    | (1,468)         | —           |
| (Amortization)/accretion, net           | 468             | (762)       |
| Net realized gains                      | 168             | —           |
| Change in net unrealized gains (losses) | 1,944           | (886)       |
| Ending balance as of June 30, 2014      | \$ 35,668       | \$ 14,276   |

All amounts of net realized and changes in net unrealized gains (losses) in the table above are reflected in the accompanying Consolidated Statement of Operations. The table above incorporates changes in net unrealized gains (losses) for both Level 3 financial instruments held by the Company at June 30, 2014, as well as Level 3 financial instruments disposed of by the Company during the three month period ended June 30, 2014. For Level 3 financial instruments held by the Company at





June 30, 2014, change in net unrealized gains (losses) of \$(0.9) million and \$2.0 million, for the three month period ended June 30, 2014 relate to Agency RMBS and non-Agency RMBS, respectively.  
 Three month period ended June 30, 2013:

| (In thousands)                          | Non-Agency<br>RMBS | Agency RMBS |
|---|--------------------|-------------|
| Beginning balance as of March 31, 2013  | \$12,360           | \$—         |
| Transfers:                              |                    |             |
| Transfers into level 3                  | —                  | —           |
| Transfers out of level 3                | —                  | —           |
| Purchases                               | 27,446             | 9,021       |
| Proceeds from sales                     | —                  | —           |
| Principal repayments                    | (1,023             | ) —         |
| (Amortization)/accretion, net           | 185                | (135 )      |
| Net realized gains                      | 1                  | —           |
| Change in net unrealized gains (losses) | (159               | ) 1,018     |
| Ending balance as of June 30, 2013      | \$38,810           | \$9,904     |

All amounts of net realized and changes in net unrealized gains (losses) in the table above are reflected in the accompanying Consolidated Statement of Operations. The table above incorporates changes in net unrealized gains (losses) for both Level 3 financial instruments held by the Company at June 30, 2013, as well as Level 3 financial instruments disposed of by the Company during the three month period ended June 30, 2013. For Level 3 financial instruments held by the Company at June 30, 2013, change in net unrealized gains (losses) of \$1.0 million and \$(0.2) million, for the three month period ended June 30, 2013 relate to Agency RMBS and non-Agency RMBS.

Six month period ended June 30, 2014:

| (In thousands)                            | Non-Agency<br>RMBS | Agency RMBS |
|---|--------------------|-------------|
| Beginning balance as of December 31, 2013 | \$30,681           | \$13,527    |
| Transfers:                                |                    |             |
| Transfers into level 3                    | —                  | —           |
| Transfers out of level 3                  | —                  | —           |
| Purchases                                 | 12,168             | 4,096       |
| Proceeds from sales                       | (7,416             | ) (1,282 )  |
| Principal repayments                      | (2,572             | ) —         |
| (Amortization)/accretion, net             | 857                | (1,420 )    |
| Net realized gains                        | 373                | 358         |
| Change in net unrealized gains (losses)   | 1,577              | (1,003 )    |
| Ending balance as of June 30, 2014        | \$35,668           | \$14,276    |

All amounts of net realized and changes in net unrealized gains (losses) in the table above are reflected in the accompanying Consolidated Statement of Operations. The table above incorporates changes in net unrealized gains (losses) for both Level 3 financial instruments held by the Company at June 30, 2014, as well as Level 3 financial instruments disposed of by the Company during the six month period ended June 30, 2014. For Level 3 financial instruments held by the Company at June 30, 2014, change in net unrealized gains (losses) of \$(0.8) million and \$1.8 million, for the six month period ended June 30, 2014 relate to Agency RMBS and non-Agency RMBS, respectively.

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Six month period ended June 30, 2013:

| (In thousands)                            | Non-Agency<br>RMBS | Agency RMBS |
|---|--------------------|-------------|
| Beginning balance as of December 31, 2012 | \$13,596           | \$—         |
| Transfers:                                |                    |             |
| Transfers into level 3                    | —                  | —           |
| Transfers out of level 3                  | —                  | —           |
| Purchases                                 | 30,777             | 9,021       |
| Proceeds from sales                       | (5,309)            | )           |
| Principal repayments                      | (1,463)            | )           |
| (Amortization)/accretion, net             | 324                | (135)       |
| Net realized gains                        | 889                | —           |
| Change in net unrealized gains (losses)   | (4)                | ) 1,018     |
| Ending balance as of June 30, 2013        | \$38,810           | \$9,904     |

All amounts of net realized and changes in net unrealized gains (losses) in the table above are reflected in the accompanying Consolidated Statement of Operations. The table above incorporates changes in net unrealized gains (losses) for both Level 3 financial instruments held by the Company at June 30, 2013, as well as Level 3 financial instruments disposed of by the Company during the six month period ended June 30, 2013. For Level 3 financial instruments held by the Company at June 30, 2013, change in net unrealized gains (losses) of \$1.0 million and \$61 thousand, for the six month period ended June 30, 2013 relate to Agency RMBS and non-Agency RMBS, respectively.

The following tables identify the significant unobservable inputs that affect the valuation of the Company's Level 3 assets and liabilities as of June 30, 2014 and December 31, 2013:

June 30, 2014:

| Description                          | Fair Value<br>(In thousands) | Valuation<br>Technique         | Significant<br>Unobservable Input           | Range   |          | Weighted<br>Average <sup>(1)</sup> |       |
|--------------------------------------|------------------------------|--------------------------------|---|---------|----------|------------------------------------|-------|
|                                      |                              |                                |   | Min     | Max      |                                    |       |
| Non-Agency RMBS                      | \$24,501                     | Market quotes                  | Non-Binding Indicative Price                | \$45.88 | \$104.50 | \$                                 | 80.43 |
| Non-Agency RMBS                      | 11,167                       | Discounted Cash Flows          | Yield                                       | 5.2     | % 13.8   | %                                  | 10.2  |
|                                      |                              |                                | Projected Collateral Prepayments            | 11.6    | % 42.1   | %                                  | 34.6  |
|                                      |                              |                                | Projected Collateral Losses                 | 3.8     | % 26.4   | %                                  | 12.2  |
|                                      |                              |                                | Projected Collateral Recoveries             | 5.4     | % 22.0   | %                                  | 12.7  |
|                                      |                              |                                | Projected Collateral Scheduled Amortization | 20.9    | % 55.7   | %                                  | 40.5  |
|                                      |                              |                                |   |         |          |                                    | 100.0 |
| Agency RMBS—Interest Only Securities | 10,249                       | Market quotes                  | Non-Binding Indicative Price                | \$4.94  | \$22.15  | \$                                 | 14.16 |
| Agency RMBS—Interest Only Securities | 4,027                        | Option Adjusted Spread ("OAS") | LIBOR OAS <sup>(2)</sup>                    | 219     | 912      | 491                                |       |
|                                      |                              |                                |   | 66.7    | % 81.9   | %                                  | 72.7  |

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|  |      |   |      |   |       |   |
|--|------|---|------|---|-------|---|
| Projected Collateral<br>Prepayments            |      |   |      |   |       |   |
| Projected Collateral<br>Scheduled Amortization | 18.1 | % | 33.3 | % | 27.3  | % |
|  |      |   |      |   | 100.0 | % |

(1) Averages are weighted based on the fair value of the related instrument.

(2) Shown in basis points.

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December 31, 2013:

| Description                          | Fair Value<br>(In thousands) | Valuation Technique            | Significant Unobservable Input              | Range   |          | Weighted Average <sup>(1)</sup> |         |
|--------------------------------------|------------------------------|--------------------------------|---|---------|----------|---------------------------------|---------|
|                                      |                              |                                |   | Min     | Max      |                                 |         |
| Non-Agency RMBS                      | \$27,422                     | Market quotes                  | Non-Binding Indicative Price                | \$20.00 | \$100.25 |                                 | \$75.39 |
| Non-Agency RMBS                      | 3,259                        | Discounted Cash Flows          | Yield                                       | 6.0     | % 17.0   | % 11.9                          | %       |
|                                      |                              |                                | Projected Collateral Prepayments            | 12.2    | % 58.1   | % 33.9                          | %       |
|                                      |                              |                                | Projected Collateral Losses                 | 6.4     | % 26.5   | % 11.8                          | %       |
|                                      |                              |                                | Projected Collateral Recoveries             | 4.6     | % 12.8   | % 8.8                           | %       |
|                                      |                              |                                | Projected Collateral Scheduled Amortization | 29.9    | % 54.9   | % 45.5                          | %       |
|                                      |                              |                                |   |         |          | 100.0                           | %       |
| Agency RMBS–Interest Only Securities | 12,368                       | Market quotes                  | Non-Binding Indicative Price                | \$4.99  | \$22.47  |                                 | \$14.92 |
| Agency RMBS–Interest Only Securities | 1,159                        | Option Adjusted Spread ("OAS") | LIBOR OAS <sup>(2)</sup>                    | 436     | 436      |                                 | 436     |
|                                      |                              |                                | Projected Collateral Prepayments            | 57.8    | % 57.8   | % 57.8                          | %       |
|                                      |                              |                                | Projected Collateral Scheduled Amortization | 42.2    | % 42.2   | % 42.2                          | %       |
|                                      |                              |                                |   |         |          | 100.0                           | %       |

(1) Averages are weighted based on the fair value of the related instrument.

(2) Shown in basis points.

Third-party non-binding indicative prices are validated by comparing such prices to internally generated prices based on the Company's models and to recent trading activity in the same or similar instruments. For those instruments valued using discounted cash flows, collateral prepayments, losses, recoveries, and scheduled amortization are projected over the remaining life of the collateral and expressed as a percentage of the collateral's current principal balance. For those assets valued using the LIBOR Option Adjusted Spread, or "OAS," valuation methodology, cash flows are projected using the Company's models over multiple interest rate scenarios, and these projected cash flows are then discounted using the LIBOR rates implied by each interest rate scenario. The LIBOR OAS of an asset is then computed as the unique constant yield spread that, when added to all LIBOR rates in each interest rate scenario generated by the model, will equate (a) the expected present value of the projected asset cash flows over all model scenarios to (b) the actual current market price of the asset. LIBOR OAS is therefore model-dependent. Generally speaking, LIBOR OAS measures the additional yield spread over LIBOR that an asset provides at its current market price after taking into account any interest rate options embedded in the asset.

Material changes in any of the inputs above in isolation could result in a significant change to reported fair value measurements. Fair value measurements are impacted by the interrelationships of these inputs. For example, a higher expectation of collateral prepayments will generally result in a lower expectation of collateral losses. Conversely, higher losses will generally result in lower prepayments.

## 5. Financial Derivatives

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The Company is exposed to certain risks arising from both its business operations and economic conditions. Specifically, the Company's primary source of debt financing is repurchase agreements and the Company enters into financial derivative and other instruments to manage exposure to variable cash flows on portions of its borrowings under those repurchase agreements. Since the interest rates on repurchase agreements typically change with market interest rates such as LIBOR, the Company is exposed to constantly changing interest rates, which accordingly affects cash flows associated with these rates on its borrowings. To mitigate the effect of changes in these interest rates and their related cash flows, the Company may enter into a variety of derivative contracts, including interest rate swaps, interest rate swaptions, and TBAs.

The following table details fair value of the Company's holdings of financial derivatives as of June 30, 2014 and December 31, 2013:

|   | June 30, 2014<br>(In thousands) | December 31, 2013 |
|---|---------------------------------|-------------------|
| Financial derivatives—assets, at fair value:            |                                 |                   |
| TBA securities purchase contracts                       | \$385                           | \$1               |
| TBA securities sale contracts                           | —                               | 2,262             |
| Fixed payer interest rate swaps                         | 9,730                           | 32,700            |
| Total financial derivatives—assets, at fair value:      | \$10,115                        | \$34,963          |
| Financial derivatives—liabilities, at fair value:       |                                 |                   |
| TBA securities sale contracts                           | \$(3,347                        | ) \$(28 )         |
| Fixed payer interest rate swaps                         | (2,536                          | ) (956 )          |
| Swaptions   | (924                            | ) (85 )           |
| Total financial derivatives—liabilities, at fair value: | \$(6,807                        | ) \$(1,069 )      |
| Total   | \$3,308                         | \$33,894          |

Interest Rate Swaps

The following tables provide information about the Company's interest rate swaps as of June 30, 2014 and December 31, 2013:

June 30, 2014:

| Remaining Maturity | Notional Amount<br>(In thousands) | Fair Value | Weighted Average |              | Remaining Years to Maturity |
|--------------------|-----------------------------------|------------|------------------|--------------|-----------------------------|
|                    |                                   |            | Pay Rate         | Receive Rate |                             |
| 2016               | \$48,000                          | \$(197     | ) 0.80           | % 0.23       | % 2.28                      |
| 2017               | 93,750                            | (874       | ) 1.23           | 0.23         | 3.11                        |
| 2018               | 61,500                            | 967        | 0.88             | 0.22         | 3.87                        |
| 2020               | 52,600                            | 1,380      | 1.43             | 0.23         | 5.88                        |
| 2023               | 210,600                           | 5,344      | 2.13             | 0.23         | 8.90                        |
| 2024               | 14,200                            | (409       | ) 2.84           | 0.23         | 9.80                        |
| 2043               | 54,500                            | 1,428      | 3.15             | 0.23         | 28.93                       |
| 2044               | 5,000                             | (445       | ) 3.69           | 0.23         | 29.72                       |
| Total              | \$540,150                         | \$7,194    | 1.78             | % 0.23       | % 8.68                      |

December 31, 2013:

| Remaining Maturity | Notional Amount<br>(In thousands) | Fair Value | Weighted Average |              | Remaining Years to Maturity |
|--------------------|-----------------------------------|------------|------------------|--------------|-----------------------------|
|                    |                                   |            | Pay Rate         | Receive Rate |                             |
| 2016               | \$48,000                          | \$(171)    | ) 0.80           | % 0.24       | % 2.77                      |
| 2017               | 124,000                           | (517)      | ) 1.19           | 0.24         | 3.61                        |
| 2018               | 156,500                           | 2,784      | 1.19             | 0.24         | 4.63                        |
| 2020               | 137,100                           | 6,444      | 1.49             | 0.24         | 6.06                        |
| 2023               | 218,000                           | 14,599     | 2.16             | 0.24         | 9.41                        |
| 2043               | 64,750                            | 8,605      | 3.18             | 0.24         | 29.44                       |
| Total              | \$748,350                         | \$31,744   | 1.67             | % 0.24       | % 8.14                      |

## Interest Rate Swaptions

The following tables provide information about the Company's swaptions as of June 30, 2014 and December 31, 2013.  
June 30, 2014:

| Option Type       | Fair Value | Months to Expiration | Underlying Swap |              |            |
|-------------------|------------|----------------------|-----------------|--------------|------------|
|                   |            |                      | Notional Amount | Term (Years) | Fixed Rate |
| (\$ in thousands) |            |                      |                 |              |            |
| Fixed Payer       | \$(723)    | ) 2.9                | \$22,000        | 10           | 3.31%      |
| Straddle          | \$(201)    | ) 3.9                | \$8,000         | 10           | 3.08%      |

December 31, 2013:

| Option Type       | Fair Value | Months to Expiration | Underlying Swap |              |            |
|-------------------|------------|----------------------|-----------------|--------------|------------|
|                   |            |                      | Notional Amount | Term (Years) | Fixed Rate |
| (\$ in thousands) |            |                      |                 |              |            |
| Fixed Payer       | \$(59)     | ) 8.9                | \$22,000        | 10           | 3.31%      |
| Straddle          | \$(26)     | ) 9.9                | \$8,000         | 10           | 3.08%      |

## TBAs

The Company uses TBAs primarily for hedging purposes, typically in the form of short positions. However, the Company may also invest in TBAs for speculative purposes, including holding long positions. Overall, the Company typically holds a net short position.

The Company transacts in the forward settling To Be Announced MBS ("TBA") market. Pursuant to these TBA transactions, the Company agrees to purchase or sell, for future delivery, Agency RMBS with certain principal and interest terms and certain types of underlying collateral, but the particular Agency RMBS to be delivered is not identified until shortly before the TBA settlement date. TBAs are liquid and have quoted market prices and represent the most actively traded class of MBS. The Company primarily uses TBAs to hedge interest rate risk, typically in the form of short positions. However, from time to time the Company also invests in TBAs as a means of acquiring additional exposure to Agency RMBS, or for speculative purposes, including holding long positions. Overall, the Company typically holds a net short position.

The Company does not generally take delivery of TBAs; rather, it settles the associated receivable and payable with its trading counterparties on a net basis. Transactions with the same counterparty for the same TBA that result in a reduction of the position are treated as extinguished.

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As of June 30, 2014 and December 31, 2013, the Company had outstanding contracts to purchase ("long positions") and sell ("short positions") TBA securities as follows:

| TBA Securities            | June 30, 2014                  |                           |                             |                                   | December 31, 2013              |                           |                             |                                   |
|---------------------------|--------------------------------|---------------------------|-----------------------------|-----------------------------------|--------------------------------|---------------------------|-----------------------------|-----------------------------------|
|                           | Notional Amount <sup>(1)</sup> | Cost Basis <sup>(2)</sup> | Market Value <sup>(3)</sup> | Net Carrying Value <sup>(4)</sup> | Notional Amount <sup>(1)</sup> | Cost Basis <sup>(2)</sup> | Market Value <sup>(3)</sup> | Net Carrying Value <sup>(4)</sup> |
| (In thousands)            |                                |                           |                             |                                   |                                |                           |                             |                                   |
| Purchase contracts:       |                                |                           |                             |                                   |                                |                           |                             |                                   |
| Assets                    | \$47,040                       | \$46,385                  | \$46,770                    | \$385                             | \$1,600                        | \$1,725                   | \$1,726                     | \$1                               |
| Sale contracts:           |                                |                           |                             |                                   |                                |                           |                             |                                   |
| Assets                    | —                              | —                         | —                           | —                                 | (363,078 )                     | (375,524 )                | (373,262 )                  | 2,262                             |
| Liabilities               | (534,527 )                     | (566,897 )                | (570,244 )                  | (3,347 )                          | (16,400 )                      | (17,518 )                 | (17,546 )                   | (28 )                             |
| Total TBA securities, net | \$(487,487)                    | \$(520,512)               | \$(523,474)                 | \$(2,962)                         | \$(377,878)                    | \$(391,317)               | \$(389,082)                 | \$2,235                           |

(1) Notional amount represents the principal balance of the underlying Agency RMBS.

(2) Cost basis represents the forward price to be paid for the underlying Agency RMBS.

(3) Market value represents the current market value of the underlying Agency RMBS (on a forward delivery basis) as of period end.

(4) Net carrying value represents the difference between the market value of the TBA contract as of period end and the cost basis and is reported in Financial derivatives-assets at fair value and Financial derivatives-liabilities at fair value on the Consolidated Balance Sheet.

Gains and losses on the Company's financial derivatives for the three and six month periods ended June 30, 2014 are summarized in the tables below:

Three Month Period Ended June 30, 2014

| Derivative Type                 | Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps | Net Realized Gains (Losses) Other Than Periodic Settlements of Interest Rate Swaps | Net Realized Gains (Losses) on Financial Derivatives | Change in Net Unrealized Gains (Losses) on Accrued Periodic Settlements of Interest Rate Swaps | Change in Net Unrealized Gains (Losses) Other Than on Accrued Periodic Settlements of Interest Rate Swaps | Change in Net Unrealized Gains (Losses) on Financial Derivatives |
|---------------------------------|--|--|--|--|---|--|
| (In thousands)                  |  |  |  |  |   |  |
| Fixed payer interest rate swaps | \$(4,102 )   | \$80   | \$(4,022 )   | \$1,744  | \$(10,646 )   | \$(8,902 )   |
| Swaptions                       |  | —  | —  |  | (201 )  | (201 )   |
| TBAs                            |  | (7,133 )   | (7,133 )   |  | (3,686 )  | (3,686 )   |
| Total                           | \$(4,102 )   | \$(7,053 )   | \$(11,155 )  | \$1,744  | \$(14,533 )   | \$(12,789 )  |

Six Month Period Ended June 30, 2014

| Derivative Type                 | Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps | Net Realized Gains (Losses) Other Than Periodic Settlements of Interest Rate Swaps | Net Realized Gains (Losses) on Financial Derivatives | Change in Net Unrealized Gains (Losses) on Accrued Periodic Settlements of Interest Rate Swaps | Change in Net Unrealized Gains (Losses) Other Than on Accrued Periodic Settlements of Interest Rate Swaps | Change in Net Unrealized Gains (Losses) on Financial Derivatives |
|---------------------------------|--|--|--|--|---|--|
| (In thousands)                  |  |  |  |  |   |  |
| Fixed payer interest rate swaps | \$(4,102 )   | \$80   | \$(4,022 )   | \$1,744  | \$(10,646 )   | \$(8,902 )   |
| Swaptions                       |  | —  | —  |  | (201 )  | (201 )   |
| TBAs                            |  | (7,133 )   | (7,133 )   |  | (3,686 )  | (3,686 )   |
| Total                           | \$(4,102 )   | \$(7,053 )   | \$(11,155 )  | \$1,744  | \$(14,533 )   | \$(12,789 )  |

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|                                 |          |            | Swaps       |         | Interest Rate Swaps |             |
|---------------------------------|----------|------------|-------------|---------|---------------------|-------------|
| (In thousands)                  |          |            |             |         |                     |             |
| Fixed payer interest rate swaps | \$(4,896 | ) \$3,511  | \$(1,385    | ) \$160 | \$(24,710           | ) \$(24,550 |
| Swaptions                       |          | —          |             | —       | (838                | ) (838      |
| TBAs                            |          | (13,198    | ) (13,198   | )       | (5,197              | ) (5,197    |
| Futures                         |          | 19         |             | 19      | —                   | —           |
| Total                           | \$(4,896 | ) \$(9,668 | ) \$(14,564 | ) \$160 | \$(30,745           | ) \$(30,585 |

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Gains and losses on the Company's financial derivatives for the three and six month periods ended June 30, 2013 are summarized in the tables below:

Three and Six Month Period Ended June 30, 2013<sup>(1)</sup>

| Derivative Type | Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps | Net Realized Gains (Losses) Other Than Periodic Settlements of Interest Rate Swaps | Net Realized Gains (Losses) on Financial Derivatives | Change in Net Unrealized Gains (Losses) on Accrued Periodic Settlements of Interest Rate Swaps | Change in Net Unrealized Gains (Losses) Other Than on Accrued Periodic Settlements of Interest Rate Swaps | Change in Net Unrealized Gains (Losses) on Financial Derivatives |
|-----------------|--|--|--|--|---|--|
|-----------------|--|--|--|--|---|--|

(In thousands)

|                                 |        |         |         |           |          |          |
|---------------------------------|--------|---------|---------|-----------|----------|----------|
| Fixed payer interest rate swaps | \$(69) | \$179   | \$110   | \$(1,042) | \$27,238 | \$26,196 |
| TBAs                            |        | 8,266   | 8,266   |           | 2,090    | 2,090    |
| Total                           | \$(69) | \$8,445 | \$8,376 | \$(1,042) | \$29,328 | \$28,286 |

The Company did not have derivative positions on or prior to March 31, 2013, and as a result net realized and <sup>(1)</sup> unrealized gains and losses for three month period ended June 30, 2013 are the same as for the six month period ended June 30, 2013.

#### 6. Borrowings under Repurchase Agreements

The Company enters into repurchase agreements. A repurchase agreement involves the sale of an asset to a counterparty together with a simultaneous agreement to repurchase the transferred asset or similar asset from such counterparty at a future date. The Company accounts for its repurchase agreements as collateralized borrowings, with the transferred assets effectively serving as collateral for the related borrowing. The Company's repurchase agreements typically range in term from 30 to 180 days. The principal economic terms of each repurchase agreement—such as loan amount, interest rate, and maturity date—are typically negotiated on a transaction-by-transaction basis. Other terms and conditions, such as relating to events of default, are typically governed under the Company's master repurchase agreements, or "MRAs." Absent an event of default, the Company maintains beneficial ownership of the transferred securities during the term of the repurchase agreement and receives the related principal and interest payments. Interest rates on these borrowings are generally fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase agreement at which time the Company may enter into a new repurchase agreement at prevailing market rates with the same counterparty, repay that counterparty and possibly negotiate financing terms with a different counterparty, or choose to no longer finance the related asset. In response to a decline in the fair value of the transferred securities, whether as a result of changes in market conditions, security paydowns, or other factors, repurchase agreement counterparties will typically make a margin call, whereby the Company will be required to post additional securities and/or cash as collateral with the counterparty in order to re-establish the agreed-upon collateralization requirements. The contractual amount (loan amount) of the Company's repurchase agreements approximates their fair value, as the debt is short-term in nature.

At any given time, the Company seeks to have its outstanding borrowings under repurchase agreements with several different counterparties in order to reduce the exposure to any single counterparty. As of June 30, 2014 and December 31, 2013, the Company had outstanding borrowings under repurchase agreements with ten and nine counterparties, respectively.

The following table details the Company's outstanding borrowings under repurchase agreements as of June 30, 2014 and December 31, 2013:

| Remaining Days to Maturity | June 30, 2014          |                                |                            | December 31, 2013      |                                |                            |
|----------------------------|------------------------|--------------------------------|----------------------------|------------------------|--------------------------------|----------------------------|
|                            | Borrowings Outstanding | Weighted Average Interest Rate | Remaining Days to Maturity | Borrowings Outstanding | Weighted Average Interest Rate | Remaining Days to Maturity |
|                            | (In thousands)         |                                |                            |                        |                                |                            |
| 30 days or less            | \$397,482              | 0.33                           | % 15                       | \$338,700              | 0.35                           | % 14                       |
| 31-60 days                 | 469,254                | 0.32                           | 44                         | 531,799                | 0.39                           | 46                         |
| 61-90 days                 | 327,111                | 0.35                           | 74                         | 326,386                | 0.38                           | 72                         |
| 91-120 days                | 29,512                 | 0.38                           | 106                        | 109,476                | 0.45                           | 100                        |
| 121-150 days               | 23,005                 | 0.35                           | 136                        | 3,986                  | 0.56                           | 136                        |
| 151-180 days               | 39,229                 | 0.36                           | 169                        | —                      | —                              | —                          |
| Total                      | \$1,285,593            | 0.33                           | % 50                       | \$1,310,347            | 0.38                           | % 49                       |

Repurchase agreements involving underlying investments that we sold prior to period end, for settlement following period end, are shown using their original maturity dates even though such repurchase agreements may be expected to be terminated early upon settlement of the sale of the underlying investment. Not included are any repurchase agreements that we may have entered into prior to period end for which delivery of the borrowed funds is not scheduled until after period end.

As of June 30, 2014 and December 31, 2013, the fair value of Agency RMBS transferred as collateral under outstanding borrowings under repurchase agreements was \$1.3 billion and \$1.4 billion, respectively. Collateral transferred under outstanding borrowings as of June 30, 2014 include Agency RMBS in the amount of \$93.1 million that were sold prior to period end but for which such sale had not yet settled. Collateral transferred under outstanding borrowings as of December 31, 2013 include Agency RMBS in the amount of \$76.1 million that were sold prior to period end but for which such sale had not yet settled. In addition the Company posted net cash collateral of \$1.9 million and additional securities with a fair value of \$1.0 million as of June 30, 2014 as a result of margin calls with various counterparties. The Company posted additional net cash collateral of \$14.8 million and additional securities with a fair value of \$3.5 million as of December 31, 2013 as a result of margin calls with various counterparties. The Company also held investments with an aggregate value of approximately \$0.5 million which were received to satisfy collateral requirements for various repurchase agreements.

#### 7. Offsetting of Assets and Liabilities

The Company records financial instruments at fair value as described in Note 4. All financial instruments are recorded on a gross basis on the Consolidated Balance Sheet. In connection with its financial derivatives, repurchase agreements, and related trading agreements, the Company and its counterparties are required to pledge collateral. Cash or other collateral is exchanged as required with each of the Company's counterparties in connection with open derivative positions and repurchase agreements.

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The following tables present information about certain assets and liabilities representing financial instruments as of June 30, 2014 and December 31, 2013. The Company has not previously entered into master netting agreements with any of its counterparties. Certain of the Company's repurchase and reverse repurchase agreements and financial derivative transactions are governed by underlying agreements that generally provide a right of offset in the event of default or in the event of a bankruptcy of either party to the transaction.

June 30, 2014:

| Description                       | Amount of Assets<br>(Liabilities)<br>Presented in the<br>Consolidated<br>Balance Sheet <sup>(1)</sup> | Financial<br>Instruments Available<br>for Offset | Financial<br>Instruments<br>Transferred or<br>Pledged as<br>Collateral <sup>(2)(3)</sup> | Cash<br>Collateral<br>(Received)<br>Pledged <sup>(2)(3)</sup> | Net Amount |
|-----------------------------------|---|--|--|---|------------|
| (In thousands)                    |   |  |  |   |            |
| Assets:                           |   |  |  |   |            |
| Financial derivatives—assets      | \$10,115  | \$(1,652 )                                       | \$—  | \$(4,759 )  | \$3,704    |
| Liabilities:                      |   |  |  |   |            |
| Financial derivatives—liabilities | (6,807 )  | 1,652  | —  | 3,966   | (1,189 )   |
| Repurchase Agreements             | (1,285,593 )  | —  | 1,283,715  | 1,878   | —          |

(1) In the Company's Consolidated Balance Sheet, all balances associated with the repurchase agreements and financial derivatives are presented on a gross basis.

(2) For the purpose of this presentation, for each row the total amount of financial instruments transferred or pledged and cash collateral (received) or pledged may not exceed the applicable gross amount of assets or (liabilities) as presented here. Therefore, we have reduced the amount of financial instruments transferred or pledged as collateral related to our repurchase agreements and cash collateral pledged on our financial derivative assets and liabilities.

Total financial instruments transferred or pledged as collateral on our repurchase agreements as of June 30, 2014 were \$1.35 billion. As of June 30, 2014 total cash collateral on financial derivative liabilities excludes \$5.7 million of net excess cash collateral.

(3) When collateral is pledged to or pledged by a counterparty, it is often pledged or posted with respect to all positions with such counterparty, and in such cases such collateral cannot be specifically identified as relating to a specific asset or liability. As a result, in preparing the above table, the Company has made assumptions in allocating pledged or posted collateral among the various rows.

December 31, 2013:

| Description                       | Amount of Assets<br>(Liabilities)<br>Presented in the<br>Consolidated<br>Balance Sheet <sup>(1)</sup> | Financial<br>Instruments Available<br>for Offset | Financial<br>Instruments<br>Transferred or<br>Pledged as<br>Collateral <sup>(2)(3)</sup> | Cash<br>Collateral<br>(Received)<br>Pledged <sup>(2)(3)</sup> | Net Amount |
|-----------------------------------|---|--|--|---|------------|
| (In thousands)                    |   |  |  |   |            |
| Assets:                           |   |  |  |   |            |
| Financial derivatives—assets      | \$34,963  | \$(1,042 )                                       | \$—  | \$(22,360 )   | \$11,561   |
| Liabilities:                      |   |  |  |   |            |
| Financial derivatives—liabilities | (1,069 )  | 1,042  | —  | 26  | (1 )       |
| Repurchase Agreements             | (1,310,347 )  | —  | 1,295,567  | 14,780  | —          |

(1) In the Company's Consolidated Balance Sheet, all balances associated with the repurchase agreements and financial derivatives are presented on a gross basis.

(2) For the purpose of this presentation, for each row the total amount of financial instruments transferred or pledged and cash collateral (received) or pledged may not exceed the applicable gross amount of assets or (liabilities) as presented here. Therefore we have reduced the amount of financial instruments transferred or pledged as collateral related to our repurchase agreements and cash collateral pledged on our financial derivative assets and liabilities.

Total financial instruments transferred or pledged as collateral on our repurchase agreements as of December 31,

2013 were \$1.36 billion. As of December 31, 2013 total cash collateral on financial derivative assets and liabilities excludes \$0.3 million and \$3.1 million, respectively of net excess cash collateral.

(3) When collateral is pledged to or pledged by a counterparty, it is often pledged or posted with respect to all positions with such counterparty, and in such cases such collateral cannot be specifically identified as relating to a specific asset or liability. As a result, in preparing the above table, the Company has made assumptions in allocating pledged or posted collateral among the various rows.

#### 8. Management Fees

The Manager receives an annual management fee in an amount equal to 1.50% per annum of shareholders' equity (as defined in the Management Agreement) as of the end of each fiscal quarter (before deductions for any management fee with respect to such fiscal period). The management fee is payable quarterly in arrears. For the three month periods ended June 30, 2014 and 2013, the total management fee incurred was approximately \$0.6 million and \$0.7 million, respectively. For the six

month periods ended June 30, 2014 and 2013, the total management fee incurred was approximately \$1.2 million and \$0.8 million, respectively.

Shareholders' equity is defined in the Management Agreement, as of the end of any fiscal quarter, as (a) the sum of (1) the net proceeds from any issuances of common shares or other equity securities of the Company or the Operating Partnership (without double counting) since inception, plus (2) the Company's and the Operating Partnership's (without double counting) retained earnings or accumulated deficit calculated in accordance with U.S. GAAP at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less (b) any amount that the Company or the Operating Partnership has paid to repurchase common shares, limited partnership interests in the Operating Partnership or other equity securities since inception. Shareholders' equity excludes (1) any unrealized gains, losses, or non-cash equity compensation expenses that have impacted shareholders' equity as reported in the financial statements prepared in accordance with U.S. GAAP, regardless of whether such items are included in net income, and (2) one-time events pursuant to changes in U.S. GAAP, and certain non-cash items not otherwise described above, in each case, after discussions between the Manager and the Company's independent trustees and approval by a majority of the Company's independent trustees.

#### 9. Earnings Per Share

Basic earnings per share, or "EPS," is calculated by dividing net income (loss) for the period by the weighted average of the Company's common shares outstanding for the period. Diluted EPS takes into account the effect of dilutive instruments, such as share options and warrants, and uses the average share price for the period in determining the number of incremental shares that are to be added to the weighted average number of shares outstanding. As of June 30, 2014 and 2013, the Company did not have any dilutive instruments outstanding.

The following table presents a reconciliation of the earnings/(losses) and shares used in calculating basic EPS for the three and six month periods ended June 30, 2014 and 2013:

| (In thousands except share amounts)       | Three Month<br>Period Ended<br>June 30, 2014 | Three Month<br>Period Ended<br>June 30, 2013 | Six Month<br>Period Ended<br>June 30, 2014 | Six Month<br>Period Ended<br>June 30, 2013 |
|---|--|--|--|--|
| Numerator:                                |  |  |  |  |
| Net income (loss)                         | \$ 11,050                                    | \$(9,704)                                    | \$ 13,811                                  | \$(8,574)                                  |
| Denominator:                              |  |  |  |  |
| Basic weighted average shares outstanding | 9,139,842                                    | 6,248,763                                    | 9,139,842                                  | 3,953,820                                  |
| Basic Earnings Per Share                  | \$ 1.21                                      | \$(1.55)                                     | \$ 1.51                                    | \$(2.17)                                   |

#### 10. Related Party Transactions

##### Management Agreement

The Company has entered into a management agreement with the Manager, which provides for an initial term through September 24, 2017, and which will be renewed automatically each year thereafter for an additional one-year period, subject to certain termination rights. The Company is externally managed and advised by the Manager. Pursuant to the terms of the Management Agreement, effective September 24, 2012, the Manager provides the Company with its management team, including its officers and appropriate support personnel. The Company does not have any employees. The Manager is responsible for the day-to-day operations of the Company.

##### Services Agreement

The Manager and EMG are parties to a services agreement, pursuant to which EMG is required to provide to the Manager sufficient personnel, services, and resources to enable the Manager to carry out its obligations and responsibilities under the Management Agreement. The Company is a named third-party beneficiary to the services agreement and, as a result, has, as a non-exclusive remedy, a direct right of action against EMG in the event of any breach by the Manager of any of its duties, obligations, or agreements under the Management Agreement that arise out of or result from any breach by EMG of its obligations under the services agreement. The services agreement will terminate upon the termination of the Management Agreement. Pursuant to the services agreement, the Manager makes certain payments to EMG in connection with the services provided. The Manager and EMG are under common ownership and control. As a result, all management fee compensation earned by the Manager and all service agreement fees earned by EMG accrue to the common benefit of the owners of the Manager and EMG, other than in

respect of certain special non-voting membership interests in Ellington Residential Mortgage Management LLC held by certain shareholders of the Company.

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### Expense Reimbursement

Under the terms of the Management Agreement the Company is required to reimburse the Manager for operating expenses related to the Company that are incurred by the Manager, including expenses relating to legal, accounting, due diligence, other services, and all other costs and expenses. The Company's reimbursement obligation is not subject to any dollar limitation. Expenses will be reimbursed in cash within 60 days following delivery of the expense statement by the Manager; provided, however, that such reimbursement may be offset by the Manager against amounts due to the Company from the Manager. The Company will not reimburse the Manager for the salaries and other compensation of the Manager's personnel except that the Company will be responsible for expenses incurred by the Manager in employing certain dedicated or partially dedicated personnel as further described below.

The Company reimburses the Manager for the allocable share of the compensation, including, without limitation, wages, salaries, and employee benefits paid or reimbursed, as approved by the Compensation Committee of the Board of Trustees, to certain dedicated or partially dedicated personnel who spend all or a portion of their time managing the Company's affairs, based upon the percentage of time devoted by such personnel to the Company's affairs. In their capacities as officers or personnel of the Manager or its affiliates, such personnel will devote such portion of their time to the Company's affairs as is necessary to enable the Company to operate its business.

For the both six month periods ended June 30, 2014 and 2013, the Company reimbursed the Manager \$1.2 million and \$0.9 million, respectively for previously incurred operating and compensation expenses.

### Termination Fee

The Management Agreement requires the Company to pay a termination fee to the Manager in the event of (1) the Company's termination or non-renewal of the Management Agreement without cause or (2) the Manager's termination of the Management Agreement upon a default by the Company in the performance of any material term of the Management Agreement. Such termination fee will be equal to 5% of Shareholders' Equity, as defined in the Management Agreement (see Note 8 above) as of the month-end preceding termination.

### Registration Rights Agreement

The Company is a party to a registration rights agreement with an affiliate of EMG and with the Blackstone Tactical Opportunities Funds (the "Blackstone Funds") pursuant to which the Company has granted its initial investors and each of their permitted transferees and other holders of the Company's "registrable common shares" (as such term is defined in the registration rights agreement) who become parties to the registration rights agreement with certain demand and/or piggy-back registration and shelf takedown rights.

### 11. Capital

The Company has authorized 500,000,000 common shares, \$0.01 par value per share, and 100,000,000 preferred shares, \$0.01 par value per share. The Board of Trustees may authorize the issuance of additional shares of either class. As of both June 30, 2014 and December 31, 2013, there were 9,139,842 common shares outstanding, respectively. No preferred shares have been issued.

The below table details cash dividends declared by the Board of Trustees during the six month period ended June 30, 2014:

|                | Dividend<br>Per Share | Dividend<br>Amount<br>(In thousands) | Declaration Date | Record Date    | Payment Date   |
|----------------|-----------------------|--------------------------------------|------------------|----------------|----------------|
| First Quarter  | \$0.55                | \$5,027                              | March 12, 2014   | March 31, 2014 | April 28, 2014 |
| Second Quarter | \$0.55                | \$5,027                              | June 17, 2014    | June 30, 2014  | July 25, 2014  |

The below table details cash dividends declared by the Board of Trustees during the six month period ended June 30, 2013:

|                | Dividend<br>Per Share | Dividend<br>Amount<br>(In thousands) | Declaration Date | Record Date   | Payment Date  |
|----------------|-----------------------|--------------------------------------|------------------|---------------|---------------|
| Second Quarter | \$0.14                | \$1,279                              | June 18, 2013    | June 28, 2013 | July 26, 2013 |





The Board of Trustees did not declare any cash dividends prior to the second quarter of 2013.

On August 13, 2013, the Company's Board of Trustees approved the adoption of a \$10 million share repurchase program. The program, which is open-ended in duration, allows the Company to make repurchases from time to time on the open market or in negotiated transactions. Repurchases are at the Company's discretion, subject to applicable law, share availability, price and the Company's financial performance, among other considerations. No purchases have been made under the program to date.

#### Distribution Policy

The timing and frequency of distributions will be determined by the Board of Trustees based upon a variety of factors deemed relevant by the Company's trustees, including restrictions under applicable law, capital requirements of the Company, and the REIT requirements of the Code. Distributions to shareholders generally will be taxable as ordinary income, although a portion of such distributions may be designated as long-term capital gain or qualified dividend income, or may constitute a return of capital. The Company will furnish annually to each shareholder a statement setting forth distributions paid during the preceding year and their U.S. federal income tax treatment.

It is the intention of the Company to distribute at least 100% of its taxable income, after application of available tax attributes, within the limits prescribed by the Internal Revenue Code, which may extend into the subsequent taxable year.

#### 12. Commitments and Contingencies

From time to time, the Company may become involved in various claims and legal actions arising in the ordinary course of business. Management is not aware of any significant contingencies at June 30, 2014.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

In this Quarterly Report on Form 10-Q, except where the context suggests otherwise, "EARN," "we," "us," and "our" refer to Ellington Residential Mortgage REIT and its subsidiaries, our "Manager" refers to Ellington Residential Mortgage Management LLC, our external manager, and "Ellington" refers to Ellington Management Group, L.L.C. and its affiliated investment advisory firms.

### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

When used in this quarterly report on Form 10-Q, in future filings with the Securities and Exchange Commission ("SEC") or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as "believe," "expect," "anticipate," "estimate," "project," "plan," "continue," "intend," "should," "would," "could," "goal," "objective," "will," "may," "seek" or similar expressions, are intended to identify "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and, as such, may involve known and unknown risks, uncertainties, and assumptions.

Forward-looking statements are based on our beliefs, assumptions, and expectations of our future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. The following factors are examples of those that could cause actual results to vary from our forward-looking statements: changes in interest rates and the market value of our securities; our use and dependence on leverage; the impact of Fannie Mae and Freddie Mac being placed into conservatorship and related events, including the lack of certainty as to the future roles and structures of these entities and changes to legislation and regulations affecting these entities; market volatility; changes in the prepayment rates on the mortgage loans underlying the securities we own and intend to acquire; changes in rates of default and/or recovery rates on our non-agency assets; our ability to borrow to finance our assets and the costs of such borrowings; changes in government regulations affecting our business; our ability to maintain our exemption from registration under the Investment Company Act of 1940, as amended (the "Investment Company Act"); and risks associated with investing in real estate related assets, including changes in business conditions and the general economy. These and other risks, uncertainties and factors, including the risk factors described under Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2013 as filed with the SEC, could cause our actual results to differ materially from those projected in any forward-looking statements we make. All forward-looking statements speak only as of the date on which 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 are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

### Executive Summary

We are a Maryland real estate investment trust, or "REIT," formed in August 2012 that specializes in acquiring, investing in, and managing residential mortgage- and real estate-related assets. Our primary objective is to generate attractive current yields and risk-adjusted total returns for our shareholders by making investments that we believe compensate us appropriately for the risks associated with them. We seek to attain this objective by constructing and actively managing a portfolio comprised primarily of Agency residential mortgage-backed securities, or "RMBS," and, to a lesser extent, non-Agency RMBS. We also may opportunistically acquire and manage other types of residential mortgage-related and real estate-related asset classes, such as residential mortgage loans, and mortgage servicing rights, or "MSRs." We believe that being able to combine Agency RMBS with non-Agency RMBS and other residential mortgage- and real estate-related asset classes enables us to balance a range of mortgage-related risks. We were formed through an initial strategic venture among affiliates of Ellington, an investment management firm and registered investment adviser with a 19-year history of investing in a broad spectrum of mortgage-backed securities and related derivatives, with an emphasis on the RMBS market, and the Blackstone Tactical Opportunity Funds, or the "Blackstone Funds." These initial investors made an aggregate investment of approximately \$31.5 million on September 25, 2012. On May 1, 2013, we priced an initial public offering of our common shares, pursuant to which we sold 6,450,000 shares to the public at a price of \$20.00 per share. Concurrent with the initial public offering, we completed a private placement of 1,050,000 common shares to our initial investors at a purchase price of

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\$20.00 per share which generated gross proceeds of \$21.0 million. No further capital commitments from the initial investors remain as a result of this private placement. Total gross proceeds to us from the initial public offering and concurrent private placement were \$150.0 million. Proceeds to us, net of offering costs, were approximately \$148.5 million.

We are externally managed and advised by our Manager, an affiliate of Ellington.

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We use leverage in our Agency RMBS strategy and, while we have not done so to date, we may use leverage in our non-Agency RMBS strategy as well, although we expect such leverage to be lower. We have financed our purchases of Agency RMBS exclusively through repurchase agreements, which we account for as collateralized borrowings. As of June 30, 2014, we had outstanding borrowings under repurchase agreements in the amount of \$1.3 billion.

We made an election to be taxed as a corporation effective as of May 1, 2013 and beginning with our short taxable year May 1, 2013 through December 31, 2013, we intend to elect to be taxed as a REIT for U.S. federal income tax purposes. Accordingly, we generally will not be subject to U.S. federal income taxes on our taxable income that we distribute currently to our shareholders as long as we maintain our intended qualification as a REIT. We intend to conduct our operations so that neither we nor any of our subsidiaries is required to register as an investment company under the Investment Company Act of 1940, as amended.

As of June 30, 2014, our book value per share was \$18.71, as compared to \$18.05 and \$18.29 as of March 31, 2014 and December 31, 2013, respectively.

#### Trends and Recent Market Developments

Key trends and recent market developments for the mortgage-backed security, or "MBS," market include the following:

**Federal Reserve and Monetary Policy**—Since December 2013, the U.S. Federal Reserve, or "Federal Reserve," has announced six incremental reductions of its purchases of Agency RMBS and U.S. Treasury securities under its accommodative monetary policies. Thus far, taper announcements by the Federal Reserve have each been in increments of \$10 billion, with the monthly asset purchasing pace now standing at \$25 billion per month, down from a pace of \$85 billion per month in late 2013;

**Housing and Mortgage Market Statistics**—Data released by S&P Indices for its S&P/Case-Shiller Home Price Indices for May 2014 showed, consistent with recent months, that the pace of home price appreciation slowed; meanwhile the Freddie Mac survey 30-year mortgage rate ended the second quarter at 4.14% down from 4.40% at March 31, 2014;

**Prepayment Rate Trends**—Prepayments increased marginally during the second quarter, but remain low given the level of mortgage rates;

**Government Sponsored Enterprise, or "GSE," Developments**—While several proposals have been put forth, no definitive legislation has yet been enacted to replace or eliminate the GSEs or materially revise their current roles in the U.S. mortgage market. In May 2014, Federal Housing Finance Agency, or "FHFA," Director Mel Watt presented the 2014 Strategic Plan for the Conservatorship of Fannie Mae and Freddie Mac, and the 2014 Conservatorship Scorecard for Fannie Mae and Freddie Mac, providing new strategic goals reflective of his tendency to favor policies that promote affordability and the expansion of credit availability;

**Bank Regulatory Capital**—Proposed changes will increase regulatory capital requirements for the largest, most systemically significant U.S. banks and their holding companies; while these changes could ultimately alter these institutions' appetite for various risk-taking activities, and could ultimately affect the terms and availability of our repo financing, thus far repo financing has remained readily available and in fact, competition among banks and other lending institutions to provide repo financing has actually increased;

**Portfolio Overview and Outlook**—Both Agency RMBS and non-Agency RMBS assets rallied during the second quarter as interest rates declined and interest rate volatility remained relatively muted. Agency RMBS were also supported by low prepayment activity (in spite of lower mortgage rates) and low production of Agency mortgages. Non-Agency RMBS continued to be supported by overall positive trends in home prices as well as a declining level of foreclosure inventory.

#### Federal Reserve and Monetary Policy

Since December 2013, the Federal Reserve has announced six incremental reductions in its purchases of Agency RMBS and U.S. Treasury securities under its accommodative monetary policies. Prior to these "taper" announcements, and since September 2012, the Federal Reserve had been purchasing long-dated U.S. Treasury securities and Agency RMBS assets at the pace of \$85 billion per month, comprised of \$45 billion of U.S. Treasury securities and \$40 billion of Agency RMBS. Based on the announcements, the combined monthly reduction in asset purchases currently amounts to \$60 billion, split evenly between Agency RMBS and U.S. Treasury securities, leaving current monthly purchases of Agency RMBS at \$10 billion and U.S. Treasury securities at \$15 billion. The Federal Reserve has stated that it will further reduce its monthly purchases if conditions continue to broadly improve as

anticipated, although it expects to continue to reinvest principal payments from its holdings into additional asset purchases. Notwithstanding its view that the broader economy has strengthened considerably, the Federal Reserve continues to express concern that inflation persistently below its 2% objective could pose risks to economic performance.

In its July 2014 statement, in addition to announcing its intention to further reduce its monthly asset purchases, the Federal Open Market Committee, or "FOMC," reiterated its intention to maintain the target range for the federal funds rate at 0% to 0.25%. The FOMC also indicated that it continues to anticipate, based on its assessment of labor market conditions, inflationary pressures and expectations, and other factors that it will likely maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends.

Since the Federal Reserve's initial taper announcement in December 2013, long-term interest rates have declined. As of June 30, 2014, the 10-year U.S. Treasury yield was 2.53% as compared to 2.72% as of March 31, 2014 and 3.03% as of December 31, 2013. Prices of Agency RMBS have also rallied. For example, the price of TBA 30-year Fannie Mae 3.5s, a widely traded Agency RMBS, rose to 102.78 as of June 30, 2014, up from 100.66 at March 31, 2014 and 99.34 as of December 31, 2013.

Notwithstanding the recent decline in interest rates, we believe that there remains substantial risk that interest rates could begin to rise again. Market speculation has shifted from the tapering of asset purchases by the Federal Reserve to the timing of a tightening of monetary policy through, for example, interest rate increases by the Federal Reserve. This reinforces the importance of our ability, subject to our qualifying and maintaining our qualification as a REIT, to hedge interest rate risk in both our Agency and non-Agency RMBS portfolios using a variety of tools, including TBAs, interest rate swaps, and various other instruments.

#### Housing and Mortgage Market Statistics

The following table demonstrates the decline in residential mortgage delinquencies and foreclosure inventory on a national level, as reported by CoreLogic in its June 2014 National Foreclosure Report:

|   | As of     |           |
|---|-----------|-----------|
| Number of Units (In thousands)                | June 2014 | June 2013 |
| Seriously Delinquent Mortgages <sup>(1)</sup> | 1,679     | 2,224     |
| Foreclosure Inventory                         | 648       | 998       |

<sup>(1)</sup> Seriously Delinquent Mortgages are ninety days and over in delinquency and include foreclosures and real estate owned, or "REO," property.

As the above table indicates, both the number of seriously delinquent mortgages and the number of homes in foreclosure have declined significantly over the past year. This decline supports the thesis that as many homeowners have re-established equity in their homes through recovering real estate prices, they have become less likely to become delinquent and default on their mortgages.

Monthly housing starts provide another indicator of market fundamentals. The following table shows the trailing three-month average housing starts for the periods referenced:

|                              | June 2014 | May 2014 | June 2013 |
|------------------------------|-----------|----------|-----------|
| Single-family <sup>(1)</sup> | 619       | 639      | 596       |
| Multi-family <sup>(1)</sup>  | 351       | 350      | 256       |

<sup>(1)</sup> Shown in thousands of units:

Source: U.S. Census Bureau

As of June 2014, average single-family housing starts during the trailing three months fell 3.1% as compared to May 2014, to 619,000 units. Multi-family housing starts were essentially unchanged during the same period. On a year-over-year basis, while multi-family housing starts during the trailing three months increased over 37% from June 2013, single-family housing starts essentially remained flat, as continuing tight residential mortgage loan underwriting standards have likely impacted demand for new single-family homes. Even though home prices have recovered meaningfully over the last few years, this recovery has not translated into growth in single-family housing starts. This suggests that the recovery in home prices may have been driven more by the active purchase of foreclosure inventory by institutional investors, as opposed to by an increase in demand for traditional owner-occupied single-family housing. In addition, continuing tight mortgage loan underwriting standards are likely part of the cause of this weakness.

Data released by S&P Indices for its S&P/Case-Shiller Home Price Indices for May 2014 showed that, on average, home prices had increased from May 2013 by 9.4% and 9.3% for its 10- and 20-City Composites, respectively, rising at their slowest pace since February 2013. Recently, the home price indices have flattened out, suggesting that the pace of home price appreciation in 2013 will likely not be repeated in 2014. Compared to December 2013, the 10- and

20-City Composites increased 2.9% and 3.0%, respectively. According to the report, home prices remain below the peak levels of 2006, but, on average, are back to their summer 2004 levels for both the 10- and 20-City Composites. Finally, as indicated in the table above,

as of June 2014, the national inventory of foreclosed homes fell to 648,000 units, a 25% decline when compared to June 2013; this represented the thirty-second consecutive month with a year-over-year decline and the lowest level since November 2008. As a result, there are much fewer unsold foreclosed homes overhanging the housing market than there were a year ago. We believe that near-term home price trends are more likely to be driven by fundamental factors such as economic growth, mortgage rates, and affordability, rather than by technical factors such as shadow inventory. Shadow inventory represents the number of properties that are seriously delinquent, in foreclosure, or held as REO by mortgage servicers, but not currently listed on multiple listing services.

On August 1, 2014, the U.S. Bureau of Labor Statistics, or "BLS," reported that, as of July 2014 the U.S. unemployment rate increased slightly to 6.2%. Another, perhaps more relevant, measure of labor market conditions is employment growth, which has been relatively robust in recent months. The BLS also reported that non-farm payrolls rose by 209,000 during July, a level that is considered reflective of improving labor market conditions. While it is difficult to quantify the relationship between employment data and the housing and mortgage markets, we believe that current levels of unemployment and job creation no longer represent a significant impediment to a continuing housing recovery. However, the continued recovery of the housing market, while supported by still-historically-low mortgage rates and the momentum of improving home prices, faces a number of potential headwinds. These include volatility in interest rates, the sluggish rate of growth in housing starts and new loan origination, and the uneven pace of the recovery of the U.S. economy.

#### Prepayment Rate Trends

The relatively muted level of prepayment activity as interest rates broadly declined in recent years has in large part been the result of: (i) home price declines during the financial crisis, which has left many borrowers with minimal or negative home equity; (ii) more restrictive underwriting guidelines, even for refinancings; and (iii) increased origination costs, especially related to underwriting and compliance. These factors have resulted in substantial variations in prepayment rates between Agency pools as a function of loan-to-value, or "LTV" ratio, loan balance, credit score, geography, property type, loan purpose, and other factors. In recognition of the importance of these underlying characteristics on prepayment behavior, the MBS market continues to promote the creation of "specified" Agency pools that emphasize or de-emphasize many of these characteristics, such as pools where the principal balance of every underlying mortgage loan is below \$85,000. The Making Homes Affordable, or "MHA," refinancing program, which was initiated in response to the housing market crisis, has facilitated the origination of many of these kinds of specified Agency pools. The extension of the MHA refinancing program into 2015 should sustain creation of such pools in the coming years. We expect that the ongoing origination of Agency pools with a wide variety of loan characteristics will continue to create opportunities for us to exploit the resulting differences in prepayments. The Freddie Mac survey 30-year fixed mortgage rate ended the second quarter at 4.14%, a 26 basis point decline from the end of the first quarter. The Refinance Index published by the Mortgage Bankers Association, or "MBA," fell approximately 4.8% over the second quarter on a seasonally adjusted basis, and similarly the MBA's Market Composite Index, a measure of mortgage application volume, fell 2.6% over the second quarter on a seasonally adjusted basis. The decreases in the indices in the second quarter reversed much of the gains during the first quarter and continued the 2013 trend whereby both indices declined.



The table below illustrates the relationship between the Freddie Mac survey 30-year fixed mortgage rate and the MBA Refinance Index since September 2012. Generally speaking, over the period September 2012 through September 2013, mortgage rates and the level of refinancing activity were nearly linearly correlated. However, following September 2013 and through June 2014, there has been a decoupling of these two time series. As the figure below shows, by June 2014 the MBA Refinance Index was meaningfully lower than one might have expected given the nearly linear relationship that had existed between the two indices from September 2012 and September 2013. One possible explanation for this divergence is that because mortgage rates were so low for so long before finally increasing in 2013, many borrowers may now believe that they have missed the opportunity to refinance. It is a central question in the Agency RMBS market whether these subdued refinancing speeds will continue to persist, and if so, for how long.

#### GSE Developments

On May 13, 2014, Mel Watt, Director of the FHFA, presented the FHFA's 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac, or the "Strategic Plan," and the 2014 Conservatorship Scorecard for Fannie Mae and Freddie Mac. The Strategic Plan outlines the FHFA's plan to clarify and refine representation and warranty guidelines. Examples offered by Watt include the GSE's relaxation of payment history requirements and elimination of automatic repurchases when mortgage insurance is rescinded. Reflective of his tendency to favor policies that promote affordability through expanded credit, Watt announced that the FHFA will maintain conforming loan limits for GSEs rather than implementing the reductions that were proposed in late 2013 by former FHFA director Ed DeMarco. Credit risk transfers to private investors, which increase capital flows while reducing tax payer risk, are to grow to \$90 billion per agency, triple the amount required in 2013. The FHFA continues to re-evaluate the implementation of DeMarco's proposed initiative to raise guarantee fees, or "g-fees," on new Fannie Mae and Freddie Mac business. G-fees are the fees charged by the GSEs to include mortgage loans in Agency pools, and thereby insure the mortgage loan against loss. Since these fees are passed on to borrowers whose loans are originated for inclusion in Agency pools, increased g-fees have the effect of reducing housing affordability for GSE borrowers, but potentially make it more attractive for private lenders to replace the GSEs. Decreased expectations of g-fee increases are suggestive of potentially faster prepayment speeds.

Under Watt, the FHFA has reinvigorated the Home Affordable Finance Program, or "HARP," outreach effort by hosting town hall-style meetings in areas with high concentrations of borrowers eligible for the program, which targets high LTV loans owned or guaranteed by GSEs. We believe this may result in only marginally higher prepayments for higher coupon loans to pre-HARP borrowers.

To date, no definitive legislation has been enacted with respect to a possible unwinding of the GSEs or a material reduction in their roles in the U.S. mortgage market. There have been several proposals offered by members of Congress, including the Corker-Warner bill introduced in June 2013, the Johnson-Crapo bill introduced in March 2014, and the Partnership to Strengthen Homeownership Act, which was introduced in July 2014. Though it appears unlikely that one of these bills will be passed in its current form, features may be incorporated into future proposals. The Johnson-Crapo bill would create a new regulator, the Federal Mortgage Insurance Corp., or "FMIC." The FMIC's backing for MBS would come in the form of a Mortgage Insurance Fund, which would be designed to protect investors' losses beyond a 10% first-loss position held by private investors. The FMIC would supervise private-sector participants in the mortgage sector and provide additional means of support to the mortgage market during economic downturns. The FMIC would also be responsible for establishing securitization standards and underwriting requirements for any loans that are included in securities guaranteed by the FMIC. The Johnson-Crapo bill also details how regulators would wind down Fannie Mae and Freddie Mac, and begin the transition to the new housing finance system. The plan provides for the process to take place over a five-year period, at the end of which the FMIC would be required to have met several benchmarks, including establishing a new securitization platform and approving a "sufficient number" of guarantors, aggregators, private mortgage insurers, and multi-family guarantors. The Partnership to Strengthen Homeownership Act proposes a Ginnie Mae insurance program whereby private investors would own a minimum 5% first-loss position in all pools guaranteed by the agency, with Ginnie Mae and a private reinsurer sharing the remaining 95% of the risk on a pari passu basis. Provisions for the wind-down and potential privatization and recapitalization of Fannie Mae and Freddie Mac are also provided. Passage of any GSE reform bill before the upcoming mid-term elections in November will be challenging. Ultimately, we believe that a reduced role for (or elimination of) the GSEs would present many opportunities for us and other private investors to fill the resulting void.

#### Bank Regulatory Capital Changes

Upcoming changes in banking regulations could impact MBS and ABS pricing, as well as the availability and cost of financing of MBS and ABS assets. The Federal Reserve's current implementation of the Basel III rules on bank Supplementary Leverage Ratios, or "SLRs," will significantly curtail the extent to which banks will be permitted to net certain repo and reverse repo agreements against each other when calculating their capital requirements. In addition, rules recently adopted by the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency will require the largest U.S. bank holding companies to hold capital equal to 5% of total assets, thus going beyond the 3% minimum set by Basel III rules. As a consequence, in an effort to maximize return on equity, banks may be incentivized to reduce their repo financing operations, especially for lower-profit-margin financings such as those involving U.S. Treasury securities and Agency RMBS. U.S. banking regulators also released a notice of proposed rulemaking outlining some minor changes to the SLR rules that would make the U.S. SLR definitions more similar to those currently used in Europe. In particular, these proposed rules would result in slightly more stringent capital treatment of repo lending activities. In addition, full implementation of Basel III regulations, in particular the carve-out rules related to accumulated other comprehensive income, or "AOCI," are likely to reduce bank demand for assets with higher duration, and as a result could hurt the liquidity of the tradable MBS market. Under the AOCI carve-out rules, banks with more than \$250 billion in assets will be required to include mark-to-market gains and losses on available-for-sale, or "AFS," securities when calculating their Tier 1 capital. This incentivizes banks to classify Agency RMBS as held-to-maturity and other illiquid assets, effectively locking more bank-held Agency RMBS out of the tradable market, and thus reducing market liquidity. In addition, banks will likely want to reduce the risk of their AFS securities holdings, which will incentivize them to hold lower duration assets such as 15-year Agency RMBS. While our access to repo financing continues to not be negatively impacted, it is still possible that certain of our lending institutions could, in the future, decide to curtail their repo lending activities in response to these developments, particularly in connection with repo financing on Agency RMBS. However, it is also possible that these changes will create opportunities for smaller banks and/or non-bank lenders to enter the repo financing market, and in fact we continue to see smaller broker-dealers becoming more active in the Agency pool repo financing market.

#### Portfolio Overview and Outlook

##### Agency

Agency RMBS rallied in the second quarter, continuing the first quarter trend. Our Agency RMBS are principally comprised of "specified pools." Specified pools are fixed rate Agency pools with special prepayment characteristics, such as pools comprised of low loan balance mortgages, pools comprised of mortgages backed by investor properties, pools containing mortgages originated through the government-sponsored "Making Homes Affordable" refinancing programs, and pools containing mortgages with various other prepayment characteristics.

As discussed above in "—Federal Reserve and Monetary Policy," the Federal Reserve has continued to taper its monthly purchases of Agency RMBS and U.S. Treasury securities. While the Federal Reserve will likely cease its monthly bond purchases by the fall of this year, it has stated that it will continue to reinvest paydown proceeds from its held portfolio into additional Agency RMBS and U.S. Treasury securities. Similar to the first quarter, the additional supply of Agency RMBS that resulted from the taper was readily absorbed during the second quarter by other market participants. As the Federal Reserve continues to reduce its purchases, its market dominance will further wane, which we believe will create additional opportunities for us and other private investors.

During the second quarter, our Agency RMBS purchasing activity continued to focus primarily on higher coupon specified pools. As in the first quarter, pay-ups (price premiums for specified pools relative to their generic pool "TBA" counterparts) increased during the second quarter, thus continuing the reversal of last year's pay-up declines. Notwithstanding these increases of the past two quarters, pay-ups for many specified pool sectors remain well below their previous highs. Yield spreads on fixed rate reverse mortgage pools, which had tightened about 30 basis points during the first quarter, continued this trend and tightened an additional 10-15 basis points in the second quarter, as issuance of reverse mortgage pools continued to slow. In light of this yield spread tightening, we sold some of our holdings of reverse mortgage pools during the second quarter, thereby monetizing gains.

Prepayment rates increased only marginally in the second quarter, and they remain low by historical standards relative to the current level of mortgage rates. However, based on observations in the beginning of the third quarter, we believe that prepayments may soon begin to increase. As a result, we are still finding it attractive to buy pools with prepayment protection, particularly in those sectors that are more susceptible to increased prepayments. During the second quarter, we slightly reduced our holdings of pools backed by 30-year mortgages in favor of those backed by 15-year mortgages and those backed by adjustable rate mortgages. For the second consecutive quarter, and despite an approximate 25 basis point drop in mortgage rates during April and May, our Agency interest only securities performed well, as prepayments increased but remained relatively low.

While Agency RMBS prices generally increased in the second quarter, over the near term we believe that the combined effects of continued Federal Reserve tapering and a potential rise in mortgage originations may ultimately put pressure on valuations of Agency RMBS. We also think it is unlikely that interest rate volatility will remain as subdued as it was in the first and second quarters. While both of these factors may weigh on the performance of Agency RMBS relative to U.S. Treasury securities, we believe that each of these factors should weigh more heavily on TBAs as compared to specified pools, so they should actually support specified pool pay-ups. As the Federal Reserve continues to taper its Agency RMBS purchases, which are concentrated in purchases of TBAs, specified pools should outperform TBAs. The effects of the taper can already be observed in the TBA roll market: TBA roll prices in early July were noticeably weaker than they were at the beginning of the second quarter. We have also noted that as dealer balance sheets contract in light of regulatory changes, and risk appetite decreases, the depth of the Agency RMBS market has weakened somewhat. Essentially, this means that the amount of a particular asset that can be bought or sold without materially impacting its price has declined. At the same time, however, the decline in competition from dealers is helping us to find attractive opportunities to purchase assets.

We continue to target pools that, taking into account their particular composition and based on our prepayment projections: (1) should generate attractive yields relative to other Agency RMBS and U.S. Treasury securities, (2) should have less prepayment sensitivity to government policy shocks, and/or (3) create opportunities for trading gains once the market recognizes their value, which for newer pools may come only after several months, when actual prepayment experience can be observed. We believe that our research team, our proprietary prepayment models, and our extensive databases remain essential tools in our implementation of this strategy. Notwithstanding the opportunities that volatility may create to buy and sell assets, the presence of volatility also underscores the importance of our flexibility in hedging our risks using a variety of tools, including TBAs, as we adapt to changing market conditions. We also believe that our active trading style, coupled with our ability to dynamically alter the mix of TBAs and interest rate derivatives that we use to hedge interest rate risk, is of great benefit to our Agency RMBS portfolio.

Over the course of the second quarter and consistent with our strategy, we continued to hedge against the risk of rising interest rates, primarily with interest rate swaps and TBAs. Since long-term interest rates declined during the quarter, our interest rate hedges generated net losses, thereby partially reducing the impact of increasing asset prices.

Notwithstanding the recent trend of declining interest rates and the relatively muted level of volatility, we believe the risk of higher near-term volatility in the Agency RMBS market remains.

### Non-Agency

In the non-Agency RMBS market, credit spreads continued to tighten over the course of the second quarter, as strong investor appetite, propelled in large part by retail bond fund inflows, has fueled demand for higher yielding assets among fixed income products. While non-Agency RMBS credit spreads have tightened, we are still finding attractive buying opportunities, for example, in sectors where we believe defaults have finally "burned out," but where market prices have yet to reflect much default burnout. At the same time, we have taken advantage of the spread tightening by opportunistically selling assets that we believe have become overvalued, since we continue to believe that certain non-Agency RMBS sectors may now have limited remaining upside potential. For example, we believe that the recent increases in home prices have led the market to ascribe too much value to certain later vintage sub-prime RMBS securities. In fact, we believe that the combination of longer resolution timelines and adverse selection of the remaining delinquent loans within these securities implies that loss severities may not come down at all. As yields continue to compress in the non-Agency RMBS market, factors such as these make prudent and careful security selection, based on loan level analysis performed on a security by security basis, of paramount importance.

While we believe that fundamental factors, such as home price appreciation and a declining foreclosure inventory, remain relatively positive for non-Agency RMBS, we believe that on the technical side the non-Agency MBS market remains vulnerable, especially to a resumption of increases in long-term interest rates. The non-Agency MBS market has become dominated by large bond mutual funds, and is therefore now driven indirectly by the large-scale behavior of retail investors. This behavior tends to be much more momentum-driven, as evidenced in mid-2013 when the increase in U.S. Treasury yields was followed by substantial retail bond outflows, thereby putting downward pressure on prices as redemptions forced bond mutual fund managers to sell assets. This technical vulnerability has been heightened further by the fact that dealers, faced with regulatory requirements such as Basel III and the Volcker Rule, are no longer willing to hold large inventories of non-Agency MBS, and thus are no longer able to absorb large-scale selling by bond funds into their inventories. In the meantime, however, demand for non-Agency MBS assets remains strong. As of June 30, 2014, our non-Agency RMBS portfolio was \$35.7 million, as compared to \$32.0 million as of March 31, 2014.

### Financing

During the first six months of 2014, we have continued to find repo financing to be readily available for Agency RMBS. In fact, dealers have actually increased their appetite for providing repo financing for Agency specified pools. As a result of this increased competition, our weighted average borrowing rate as of June 30, 2014 declined to 0.33% from 0.35% as of March 31, 2014 and 0.38% as of December 31, 2013. To date, our borrowings have consisted solely of repos collateralized by Agency RMBS. Our average haircuts on our repo borrowings have also modestly declined as compared to December 31, 2013. We have found increased repo lending appetite from both larger and smaller dealers with more competitive terms. As of June 30, 2014, our outstanding repos were with 10 different counterparties.

### Critical Accounting Policies

Our consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America, or "U.S. GAAP," Entities in which we have a controlling financial interest, through ownership of the majority of the entities' voting equity interests, or through other contractual right that give us control, are consolidated by us. All inter-company balances and transactions have been eliminated.

Certain of our critical accounting policies require management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. We believe that all of the decisions and assessments upon which our consolidated financial statements are based were reasonable at the time made based upon information available to us at that time. We rely on our Manager and Ellington's experience and analysis of historical and current market data in order to arrive at what we believe to be reasonable estimates. See Note 2 to the consolidated financial statements included in this Quarterly Report on Form 10-Q for a complete discussion of our significant accounting policies. We have identified our most critical accounting policies to be the following:

Valuation: We apply Accounting Standards Codification ("ASC") ASC 820-10, Fair Value Measurement and Disclosures ("ASC 820-10"), to our holdings of financial instruments. ASC 820-10 establishes a three-level valuation

hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. Financial instruments include securities and financial derivatives. A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in these securities.

The following is a description of the valuation methodologies used for our financial instruments:

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Level 1 valuation methodologies include the observation of quoted prices (unadjusted) for identical assets or liabilities in active markets, often received from widely recognized data providers.

Level 2 valuation methodologies include the observation of (i) quoted prices for similar assets or liabilities in active markets, (ii) inputs other than quoted prices that are observable for the asset or liability (for example, interest rates and yield curves) in active markets and (iii) quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3 valuation methodologies include (i) the solicitation of valuations from third parties (typically, broker-dealers), (ii) the use of proprietary models that require the use of a significant amount of judgment and the application of various assumptions including, but not limited to, prepayment assumptions and default rate assumptions, and (iii) the assessment of observable or reported recent trading activity. We utilize such information to assign a good faith fair value (the estimated price that would be received to sell an asset or paid to transfer a liability in an orderly transaction at the valuation date) to each such financial instrument.

We seek to obtain at least one third-party indicative valuation for each instrument, and often obtain multiple indicative valuations when available. Third-party valuation providers often utilize proprietary models that are highly subjective and also require the use of a significant amount of judgment and the application of various assumptions including, but not limited to, prepayment assumptions and default rate assumptions. We have been able to obtain third-party valuations on the vast majority of our assets, and we expect to continue to solicit third-party valuations on substantially all of our assets in the future to the extent practical. Generally, we value each financial instrument at the average of all third-party valuations received and not rejected as described below. Third-party valuations are not binding on us, and while we generally do not adjust such valuations, we may challenge or reject a valuation when, based on our validation criteria, we determine that such valuation is unreasonable or erroneous. Furthermore, we may determine, based on our validation criteria, that for a given instrument the average of the third-party valuations received does not result in what we believe to be fair value, and in such circumstances we may override this average with our own good faith valuation. Our validation criteria include the use of our own models, recent trading activity in the same or similar instruments, and valuations received from third parties. Our valuation process, including the application of our validation criteria, is overseen by a valuation committee. Because of the inherent uncertainty of valuation, these estimated values may differ significantly from the values that would have been used had a ready market for the financial instruments existed, and the differences could be material to the consolidated financial statements.

See the notes to our consolidated financial statements for more information on valuation.

**Accounting for Mortgage-Backed Securities:** Investments in mortgage-backed securities are recorded on trade date.

We have chosen to make a fair value election pursuant to ASC 825-10, Financial Instruments, for our mortgage-backed securities portfolio. Electing the fair value option allows us to record changes in fair value in our Consolidated Statement of Operations, which, in our view, more appropriately reflects the results of our operations for a particular reporting period as all securities activities will be recorded in a similar manner. As such, the mortgage-backed securities are recorded at fair market value on our Consolidated Balance Sheet and the period change in fair value is recorded in current period earnings on our Consolidated Statement of Operations as a component of Change in net unrealized gains (losses) on mortgage-backed securities.

Realized gains or losses on sales of mortgage-backed securities are included in Net realized gains (losses) on mortgage-backed securities on the Consolidated Statement of Operations, and are recorded at the time of disposition. The cost of positions sold is calculated based on identified cost. Principal write-offs are generally treated as realized losses.

**Interest Income:** We accrete market discounts and amortize market premiums on debt securities using the effective yield method. Accretion of market discount and amortization of market premiums requires the use of a significant amount of judgment and the application of several assumptions including, but not limited to, prepayment assumptions and default rate assumptions, which are re-evaluated not less than quarterly and require the use of a significant amount of judgment. Our accretion of discounts and amortization of premiums for U.S. federal and other tax purposes is likely to differ from the financial accounting treatment of these items.

**Income Taxes:** Prior to May 1, 2013, we, as a business trust with more than one owner, were considered a partnership for U.S. federal income tax purposes. In general, partnerships are not subject to entity-level tax on their income, but



the income of a partnership is taxable to its owners on a flow-through basis. Interest, dividend, and other income that we realize from non-U.S. sources and capital gains that we realize on the sale of securities of non-U.S. issuers may be subject to entity-level taxes, such as withholding and other taxes levied by the jurisdiction in which the income is sourced. We made an election to be taxed as a corporation effective as of May 1, 2013, and beginning with our short taxable year May 1, 2013 through December 31, 2013, we intend to elect to be taxed as a REIT for U.S. federal income tax purposes. We follow the authoritative guidance on accounting for and disclosure of uncertainty on tax positions, which requires management to determine whether our tax position is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related

appeals of the litigation process, based on the technical merits of the position. For uncertain tax positions, the tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. In the normal course of business, we may be subject to examination by federal, state, local, and foreign jurisdictions, where applicable, for the current period, 2013 or 2012 (our open tax years). We may take positions with respect to certain tax issues which depend on legal interpretation of facts or applicable tax regulations. Should the relevant tax regulators successfully challenge any such positions; we might be found to have a tax liability that has not been recorded in the accompanying consolidated financial statements. Also, management's conclusions regarding the authoritative guidance may be subject to review and adjustment at a later date based on changing tax laws, regulations, and interpretations thereof. There were no amounts accrued for penalties or interest as of or during the periods presented in the consolidated financial statements included in this Quarterly Report on Form 10-Q.

"Emerging Growth Company" Status: On April 5, 2012, the Jumpstart Our Business Startups Act, or the "JOBS Act," was signed into law. The JOBS Act contains provisions that, among other things, reduce certain reporting requirements for qualifying public companies. Because we qualify as an "emerging growth company," we may, under Section 7(a)(2)(B) of the Securities Act of 1933, or "the Securities Act," delay adoption of new or revised accounting standards applicable to public companies until such standards would otherwise apply to private companies. We may take advantage of this extended transition period until the first to occur of the date that we (i) are no longer an "emerging growth company" or (ii) affirmatively and irrevocably opt out of this extended transition period. We have elected to take advantage of the benefits of this extended transition period. As a result, our financial statements may not be comparable to those of other public companies that comply with such new or revised accounting standards. Until the date that we are no longer an "emerging growth company" or affirmatively and irrevocably opt out of the exemption provided by Securities Act Section 7(a)(2)(B), upon issuance of a new or revised accounting standard that applies to our financial statements and that has a different effective date for public and private companies, we will disclose the date on which adoption is required for non-emerging growth companies and the date on which we will adopt the recently issued accounting standard.

#### Recent Accounting Pronouncements

Refer to the notes to our consolidated financial statements for a description of relevant recent accounting pronouncements.

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Financial Condition  
Investment portfolio

The following tables summarize our investment portfolio as of June 30, 2014 and December 31, 2013:  
June 30, 2014:

(\$ in thousands)

|                              | Current Principal | Unamortized Premium (Discount) | Amortized Cost | Gross Unrealized |           |             | Weighted Average |        |   |
|------------------------------|-------------------|--------------------------------|----------------|------------------|-----------|-------------|------------------|--------|---|
|                              |                   |                                |                | Gains            | Losses    | Fair Value  | Coupon           | Yield  | Weighted Average Life(Years) <sup>(1)</sup> |
| Agency RMBS:                 |                   |                                |                |                  |           |             |                  |        |   |
| 15-year fixed rate mortgages | \$166,910         | \$7,816                        | \$174,726      | \$1,147          | \$(290)   | \$175,583   | 3.36%            | 2.46%  | 5.64  |
| 20-year fixed rate mortgages | 10,158            | 604                            | 10,762         | 174              | —         | 10,936      | 4.00%            | 2.71%  | 7.11  |
| 30-year fixed rate mortgages | 957,162           | 52,577                         | 1,009,739      | 14,530           | (4,185)   | 1,020,084   | 4.07%            | 3.27%  | 9.05  |
| ARMs                         | 66,864            | 3,722                          | 70,586         | 152              | (198)     | 70,540      | 4.20%            | 3.52%  | 7.33  |
| Reverse mortgages            | 15,824            | 1,284                          | 17,108         | 249              | —         | 17,357      | 4.77%            | 2.48%  | 4.17  |
| Interest only securities     | n/a               | n/a                            | 12,469         | 2,484            | (677)     | 14,276      | 4.20%            | 15.26% | 3.86  |
| Total Agency RMBS            | 1,216,918         | 66,003                         | 1,295,390      | 18,736           | (5,350)   | 1,308,776   | 4.00%            | 3.27%  | 7.99  |
| Non-Agency RMBS              | 55,395            | (23,307)                       | 32,088         | 3,821            | (241)     | 35,668      | 2.38%            | 9.83%  | 5.97  |
| Total RMBS                   | \$1,272,313       | \$42,696                       | \$1,327,478    | \$22,557         | \$(5,591) | \$1,344,444 | 3.94%            | 3.43%  | 7.91  |

December 31, 2013:

(\$ in thousands)

|                              | Current Principal | Unamortized Premium (Discount) | Amortized Cost | Gross Unrealized |           |            | Weighted Average |        |   |
|------------------------------|-------------------|--------------------------------|----------------|------------------|-----------|------------|------------------|--------|---|
|                              |                   |                                |                | Gains            | Losses    | Fair Value | Coupon           | Yield  | Weighted Average Life(Years) <sup>(1)</sup> |
| Agency RMBS:                 |                   |                                |                |                  |           |            |                  |        |   |
| 15-year fixed rate mortgages | \$179,906         | \$7,153                        | \$187,059      | \$65             | \$(3,252) | \$183,872  | 3.09%            | 2.52%  | 5.76  |
| 30-year fixed rate mortgages | 1,029,629         | 41,565                         | 1,071,194      | 490              | (28,111)  | 1,043,573  | 3.79%            | 3.30%  | 9.80  |
| Adjustable rate mortgages    | 43,525            | 2,647                          | 46,172         | 46               | (103)     | 46,115     | 4.72%            | 3.24%  | 3.79  |
| Reverse mortgages            | 7,581             | 673                            | 8,254          | 16               | (2)       | 8,268      | 4.85%            | 2.90%  | 3.41  |
|                              | n/a               | n/a                            | 10,718         | 2,841            | (32)      | 13,527     | 3.97%            | 11.79% | 5.02  |

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Interest only securities

|                   |             |           |             |         |            |             |       |       |      |
|-------------------|-------------|-----------|-------------|---------|------------|-------------|-------|-------|------|
| Total Agency RMBS | 1,260,641   | 52,038    | 1,323,397   | 3,458   | (31,500 )  | 1,295,355   | 3.75% | 3.26% | 8.67 |
| Non-Agency RMBS   | 50,006      | (21,327 ) | 28,679      | 2,196   | (194 )     | 30,681      | 2.84% | 9.12% | 5.54 |
| Total RMBS        | \$1,310,647 | \$30,711  | \$1,352,076 | \$5,654 | \$(31,694) | \$1,326,036 | 3.72% | 3.38% | 8.56 |

Average lives of MBS are generally shorter than stated contractual maturities. Average lives are affected by the (1) contractual lives of the underlying mortgages, scheduled periodic payments of principal, and unscheduled prepayments of principal.

The vast majority of our capital is allocated to our Agency RMBS strategy, which we began implementing in April 2013 and which includes investments in Agency pools and Agency CMOs. Within this strategy, we generally target Agency RMBS pools that, taking into account their particular composition and based on our prepayment projections: (1) will generate attractive yields relative to other Agency RMBS and U.S. Treasury securities, (2) will have less prepayment sensitivity to government policy shocks and/or (3) create opportunities for trading gains once the market recognizes their value, which for newer pools may come only after several months when actual prepayment experience can be observed. As of both June 30, 2014 and December 31, 2013, investments in non-Agency RMBS constituted a relatively small portion of our total investments.

## Financial Derivatives

The following table summarizes our portfolio of financial derivative holdings as of June 30, 2014 and December 31, 2013:

| (In thousands)  | June 30, 2014 | December 31, 2013 |
|---|---------------|-------------------|
| Financial derivatives—assets, at fair value:            |               |                   |
| TBA securities purchase contracts                       | \$ 385        | \$ 1              |
| TBA securities sale contracts                           | —             | 2,262             |
| Fixed payer interest rate swaps                         | 9,730         | 32,700            |
| Total financial derivatives—assets, at fair value:      | \$ 10,115     | \$ 34,963         |
| Financial derivatives—liabilities, at fair value:       |               |                   |
| TBA securities sale contracts                           | (3,347        | ) (28             |
| Fixed payer interest rate swaps                         | (2,536        | ) (956            |
| Swaptions   | (924          | ) (85             |
| Total financial derivatives—liabilities, at fair value: | \$(6,807      | ) \$(1,069        |
| Total   | \$ 3,308      | \$ 33,894         |

Our most prevalent method of financing RMBS is through short-term repurchase agreements, which generally have maturities of 180 days or less. The weighted average life of the RMBS we own is generally much longer.

Consequently, the weighted average term of our repurchase agreement financings will almost always be substantially shorter than the expected average maturity of our RMBS. This mismatch in maturities, together with the uncertainty of RMBS prepayments, and other potential changes in timing and/or amount of cash flows on our RMBS assets, creates the risk that changes in interest rates will cause our financing costs with respect to our RMBS to increase relative to the income on our RMBS over the term of our investments.

Pursuant to our hedging program, we engage in a variety of interest rate hedging activities that are designed to reduce the interest rate risk with respect to the liabilities incurred to acquire or hold RMBS. These interest rate hedges generally seek to reduce the interest rate sensitivity of our liabilities or, in other words, reduce the volatility of our financing cost over time attributable to interest rate changes. Our interest rate hedging transactions may include:

- Interest rate swaps (a contract exchanging a variable rate for a fixed rate, or vice versa);
- Interest rate swaptions (options to enter into interest rate swaps at a future date);
- TBA forward contracts on Agency pass-through certificates;
- U.S. Treasury securities;
- Eurodollar and U.S. Treasury futures; and
- Other derivatives.

We generally enter into these transactions to offset the potential adverse effects of rising interest rates on short-term repurchase agreements. Our repurchase agreements generally have maturities of up to 180 days and carry interest rates that are determined by reference to LIBOR or correlated benchmark rates for those same periods. As each then-existing fixed rate repo borrowing matures, it will generally be replaced with a new fixed rate repo borrowing based on market interest rates established at that future date.

In the case of interest rate swaps, most of our agreements are structured such that we receive payments based on a variable interest rate and make payments based on a fixed interest rate. The variable interest rate on which payments are received is generally calculated based on various reset mechanisms for LIBOR. To the extent that our future repo borrowing costs continue to be highly correlated with LIBOR, our swap agreements help to reduce the variability of our overall borrowing costs, thus reducing risk to the extent we hold fixed rate assets that are financed with repo borrowings.

In the case of TBAs, most of our positions are short TBA positions with a negative duration, meaning that as interest rates rise, the value of the short position increases, so these positions serve as a hedge against increases in interest rates. In the event that interest rates rise, the increase in value of the short TBA position serves to offset corollary increases in our current and/or future borrowing costs under our repurchase agreements. While we primarily use TBAs to hedge interest rate risk, from time to time, we also hold net long positions in certain TBA securities as a means of acquiring exposure to Agency RMBS.



The composition and relative mix of our hedges may vary from period to period given the amount of our liabilities outstanding or anticipated to be entered into, the overall market environment and our view as to which instruments best enable us to execute our hedging goals.

#### Leverage

The following table summarizes our outstanding liabilities under repurchase agreements as of June 30, 2014 and December 31, 2013. We had no other borrowings outstanding.

| Remaining Days to Maturity | June 30, 2014          |               |   | December 31, 2013      |               |   |
|----------------------------|------------------------|---------------|---|------------------------|---------------|---|
|                            | Borrowings Outstanding | Interest Rate | Weighted Average Remaining Days to Maturity | Borrowings Outstanding | Interest Rate | Weighted Average Remaining Days to Maturity |
|                            | (In thousands)         |               |   |                        |               |   |
| 30 days or less            | \$397,482              | 0.33          | % 15  | \$338,700              | 0.35          | % 14  |
| 31-60 days                 | 469,254                | 0.32          | 44  | 531,799                | 0.39          | 46  |
| 61-90 days                 | 327,111                | 0.35          | 74  | 326,386                | 0.38          | 72  |
| 91-120 days                | 29,512                 | 0.38          | 106   | 109,476                | 0.45          | 100   |
| 121-150 days               | 23,005                 | 0.35          | 136   | 3,986                  | 0.56          | 136   |
| 151-180 days               | 39,229                 | 0.36          | 169   | —                      | —             | —   |
| Total                      | \$1,285,593            | 0.33          | % 50  | \$1,310,347            | 0.38          | % 49  |

We finance our assets with what we believe to be a prudent amount of leverage, which will vary from time to time based upon the particular characteristics of our portfolio, availability of financing, and market conditions. As of both June 30, 2014 and December 31, 2013, our borrowings consisted entirely of repurchase agreements collateralized by our Agency RMBS. Because our strategy is flexible, dynamic, and opportunistic, our overall leverage will vary over time. As of June 30, 2014 and December 31, 2013, our total debt-to-equity ratio was 7.52 to 1 and 7.84 to 1, respectively. Collateral transferred with respect to our outstanding repo borrowings as of June 30, 2014 and December 31, 2013 had an aggregate fair value of \$1.3 billion and \$1.4 billion, respectively, and was entirely comprised of Agency RMBS.

#### Shareholders' Equity

As of June 30, 2014, our shareholders' equity increased to \$171.0 million from \$167.2 million as of December 31, 2013. This increase principally consisted of an increase in net income partially offset by dividends declared. As of June 30, 2014, our book value per share was \$18.71 as compared to \$18.29 as of December 31, 2013.

As of December 31, 2013, our shareholders' equity increased to \$167.2 million from \$31.0 million as of December 31, 2012. On May 1, 2013, we priced an initial public offering of our common shares, pursuant to which we sold 6,450,000 shares to the public at a price of \$20.00 per share. Concurrent with the initial public offering, we completed a private placement with our initial shareholders which resulted in gross proceeds to us of \$21.0 million and the issuance of 1,050,000 shares at a price of \$20.00 per share. Total gross proceeds from the initial public offering and concurrent private placement were \$150.0 million. Proceeds, net of offering costs, were approximately \$148.5 million. In addition, for the year ended December 31, 2013, we recorded a net loss of \$1.9 million. Our net loss was primarily the result of net realized and unrealized losses on our mortgage-backed securities, partially offset by net realized and unrealized gain on our financial derivatives and net interest income. Our Board of Trustees declared three dividends during the year ended December 31, 2013 totaling \$1.14 per share. For the year ended December 31, 2013, total cash dividends paid or payable amounted to \$10.4 million and we have also incurred \$0.05 million of stock based compensation costs. As of December 31, 2013, our book value per share was \$18.29 as compared to \$18.96 as of December 31, 2012.

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Results of Operations for the Three Month Periods Ended June 30, 2014 and 2013:

The following table summarizes our results of operations for the three month periods ended June 30, 2014 and 2013:

| (In thousands except for per share amounts)  | Three Month<br>Period Ended<br>June 30, 2014 | Three Month<br>Period Ended<br>June 30, 2013 |
|--|--|--|
| Net Interest income  |  |  |
| Net interest income  | \$ 10,505                                    | \$ 3,785                                     |
| Expenses   |  |  |
| Management fees  | 567  | 703  |
| Other operating expenses   | 750  | 658  |
| Total expenses   | 1,317  | 1,361  |
| Other Income (Loss)  |  |  |
| Net realized and change in net unrealized gains (losses) on mortgage-backed securities | 25,806                                       | (48,790 )                                    |
| Net realized and change in net unrealized gains (losses) on financial derivatives      | (23,944 )                                    | 36,662                                       |
| Total Other Income (Loss)  | 1,862  | (12,128 )                                    |
| Net Income (Loss)  | \$ 11,050                                    | \$ (9,704 )                                  |
| Net Income (Loss) Per Common Share   | \$ 1.21                                      | \$ (1.55 )                                   |

Core Earnings

Core Earnings consists of net income (loss), excluding realized and unrealized gains and losses on mortgage-backed securities and financial derivatives, and, if applicable, items of income or loss that are of a non-recurring nature. Core Earnings includes net realized and unrealized gains and losses associated with payments and accruals of periodic payments on interest rate swaps. Core Earnings is a supplemental non-GAAP financial measure that we present as an additional measure of our operating performance. We believe Core Earnings provides information useful to investors because it is a metric utilized by management to assess our performance and to evaluate the effective net yield provided by our portfolio. Moreover, one of our objectives is to generate income from the net interest margin on our portfolio, and we use Core Earnings to help measure the extent to which we are achieving this objective. However, because Core Earnings is an incomplete measure of our financial results and differs from net income (loss) computed in accordance with GAAP, it should be considered as supplementary to, and not as a substitute for, our net income (loss) computed in accordance with GAAP.

The table below reconciles Core Earnings for the three month periods ended June 30, 2014 and 2013 to the line, Net Income (Loss), on our Consolidated Statement of Operations, which we believe is the most directly comparable GAAP measure:

| (In thousands except share amounts)  | Three Month<br>Period Ended<br>June 30, 2014 | Three Month<br>Period Ended<br>June 30, 2013 |
|--|--|--|
| Net Income (Loss)  | \$ 11,050                                    | \$ (9,704 )                                  |
| Less:  |  |  |
| Net realized gains (losses) on mortgage-backed securities  | 382  | (3,006 )                                     |
| Net realized gains (losses) on financial derivatives, excluding periodic payments <sup>(1)</sup>                     | (7,053 )                                     | 8,445  |
| Change in net unrealized gains (losses) on mortgage-backed securities  | 25,424                                       | (45,784 )                                    |
| Change in net unrealized gains (losses) on financial derivatives, excluding accrued periodic payments <sup>(2)</sup> | (14,533 )                                    | 29,328                                       |
| Subtotal   | 4,220  | (11,017 )                                    |
| Core Earnings  | \$ 6,830                                     | \$ 1,313                                     |
| Weighted Average Shares Outstanding  | 9,139,842                                    | 6,248,763                                    |
| Core Earnings Per Share  | \$ 0.75                                      | \$ 0.21                                      |

(1) For the three month period ended June 30, 2014, represents Net realized gains (losses) on financial derivatives of \$(11,155) less Net realized gains (losses) on periodic settlements of interest rate swaps of \$(4,102). For the three



month period ended June 30, 2013, represents Net realized gains (losses) on financial derivatives of \$8,376 less Net realized gains (losses) on periodic settlements of interest rate swaps of \$(69). See Note 5 in the notes to the consolidated financial statements.

For the three month period ended June 30, 2014, represents Net change in unrealized gains (losses) on financial derivatives of \$(12,789) less Change in net unrealized gains (losses) on accrued periodic settlements of interest rate (2)swaps of \$1,744. For the three month period ended June 30, 2013, represents Net change in unrealized gains (losses) on financial derivatives of \$28,286 less Change in net unrealized gains (losses) on accrued periodic settlements of interest rate swaps of \$(1,042). See Note 5 in the notes to the consolidated financial statements.

#### Net Income (Loss)

We had net income for the three month period ended June 30, 2014 of \$11.1 million, or \$1.21 per share, and we had Core Earnings of \$6.8 million, or \$0.75 per share. For the three month period ended June 30, 2013, we had net loss of \$(9.7) million, or \$(1.55) per share, and we had Core Earnings of \$1.3 million, or \$0.21 per share. The increase in net income period over period was principally due to an increase in interest income as well as an increase in change in unrealized gains (losses) on mortgage-backed securities.

#### Interest Income

Our primary source of income is the interest earned on our mortgage-backed securities. We began purchasing Agency RMBS in April 2013. Our portfolio as of both June 30, 2014 and 2013 consisted primarily of Agency RMBS, and to a lesser extent, non-Agency RMBS, and we earned approximately \$11.6 million and \$4.3 million in interest income on these securities for the three month periods ended June 30, 2014 and 2013, respectively. The increase in interest income period over period was due to our larger portfolio during the three month period ended June 30, 2014, as we were still ramping up our RMBS portfolio during the three month period ended June 30, 2013. For the three month period ended June 30, 2014, the weighted average yield on our mortgage-backed securities was 3.43%.

#### Interest Expense

For the three month periods ended June 30, 2014 and 2013, the vast majority of interest expense that we incurred was related to our repo borrowings, which we use to finance our assets. Our average outstanding borrowings for the three month period ended June 30, 2014 was \$1.24 billion, resulting in an average cost of funds of 0.34%. Our average outstanding borrowings for the three month period ended June 30, 2013 was \$550.7 million, resulting in an average cost of funds of 0.38%. Our interest expense for the three month period ended June 30, 2014 was \$1.1 million as compared to \$0.5 million for the three month period ended June 30, 2013. This increase was mainly due to our increased repo borrowings. The following table shows information related to our average cost of funds for the three month periods ended June 30, 2014 and 2013.

| (\$ in thousands)                      | Average Borrowed Funds | Interest Expense | Average Cost of Funds | Average One-Month LIBOR | Average Six-Month LIBOR |
|--|------------------------|------------------|-----------------------|-------------------------|-------------------------|
| Three Month Period Ended June 30, 2014 | \$1,239,899            | \$1,057          | 0.34 %                | 0.15 %                  | 0.32 %                  |
| Three Month Period Ended June 30, 2013 | \$550,721              | \$523            | 0.38 %                | 0.20 %                  | 0.42 %                  |

As an alternative measure of our cost of funds, we add to our average interest cost the net periodic amounts paid or payable by us on our interest rate swaps as a percentage of our average outstanding borrowings. Our net periodic expense paid or payable under our interest rate swaps was \$2.4 million for the three month period ended June 30, 2014, or 0.76% of our average outstanding borrowings, thereby resulting in average cost of funds including interest rate swaps of 1.10%. Our net periodic expense paid or payable under our interest rate swaps was \$1.1 million for the three month period ended June 30, 2013, or 0.81% of our average outstanding borrowings, thereby resulting in average cost of funds including interest rate swaps of 1.19%. This metric does not take into account other instruments that we use to hedge interest rate risk, such as TBAs and futures.

#### Management Fees

For the three month periods ended June 30, 2014 and 2013, our management fee expense was approximately \$0.6 million and \$0.7 million, respectively, which is based on shareholders' equity at the end of each quarter, excluding any unrealized gains (losses) included in shareholders' equity. The decrease in management fees for the three month period ended June 30, 2014 was primarily due to an increase in unrealized gains on mortgage-backed securities and financial derivatives for the three month period ended June 30, 2014 as compared to the three month period ended June 30, 2013.



Other Operating Expenses

Other operating expenses include professional fees and various other expenses necessary to operate our business. Other operating expenses for the three month period ended June 30, 2014 were approximately \$0.8 million, while for the three month period ended June 30, 2013, our other operating expenses were \$0.7 million. The increase in operating expenses period over period is due to the commensurate ramp-up in our operations following our May 2013 initial public offering. Our expense ratio, which represents our management fees and other operating expenses as a percentage of our average shareholders' equity was 3.1% on an annualized basis for the three month period ended June 30, 2014, as compared to 5.3% for the three month period ended June 30, 2013.

Other Income (Loss)

Other income (loss) consisted of net realized and net change in unrealized gain (losses) on mortgage-backed securities and financial derivatives. For the three month period ended June 30, 2014, other income was \$1.9 million, and consisted of net realized and unrealized gains of \$25.8 million on our mortgage-backed securities, primarily our Agency RMBS, partially offset by net realized and unrealized losses of approximately \$23.9 million on our financial derivatives. Similar to the first quarter, long-term interest rates declined during the second quarter, causing our mortgage-backed securities to increase in value and our interest rate hedges to decline in value. Other loss for the three month period ended June 30, 2013 was \$12.1 million and consisted of net realized and unrealized losses on our mortgage-backed securities of \$48.8 million partially offset by realized and unrealized gains of \$36.7 million on our financial derivatives.

Results of Operations for the Six Month Periods Ended June 30, 2014 and 2013:

The following table summarizes our results of operations for the six month periods ended June 30, 2014 and 2013:

| (In thousands except for per share amounts)  | Six Month<br>Period Ended<br>June 30, 2014 | Six Month<br>Period Ended<br>June 30, 2013 |
|--|--|--|
| Net Interest income  |  |  |
| Net interest income  | \$21,309                                   | \$4,067                                    |
| Expenses   |  |  |
| Management fees  | 1,159                                      | 823  |
| Other operating expenses   | 1,552                                      | 734  |
| Total expenses   | 2,711                                      | 1,557                                      |
| Other Income (Loss)  |  |  |
| Net realized and change in net unrealized gains (losses) on mortgage-backed securities | 40,362                                     | (47,746 )                                  |
| Net realized and change in net unrealized gains (losses) on financial derivatives      | (45,149 )                                  | 36,662 )                                   |
| Total Other Income (Loss)  | (4,787 )                                   | (11,084 )                                  |
| Net Income (Loss)  | \$13,811                                   | \$(8,574 )                                 |
| Net Income (Loss) Per Common Share   | \$1.51                                     | \$(2.17 )                                  |

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Core Earnings

The table below reconciles Core Earnings for the six month periods ended June 30, 2014 and 2013 to the line, Net Income (Loss), on our Consolidated Statement of Operations, which we believe is the most directly comparable GAAP measure:

| (In thousands except share amounts)  | Six Month<br>Period Ended<br>June 30, 2014 | Six Month<br>Period Ended<br>June 30, 2013 |
|--|--|--|
| Net Income (Loss)  | \$13,811                                   | \$(8,574 )                                 |
| Less:  |  |  |
| Net realized gains (losses) on mortgage-backed securities  | (2,643 )                                   | (2,117 )                                   |
| Net realized gains (losses) on financial derivatives, excluding periodic payments <sup>(1)</sup>                     | (9,668 )                                   | 8,445                                      |
| Change in net unrealized gains (losses) on mortgage-backed securities  | 43,005                                     | (45,629 )                                  |
| Change in net unrealized gains (losses) on financial derivatives, excluding accrued periodic payments <sup>(2)</sup> | (30,745 )                                  | 29,328                                     |
| Subtotal   | (51 )                                      | (9,973 )                                   |
| Core Earnings  | \$13,862                                   | \$1,399                                    |
| Weighted Average Shares Outstanding  | 9,139,842                                  | 3,953,820                                  |
| Core Earnings Per Share  | \$1.52                                     | \$0.35                                     |

For the six month period ended June 30, 2014, represents Net realized gains (losses) on financial derivatives of \$(14,564) less Net realized gains (losses) on periodic settlements of interest rate swaps of \$(4,896). For the six (1) month period ended June 30, 2013, represents Net realized gains (losses) on financial derivatives of \$8,376 less Net realized gains (losses) on periodic settlements of interest rate swaps of \$(69). See Note 5 in the notes to the consolidated financial statements.

For the six month period ended June 30, 2014, represents Net change in unrealized gains (losses) on financial derivatives of \$(30,585) less Change in net unrealized gains (losses) on accrued periodic settlements of interest rate (2) swaps of \$160. For the six month period ended June 30, 2013, represents Net change in unrealized gains (losses) on financial derivatives of \$28,286 less Change in net unrealized gains (losses) on accrued periodic settlements of interest rate swaps of \$(1,042). See Note 5 in the notes to the consolidated financial statements.

Net Income (Loss)

We had net income for the six month period ended June 30, 2014 of \$13.8 million, or \$1.51 per share, and we had Core Earnings of \$13.9 million, or \$1.52 per share. For the six month period ended June 30, 2013, we had a net loss of \$(8.6) million, or \$(2.17) per share, and we had Core Earnings of \$1.4 million, or \$0.35 per share. The increase in net income period over period was principally due to an increase in interest income as well as a decrease in net realized and unrealized losses on our mortgage-backed securities and financial derivatives.

Interest Income

Our portfolio as of both June 30, 2014 and 2013 consisted primarily of Agency RMBS, and to a lesser extent, non-Agency RMBS. We earned approximately \$23.5 million and \$4.6 million in interest income on these securities for the six month periods ended June 30, 2014 and 2013, respectively. The increase in interest income period over period was due to our larger portfolio during the six month period ended June 30, 2014 as we were still ramping up our portfolio during the six month period ended June 30, 2013. For the six months ended June 30, 2014, the weighted average yield on our mortgage-backed securities was 3.45%. For the six month period ended June 30, 2014, interest income includes \$0.3 million related to the effects of a downward adjustment to premium amortization (accompanied by a corresponding \$0.3 million downward adjustment to realized and unrealized gains), as higher interest rates have caused a decline in prepayments.

Interest Expense

For the six month periods ended June 30, 2014 and 2013, the vast majority of interest expense that we incurred was related to our repo borrowings, which we use to finance our assets. Our average outstanding borrowings for the six month period ended June 30, 2014 was \$1.25 billion, resulting in an average cost of funds of 0.36%. Our average outstanding borrowings for the six month period ended June 30, 2013 was \$276.9 million, resulting in an average cost of funds of 0.38%. Our interest expense for the six month period ended June 30, 2014 was \$2.2 million as compared

to \$0.5 million for the six month period ended June 30, 2013. This increase was mainly due to our increased average outstanding repo borrowings, as we did not have any repurchase agreements prior to April 2013.

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The following table shows information related to our average cost of funds for the six month periods ended June 30, 2014 and 2013.

| (\$ in thousands)                    | Average<br>Borrowed<br>Funds | Interest<br>Expense | Average<br>Cost of<br>Funds | Average<br>One-Month<br>LIBOR | Average<br>Six-Month<br>LIBOR |
|--------------------------------------|------------------------------|---------------------|-----------------------------|-------------------------------|-------------------------------|
| Six Month Period Ended June 30, 2014 | \$1,249,844                  | \$2,205             | 0.36                        | % 0.15                        | % 0.33                        |
| Six Month Period Ended June 30, 2013 | \$276,882                    | \$523               | 0.38                        | % 0.20                        | % 0.42                        |

As an alternative measure of our cost of funds, we add to our average interest cost the net periodic amounts paid or payable by us on our interest rate swaps as a percentage of our average outstanding borrowings. Our net periodic expense paid or payable under our interest rate swaps was \$4.7 million for the six month period ended June 30, 2014, or 0.76% of our average outstanding borrowings, thereby resulting in an average cost of funds including interest rate swaps of 1.12%. Our net periodic expense paid or payable under our interest rate swaps was \$1.1 million for the six month period ended June 30, 2013, or 0.81% of our average outstanding borrowings, thereby resulting in an average cost of funds including interest rate swaps of 1.19%. This metric does not take into account other instruments that we use to hedge interest rate risk, such as TBAs and futures.

### Management Fees

For the six month periods ended June 30, 2014 and 2013, our management fee expense was approximately \$1.2 million and \$0.8 million, respectively, which is based on shareholders' equity at the end of each quarter, excluding any unrealized gains (losses) included in shareholders' equity. The increase in management fees for the six month period ended June 30, 2014 was primarily due to our larger capital base.

### Other Operating Expenses

Other operating expenses include professional fees and various other expenses necessary to operate our business. Other operating expenses for the six month period ended June 30, 2014 were approximately \$1.6 million, while for the six month period ended June 30, 2013, our other operating expenses were approximately \$0.7 million. The increase in operating expenses period over period is due to the commensurate ramp-up in our operations following our May 2013 initial public offering. Our expense ratio, which represents our management fees and other operating expenses as a percentage of our average shareholders' equity was 3.2% on an annualized basis for the six month period ended June 30, 2014, as compared to 4.3% for the six month period ended June 30, 2013.

### Other Income (Loss)

Other income (loss) consisted of net realized and net change in unrealized gain (losses) on mortgage-backed securities and financial derivatives. For the six month period ended June 30, 2014, other loss was \$4.8 million, and consisted of net realized and unrealized losses of \$45.1 million on our financial derivatives, partially offset by net realized and unrealized gains of approximately \$40.4 million on our mortgage-backed securities, primarily our Agency RMBS. Long-term interest rates declined over the course of the six month period, causing our mortgage-backed securities to increase in value and our derivatives to decline in value. Other loss for the six month period ended June 30, 2013 was \$11.1 million and consisted of net realized and unrealized losses of \$47.7 million on our RMBS, principally our Agency RMBS, partially offset by net realized and unrealized gains of approximately \$36.7 million on our financial derivatives.

### Liquidity and Capital Resources

Liquidity refers to our ability to meet our cash needs, including repaying our borrowings, funding and maintaining RMBS and other assets, paying dividends, and other general business needs. Our short-term (one year or less) and long-term liquidity requirements include acquisition costs for assets we acquire, payment of our management fee, compliance with margin requirements under our repurchase agreements, TBA and other financial derivative contracts, repayment of repurchase agreement borrowings to the extent we are unable or unwilling to extend our repurchase agreements, the payment of dividends, and payment of our general operating expenses. Our capital resources primarily include cash on hand, cash flow from our investments (including monthly principal and interest payments received on our RMBS and proceeds from the sale of mortgage-backed securities), borrowings under repurchase agreements, and proceeds from equity offerings. We expect that these sources of funds will be sufficient to meet our short-term and long-term liquidity needs.

We borrow funds in the form of repurchase agreements. The terms of these borrowings under our Master Repurchase Agreements, or "MRAs," generally conform to the terms in the standard master repurchase agreement as published by the

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Securities Industry and Financial Markets Association as to repayment and margin requirements. In addition, each lender typically requires that we include supplemental terms and conditions to the standard MRA. Typical supplemental terms and conditions include the addition of or changes to provisions relating to margin calls, net asset value requirements, cross default provisions, certain key person events, changes in corporate structure, and requirements that all controversies related to the repurchase agreement be litigated in a particular jurisdiction. These provisions may differ for each of our lenders.

As of both June 30, 2014 and December 31, 2013, we had \$1.3 billion outstanding under our repurchase agreements. As of June 30, 2014, we had MRAs in place with twelve counterparties and our outstanding repurchase agreements were with ten counterparties.

Amount at risk represents the aggregate excess, if any, for each counterparty of the fair value of collateral held by such counterparty over the amounts outstanding under repurchase agreements. The following table reflects counterparties for which the amounts at risk relating to the Company's repurchase agreements was greater than 5% of shareholders' equity as of June 30, 2014 and December 31, 2013.

June 30, 2014:

| Counterparty                | Amount at Risk <sup>(1)</sup> | Weighted Average Remaining Days to Maturity | Percentage of Shareholders' Equity |   |
|-----------------------------|-------------------------------|---|------------------------------------|---|
|                             | (In thousands)                |   |                                    |   |
| Deutsche Bank Securities    | \$14,288                      | 58  | 8.4                                | % |
| Bank of America Securities  | \$12,460                      | 62  | 7.3                                | % |
| RBC Capital Markets LLC     | \$11,223                      | 48  | 6.6                                | % |
| Barclays Capital Inc.       | \$9,924                       | 32  | 5.8                                | % |
| J.P. Morgan Securities Inc. | \$9,203                       | 58  | 5.4                                | % |

(1) Amounts at risk exclude, in aggregate, \$3.1 million of net accrued interest, defined as accrued interest on securities held as collateral less interest payable on cash borrowed.

December 31, 2013:

| Counterparty                | Amount at Risk <sup>(1)</sup> | Weighted Average Remaining Days to Maturity | Percentage of Shareholders' Equity |   |
|-----------------------------|-------------------------------|---|------------------------------------|---|
|                             | (In thousands)                |   |                                    |   |
| Deutsche Bank Securities    | \$20,180                      | 29  | 12.1                               | % |
| J.P. Morgan Securities Inc. | \$13,919                      | 54  | 8.3                                | % |
| Bank of America Securities  | \$11,588                      | 69  | 6.9                                | % |

(1) Amounts at risk exclude, in aggregate, \$2.3 million of net accrued interest, defined as accrued interest on securities held as collateral less interest payable on cash borrowed.

The amounts borrowed under our repurchase agreements are generally subject to the application of "haircuts." A haircut is the percentage discount that a repo lender applies to the market value of an asset serving as collateral for a repo borrowing, for the purpose of determining whether such reverse repo borrowing is adequately collateralized. As of June 30, 2014 and December 31, 2013, the weighted average contractual haircut applicable to the assets that serve as collateral for the Company's outstanding repo borrowings was 4.3% and 4.6%, respectively. As of both June 30, 2014 and December 31, 2013, all of the Company's repo borrowings were related to its Agency RMBS.

We held cash and cash equivalents of approximately \$49.9 million and \$50.1 million as of June 30, 2014 and December 31, 2013, respectively.

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We may declare dividends based on, among other things, our earnings, our financial condition, the REIT qualification requirements of the Internal Revenue Code, our working capital needs and new opportunities. The declaration of dividends to our shareholders and the amount of such dividends are at the discretion of our Board of Trustees. The following table sets forth the dividend distributions authorized by the Board of Trustees for the periods indicated below:

### Six Month Period Ended June 30, 2014

|                | Dividend<br>Per Share | Dividend<br>Amount<br>(In thousands) | Declaration Date | Record Date    | Payment Date   |
|----------------|-----------------------|--------------------------------------|------------------|----------------|----------------|
| First Quarter  | \$0.55                | \$5,027                              | March 12, 2014   | March 31, 2014 | April 28, 2014 |
| Second Quarter | \$0.55                | \$5,027                              | June 17, 2014    | June 30, 2014  | July 25, 2014  |

### Six Month Period Ended June 30, 2013

|                | Dividend<br>Per Share | Dividend<br>Amount<br>(In thousands) | Declaration Date | Record Date   | Payment Date  |
|----------------|-----------------------|--------------------------------------|------------------|---------------|---------------|
| Second Quarter | \$0.14                | \$1,279                              | June 18, 2013    | June 28, 2013 | July 26, 2013 |

The Board of Trustees did not declare any cash dividends prior to the second quarter of 2013.

For the six month period ended June 30, 2014, our operating activities provided net cash of \$9.9 million and our investing activities provided net cash of \$24.3 million. Our repo activity used to finance our Agency RMBS (including repayments, in conjunction with the sales of Agency RMBS, of amounts borrowed under our repurchase agreements) used net cash of \$24.8 million. Thus our operating and investing activities, when combined with our net repo financing activities, provided net cash of \$9.4 million. We used \$9.6 million to pay dividends. As a result of these activities, there was a decrease in our cash holdings of \$0.2 million from \$50.1 million as of December 31, 2013 to \$49.9 million as of June 30, 2014.

For the six month period ended June 30, 2013, our operating activities used net cash of \$14.0 million and our investing activities used net cash of \$1.32 billion. Thus our operating and investing activities, when combined, used net cash of \$1.33 billion for the six month period ended June 30, 2013. We received \$150.0 million in gross proceeds from issuance of common shares. We also received cash from borrowing under repurchase agreements (net of repayments) of \$1.22 billion. We used \$0.1 million to pay offering costs. As a result of these activities, there was an increase in our cash holdings of \$34.2 million from \$18.2 million as of December 31, 2012 to \$52.3 million as of June 30, 2013.

On August 13, 2013, our Board of Trustees approved the adoption of a \$10 million share repurchase program. The program, which is open-ended in duration, allows us to make repurchases from time to time on the open market or in negotiated transactions. Repurchases are at our discretion, subject to applicable law, share availability, price and our financial performance, among other considerations. No purchases have been made under the program to date. Based on our current portfolio, amount of free cash on hand, debt-to-equity ratio and current and anticipated availability of credit, we believe that our capital resources will be sufficient to enable us to meet anticipated short-term and long-term liquidity requirements.

We are not required by our investment guidelines to maintain any specific debt-to-equity ratio, and we believe that the appropriate leverage for the particular assets we hold depends on the credit quality and risk of those assets, as well as the general availability and terms of stable and reliable financing for those assets.

### Contractual Obligations and Commitments

We are a party to a management agreement with our Manager. Pursuant to that agreement, our Manager is entitled to receive a management fee based on shareholders' equity, reimbursement of certain expenses and, in certain circumstances, a termination fee. Such fees and expenses do not have fixed and determinable payments. For a description of the management agreement provisions, see Note 10 to our consolidated financial statements.

We enter into repurchase agreements with third-party broker-dealers whereby we sell securities to such broker-dealers at agreed-upon purchase prices at the initiation of the repurchase agreements and agree to repurchase such securities at predetermined repurchase prices and termination dates, thus providing the broker-dealers with an implied interest rate on the funds initially transferred to us by the broker-dealers. We may enter into reverse repurchase agreements with

third-party broker-dealers whereby we purchase securities under agreements to resell at an agreed-upon price and date. In general, we most often will enter into reverse repurchase agreement transactions in order to effectively borrow securities that we can then deliver to counterparties to whom we have made short sales of the same securities. The implied interest rates on the repurchase agreements and reverse repurchase agreements we enter into are based upon competitive market rates at the time of initiation. Repurchase agreements and reverse repurchase agreements that are conducted with the same counterparty may be reported on a

net basis if they meet the requirements of ASC 210-20, Balance Sheet, Offsetting. As of both June 30, 2014 and December 31, 2013, there were no repurchase agreements and reverse repurchase agreements reported on a net basis on the Consolidated Balance Sheet.

As of June 30, 2014 we had \$1.3 billion of outstanding borrowings with ten counterparties and as of December 31, 2013 we had \$1.3 billion of outstanding borrowings with nine counterparties. As of June 30, 2014, we had MRAs with twelve counterparties. We expect to continue to have discussions with various other financial institutions in order to expand our repurchase agreement capacity.

#### Off-Balance Sheet Arrangements

As of June 30, 2014 and December 31, 2013, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities nor do we have any commitment or intent to provide funding to any such entities. As such, we are not materially exposed to any market, credit, liquidity, or financing risk that could arise if we had engaged in such relationships.

#### Inflation

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

The primary components of our market risk are related to interest rate risk, prepayment risk, and credit risk. We seek to actively manage these and other risks and to acquire and hold assets that we believe justify bearing those risks, and to maintain capital levels consistent with those risks.

#### Interest Rate Risk

Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations, and other factors beyond our control. We are subject to interest rate risk in connection with most of our assets and liabilities. For some securities in our portfolio, the coupon interest rates on, and therefore also the values of, such securities are highly sensitive to interest rate movements, such as inverse floating rate RMBS, which benefit from falling interest rates. Subject to qualifying and maintaining our qualification as a REIT and our exemption from registration under the Investment Company Act, we opportunistically hedge our interest rate risk by entering into interest rate swaps, TBAs, U.S. Treasury securities, Eurodollar and U.S. Treasury futures, and other instruments. In general, such hedging instruments are used to offset the large majority of the interest rate risk we estimate to arise from our repurchase agreement indebtedness associated with our Agency RMBS positions. Hedging instruments may also be used to offset a portion of the interest rate risk arising from our repurchase agreement liabilities associated with non-Agency RMBS positions, if any.

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In addition to measuring and mitigating the risk related to changes in interest rates with respect to the generally shorter-term liabilities we incur to acquire and hold generally longer-lived RMBS, we also monitor the effect of changes in interest rates on the discounted present value of our portfolio of assets and liabilities. The following sensitivity analysis table shows the estimated impact on the fair value of our portfolio segregated by certain identified categories as of June 30, 2014, assuming a static portfolio and immediate and parallel shifts in interest rates from current levels as indicated below.

| (In thousands)                    | Estimated Change in Value<br>for a Decrease in Interest<br>Rates by |                     | Estimated Change in Value<br>for an Increase in Interest<br>Rates by |                     |
|-----------------------------------|---|---------------------|--|---------------------|
|                                   | 50 Basis<br>Points  | 100 Basis<br>Points | 50 Basis<br>Points   | 100 Basis<br>Points |
|                                   | Agency RMBS, excluding TBAs   | \$24,020            | \$39,610   | \$(32,450)          |
| TBAs                              | (7,896)   | (12,530)            | 11,161   | 25,584              |
| Non-Agency RMBS                   | 516   | 1,056               | (493)  | (962)               |
| Interest Rate Swaps and Swaptions | (19,033)  | (38,911)            | 18,186   | 35,526              |
| Repurchase Agreements             | (584)   | (584)               | 857  | 1,715               |
| Total                             | \$(2,977)   | \$(11,359)          | \$(2,739)  | \$(11,466)          |

Our analysis of interest rate risk is derived from Ellington's proprietary models as well as third-party information and analytics. Many assumptions have been made in connection with the calculations set forth in the table above and, as such, there can be no assurance that assumed events will occur or that other events will not occur that would affect the outcomes. For example, for each hypothetical immediate shift in interest rates, assumptions have been made as to the response of mortgage prepayment rates, the shape of the yield curve, and market volatilities of interest rates; each of the foregoing factors can significantly and adversely affect the fair value of our interest rate sensitive instruments. The above analysis utilizes assumptions and estimates based on management's judgment and experience, and relies on financial models, which are inherently imperfect; in fact, different models can produce different results for the same securities. While the table above reflects the estimated impacts of immediate parallel interest rate increases and decreases on specific categories of instruments in our portfolio, we intend to actively trade many of the instruments in our portfolio and intend to diversify our portfolio to reflect a portfolio comprised primarily of Agency RMBS, and, to a lesser extent, non-Agency RMBS and mortgage-related assets. Therefore, our current or future portfolios may have risks that differ significantly from those of our June 30, 2014 portfolio estimated above. Moreover, the impact of changing interest rates on fair value can change significantly when interest rates change by a greater amount than the hypothetical shifts assumed above. Furthermore, our portfolio is subject to many risks other than interest rate risks, and these additional risks may or may not be correlated with changes in interest rates. For all of the foregoing reasons and others, the table above is for illustrative purposes only and actual changes in interest rates would likely cause changes in the actual fair value of our portfolio that would differ from those presented above, and such differences might be significant and adverse. See "Special Note Regarding Forward-Looking Statements."

#### Prepayment Risk

Prepayment risk is the risk of change, whether an increase or a decrease, in the rate at which principal is returned in respect of mortgage loans underlying RMBS, including both through voluntary prepayments and through liquidations due to defaults and foreclosures. This rate of prepayment is affected by a variety of factors, including the prevailing level of interest rates as well as economic, demographic, tax, social, legal, and other factors. Changes in prepayment rates will have varying effects on the different types of securities in our portfolio. We attempt to take these effects into account in making asset management decisions with respect to our assets. Additionally, increases in prepayment rates may cause us to experience losses on our interest only securities, or "IOs," and inverse interest only securities, or "IIOs," as these securities are extremely sensitive to prepayment rates. Finally, prepayment rates, besides being subject to interest rates and borrower behavior, are also substantially affected by government policy and regulation.

#### Credit Risk

We are subject to credit risk in connection with our assets, especially our non-Agency RMBS. Credit losses on real estate loans underlying our non-Agency RMBS can occur for many reasons, including, but not limited to, poor origination practices, fraud, faulty appraisals, documentation errors, poor underwriting, legal errors, poor servicing

practices, weak economic conditions, decline in the value of homes, special hazards, earthquakes and other natural events, over-leveraging of the borrower on the property, reduction in market rents and occupancies and poor property management services in the case of rented homes, changes in legal protections for lenders, reduction in personal income, job loss, and personal events such as divorce or health problems. Property values are subject to volatility and may be affected adversely by a number of factors,

including, but not limited to, national, regional, and local economic conditions (which may be adversely affected by industry slowdowns and other factors), 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. For mortgage-related instruments, the two primary components of credit risk are default risk and severity risk.

#### Default Risk

Default risk is the risk that borrowers will fail to make principal and interest payments on their mortgage loans. Subject to qualifying and maintaining our qualification as a REIT and our exemption from registration under the Investment Company Act, we may selectively attempt to mitigate our default risk by, among other things, opportunistically entering into credit default swaps and total return swaps. These instruments can reference various RMBS indices, corporate bond indices, or corporate entities, such as publicly traded REITs. We also rely on third-party mortgage servicers to mitigate our default risk, but such third-party mortgage servicers may have little or no economic incentive to mitigate loan default rates.

#### Severity Risk

Severity risk is the risk of loss upon a borrower default on a mortgage loan underlying our RMBS. Severity risk includes the risk of loss of value of the property underlying the mortgage loan as well as the risk of loss associated with taking over the property, including foreclosure costs. We rely on third-party mortgage servicers to mitigate our severity risk, but such third-party mortgage servicers may have little or no economic incentive to mitigate loan loss severities. Such mitigation efforts may include loan modification programs and prompt foreclosure and property liquidation following a default.

### Item 4. Controls and Procedures

#### Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC, and that such information is accumulated and communicated to our management as appropriate to allow timely decisions regarding required disclosures. An evaluation was performed under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of June 30, 2014. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of June 30, 2014.

#### Internal Control Over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the three month period ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

Neither we nor our Manager are currently subject to any legal proceedings that we or our Manager consider to be material. Nevertheless, at any time, industry-wide or company-specific regulatory inquiries or proceedings can be initiated and we cannot predict when or if any such regulatory inquiries or proceedings will be initiated that involve us, Ellington, or its affiliates, including our Manager. See "Risk Factors—We, Ellington, or its affiliates may be subject to regulatory inquiries or proceedings" included in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013. Ellington and its affiliates have, over the years, received, and we expect in the future that they may receive, inquiries and requests for documents and information from various regulators.

We can give no assurances that regulatory inquiries will not result in investigations of Ellington or its affiliates or enforcement actions, fines or penalties or the assertion of private litigation claims against Ellington or its affiliates. In the event regulatory inquiries were to result in investigations, enforcement actions, fines, penalties, or the assertion of private litigation claims against Ellington or its affiliates, our Manager's ability to perform its obligations to us under the Management Agreement between us and our Manager, or Ellington's ability to perform its obligations to our Manager under the services agreement between Ellington and our Manager, could be adversely impacted, which could

in turn have a material adverse effect on our business, financial condition and results of operations, and our ability to make distributions to our shareholders.

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Item 1A. Risk Factors

For information regarding factors that could affect our results of operations, financial condition, and liquidity, see the risk factors discussed under "Risk Factors" in Part I, Item 1A of our Annual Report on Form 10-K for the year ended December 31, 2013. There have been no material changes from these previously disclosed risk factors. See also "Special Note Regarding Forward-Looking Statements," included in Part I, Item 2 of this Quarterly Report on Form 10-Q.

Item 5. Other Information

Pursuant to Section 13(r) of the Exchange Act, if during the fiscal quarter ended June 30, 2014, we or any of our affiliates had engaged in certain transactions with Iran or with persons or entities designated under certain executive orders, we would be required to disclose information regarding such transactions in our Quarterly Report on Form 10-Q as required under Section 219 of the Iran Threat Reduction and Syria Human Rights Act of 2012 ("ITRA"). During the fiscal quarter ended June 30, 2014, we did not engage in any transactions with Iran or with persons or entities related to Iran.

Blackstone Tactical Opportunities EARN Holdings L.L.C., an affiliate of The Blackstone Group L.P. ("Blackstone"), is a holder of approximately 28% of the outstanding equity interests of our Common Shares and has a representative on our Board of Trustees. Accordingly, Blackstone may be deemed an "affiliate" of us, as that term is defined in Exchange Act Rule 12b-2. We have received notice from Blackstone that it may include in its Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2014 disclosures pursuant to ITRA regarding one of its portfolio companies that may be deemed to be an affiliate of Blackstone. Because of the broad definition of "affiliate" in Exchange Act Rule 12b-2, this portfolio company of Blackstone, through Blackstone's ownership of us, may also be deemed to be an affiliate of ours.

We have reproduced below the disclosure of Travelport Limited, as provided to us by Blackstone. Travelport Limited may be considered an affiliate of Blackstone. We have no involvement in or control over the activities of Travelport Limited, any of its predecessor companies or any of its subsidiaries, and we have not independently verified or participated in the preparation of this disclosure.

"As part of our global business in the travel industry, we provide certain passenger travel-related GDS and airline IT services to Iran Air. We also provide certain airline IT services to Iran Air Tours. All of these services are either exempt from applicable sanctions prohibitions pursuant to a statutory exemption permitting transactions ordinarily incident to travel or, to the extent not otherwise exempt, specifically licensed by the U.S. Office of Foreign Assets Control. Subject to any changes in the exempt/licensed status of such activities, we intend to continue these business activities, which are directly related to and promote the arrangement of travel for individuals.

The gross revenue and net profit attributable to these activities in the quarter ended June 30, 2014 were approximately \$161,000 and \$117,000, respectively."

Neither Travelport Limited nor Blackstone has provided us with gross revenues and net profits attributable to the activities described above.

Item 6. Exhibits

| Exhibit | Description   |
|---------|---|
| 31.1    | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes – Oxley Act of 2002  |
| 31.2    | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes – Oxley Act of 2002  |
| 32.1*   | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes – Oxley Act of 2002   |
| 32.2*   | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes – Oxley Act of 2002   |
| 101**   | The following financial information from Ellington Residential Mortgage REIT's Quarterly Report on Form 10-Q for the three month period ended June 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Balance Sheet, (ii) Consolidated Statement of Operations, (iii) Consolidated Statement of Shareholders' Equity, (iv) Consolidated Statement of Cash Flows and (v) Notes to Consolidated Financial Statements. |

\*Furnished herewith. These certifications are not deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

Users of this data are advised pursuant to Rule 406T of Regulation S-T that this interactive data file is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, \*\* is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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.

Date: August 12, 2014

ELLINGTON RESIDENTIAL MORTGAGE REIT

By: /s/ LAURENCE PENN

Laurence Penn

Chief Executive Officer

(Principal Executive Officer)

Date: August 12, 2014

ELLINGTON RESIDENTIAL MORTGAGE REIT

By: /s/ LISA MUMFORD

Lisa Mumford

Chief Financial Officer

(Principal Financial and Accounting Officer)

EXHIBIT INDEX

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