

Edgar Filing: Ellington Residential Mortgage REIT - Form 10-Q

Ellington Residential Mortgage REIT  
Form 10-Q  
November 07, 2018

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 September 30, 2018

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)

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)

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

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

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

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer (do not check if a smaller reporting company)  Smaller Reporting Company   
Emerging Growth Company

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

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

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 November 2, 2018
Common Shares of Beneficial Interest, \$0.01 par value per share	12,609,837



ELLINGTON RESIDENTIAL MORTGAGE REIT

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## PART I. FINANCIAL INFORMATION

## Item 1. Consolidated Financial Statements (unaudited)

## ELLINGTON RESIDENTIAL MORTGAGE REIT

## CONSOLIDATED BALANCE SHEET

(UNAUDITED)

	September 30, 2018	December 31, 2017
(In thousands except for share amounts)		
<b>ASSETS</b>		
Cash and cash equivalents	\$ 41,016	\$ 56,117
Mortgage-backed securities, at fair value	1,575,983	1,685,998
Due from brokers	27,044	26,754
Financial derivatives—assets, at fair value	23,049	8,792
Reverse repurchase agreements	26,769	81,461
Receivable for securities sold	52,531	21,606
Interest receivable	5,675	5,784
Other assets	717	575
Total Assets	\$ 1,752,784	\$ 1,887,087
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Repurchase agreements	\$ 1,500,632	\$ 1,597,206
Payable for securities purchased	36,539	3,830
Due to brokers	8,298	489
Financial derivatives—liabilities, at fair value	333	1,863
U.S. Treasury securities sold short, at fair value	26,367	81,289
Dividend payable	4,700	4,936
Accrued expenses	704	728
Management fee payable to affiliate	641	725
Interest payable	4,340	3,318
Total Liabilities	1,582,554	1,694,384
<b>SHAREHOLDERS' EQUITY</b>		
Preferred shares, par value \$0.01 per share, 100,000,000 shares authorized; (0 shares issued and outstanding, respectively)	—	—
Common shares, par value \$0.01 per share, 500,000,000 shares authorized; (12,703,474 and 13,340,217 shares issued and outstanding, respectively)	127	134
Additional paid-in-capital	232,967	240,062
Accumulated deficit	(62,864	) (47,493 )
Total Shareholders' Equity	170,230	192,703
Total Liabilities and Shareholders' Equity	\$ 1,752,784	\$ 1,887,087

See Notes to Consolidated Financial Statements

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ELLINGTON RESIDENTIAL MORTGAGE REIT  
CONSOLIDATED STATEMENT OF OPERATIONS  
(UNAUDITED)

	Three-Month Period Ended September 30, 2018		Nine-Month Period Ended September 30, 2017	
(In thousands except for per share amounts)				
<b>INTEREST INCOME (EXPENSE)</b>				
Interest income	\$13,171	\$12,867	\$40,677	\$36,078
Interest expense	(8,519 )	(5,719 )	(23,434 )	(12,917 )
Total net interest income	4,652	7,148	17,243	23,161
<b>EXPENSES</b>				
Management fees to affiliate	641	741	1,968	1,953
Professional fees	198	157	651	510
Compensation expense	136	222	511	597
Insurance expense <sup>(1)</sup>	74	74	221	230
Other operating expenses <sup>(1)</sup>	283	287	924	900
Total expenses	1,332	1,481	4,275	4,190
<b>OTHER INCOME (LOSS)</b>				
Net realized gains (losses) on securities	(8,402 )	349	(13,590 )	(3,001 )
Net realized gains (losses) on financial derivatives	4,058	(2,981 )	16,311	(10,455 )
Change in net unrealized gains (losses) on securities	(2,636 )	3,994	(32,915 )	5,783
Change in net unrealized gains (losses) on financial derivatives	4,606	(689 )	16,005	(1,302 )
Total other income (loss)	(2,374 )	673	(14,189 )	(8,975 )
<b>NET INCOME (LOSS)</b>	<b>\$946</b>	<b>\$6,340</b>	<b>\$(1,221)</b>	<b>\$9,996</b>
<b>NET INCOME (LOSS) PER COMMON SHARE:</b>				
Basic and Diluted	\$0.07	\$0.48	\$(0.09 )	\$0.91

(1) Conformed to current period presentation.

See Notes to Consolidated Financial Statements

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

	Common Shares	Common Shares, par value	Preferred Shares	Preferred Shares, par value	Additional Paid-in-Capital	Accumulated (Deficit) Earnings	Total
(In thousands except for share amounts)							
BALANCE, December 31, 2016	9,130,897	\$ 92	—	\$ —	\$ 180,996	\$(39,411)	\$141,677
Shares issued <sup>(1)</sup>	4,194,968	42	—	—	59,061		59,103
Offering costs					(191)		(191)
Issuance of restricted shares	9,976	—	—	—	—		—
Forfeiture of common shares to satisfy tax withholding obligations	(37)	—			—		—
Share based compensation					144		144
Dividends declared <sup>(2)</sup>						(13,934)	(13,934)
Net income						9,996	9,996
BALANCE, September 30, 2017	13,335,804	\$ 134	—	\$ —	\$ 240,010	\$(43,349)	\$196,795
BALANCE, December 31, 2017	13,340,217	\$ 134	—	\$ —	\$ 240,062	\$(47,493)	\$192,703
Issuance of restricted shares	13,144	—	—	—	—		—
Share based compensation					149		149
Repurchase of common shares	(649,887)	(7)	—	—	(7,244)		(7,251)
Dividends declared <sup>(2)</sup>						(14,150)	(14,150)
Net loss						(1,221)	(1,221)
BALANCE, September 30, 2018	12,703,474	\$ 127	—	\$ —	\$ 232,967	\$(62,864)	\$170,230

(1) For the nine-month period ended September 30, 2017 proceeds from the issuance of shares is net of an underwriters' discount of \$1.9 million and third-party agent commissions and fees of \$0.2 million.

(2) For the three-month periods ended September 30, 2018 and 2017, dividends totaling \$0.37 and \$0.40, respectively, per common share outstanding, were declared. For the nine-month periods ended September 30, 2018 and 2017, dividends totaling \$1.11 and \$1.20, respectively, per common share outstanding, were declared.

See Notes to Consolidated Financial Statements

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

	Nine-Month Period Ended September 30, 2018      2017 <sup>(1)</sup>	
(In thousands)		
Cash flows provided by (used in) operating activities:		
Net income (loss)	\$(1,221)	\$ 9,996
Reconciliation of net income (loss) to net cash provided by (used in) operating activities:		
Net realized (gains) losses on securities	13,590	3,001
Change in net unrealized (gains) losses on securities	32,915	(5,783 )
Net realized (gains) losses on financial derivatives	(16,311 )	10,455
Change in net unrealized (gains) losses on financial derivatives	(16,005 )	1,302
Amortization of premiums and accretion of discounts (net)	8,165	6,025
Share based compensation	149	144
(Increase) decrease in assets:		
Interest receivable	109	(1,087 )
Other assets	(142 )	(52 )
Increase (decrease) in liabilities:		
Accrued expenses	(24 )	234
Interest payable	1,022	878
Management fees payable to affiliate	(84 )	208
Net cash provided by (used in) operating activities	22,163	25,321
Cash flows provided by (used in) investing activities:		
Purchases of securities	(1,001,324)	(2,189,278)
Proceeds from sale of securities	917,962	1,572,711
Principal repayments of mortgage-backed securities	136,490	121,543
Proceeds from investments sold short	778,977	577,630
Repurchase of investments sold short	(829,897)	(596,888 )
Proceeds from disposition of financial derivatives	28,395	10,953
Purchase of financial derivatives	(11,798 )	(20,357 )
Payments made on reverse repurchase agreements	(10,302,989)	(3,127,929)
Proceeds from reverse repurchase agreements	10,357,680	3,146,066
Due from brokers, net	6,217	(20,518 )
Due to brokers, net	7,865	(543 )
Net cash provided by (used in) investing activities	87,578	(526,610 )

See Notes to Consolidated Financial Statements

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

	Nine-Month Period Ended September 30, 2018		2017 <sup>(1)</sup>
Cash flows provided by (used in) financing activities:			
Net proceeds from the issuance of common shares	\$—	\$	59,103
Offering costs paid	—	(324	)
Repurchase of common shares	(7,251	)	—
Dividends paid	(14,386	)	(12,252
Borrowings under repurchase agreements	1,270,533	2,856,680	
Repayments of repurchase agreements	(1,367,107	)	(2,412,340
Due from brokers, net	(6,631	)	27,189
Cash provided by (used in) financing activities	(124,842)	518,056	
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(15,101	)	16,767
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	56,117	33,504	
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$41,016	\$	50,271
Supplemental disclosure of cash flow information:			
Interest paid	\$22,412	\$	12,039
Dividends payable	\$4,700	\$	5,334

(1) Conformed to current period presentation.

See Notes to Consolidated Financial Statements

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ELLINGTON RESIDENTIAL MORTGAGE REIT  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2018

(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- 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 Fifth Amended and Restated Management Agreement, or the "Management Agreement." The Manager is an affiliate of Ellington Management Group, L.L.C., or "EMG," an investment management firm that is an SEC-registered investment adviser with a 23-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 described in Note 9), 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. See Note 9 for further information on the Management Agreement.

The Company acquires and manages RMBS, for which the principal and interest payments are guaranteed by a U.S. government agency or a U.S. government-sponsored entity, or "Agency RMBS," and RMBS that do not carry such guarantees, or "non-Agency RMBS," such as RMBS backed by prime jumbo, Alternative A-paper, manufactured housing, and subprime residential mortgage loans. Agency RMBS include both Agency pools and Agency collateralized mortgage obligations, or "CMOs," and non-Agency RMBS primarily consist of non-Agency CMOs, both investment grade and non-investment grade. The Company may also acquire and manage mortgage servicing rights, credit risk transfer securities, 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 has elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended, or "the Code," and intends to conduct its operations to be qualified and taxed as a REIT. 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 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 time 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 rights 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. In management's opinion, all material adjustments considered necessary for a fair statement of the Company's interim consolidated financial statements have been included and are only of a normal recurring nature. 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, 2017.

(B) Valuation: The Company applies ASC 820-10, Fair Value Measurement ("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 observability 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. Currently, the types of financial instruments the Company generally includes in this category are exchange-traded derivatives;

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. Currently, the types of financial instruments that the Company generally includes in this category are Agency RMBS, U.S. Treasury securities, certain non-Agency RMBS, and actively traded derivatives such as TBAs, interest rate swaps, and swaptions, and;

Level 3—inputs to the valuation methodology are unobservable and significant to the fair value measurement. Currently, this category includes certain RMBS, such as certain non-Agency RMBS and certain Agency IOs, where there is less price transparency.

For certain financial instruments, the various inputs that management uses to measure fair value for such financial instrument may fall into different levels of the fair value hierarchy. In such cases, the determination of which category within the fair value hierarchy is appropriate for such financial instrument is based on the lowest level of input that is significant to the fair value measurement. ASC 820 prioritizes the various inputs that management uses to measure fair value with the highest priority to inputs that are observable and reflect quoted prices (unadjusted) for identical assets or liabilities in active markets (Level 1) and the lowest priority to inputs that are unobservable and significant to the fair value measurement (Level 3). The assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument. The Company may use valuation techniques consistent with the market and income approaches to measure the fair value of its assets and liabilities. The market approach uses third-party valuations and information obtained from market transactions involving identical or similar assets or liabilities. The income approach uses projections of the future economic benefits of an instrument to determine its fair value, such as in the discounted cash flow methodology. The inputs or methodology used for valuing financial instruments are not necessarily an indication of the risk associated with investing in these financial instruments. The leveling of each financial instrument is reassessed at the end of each period. Transfers between levels of the fair value hierarchy are assumed to occur at the end of the reporting period.

#### Summary Valuation Techniques

For financial instruments that are traded in an "active market," the best measure of fair value is the quoted market price. However, many of the Company's financial instruments are not traded in an active market. Therefore, management generally uses third-party valuations when available. If third-party valuations are not available, management uses other valuation techniques, such as the discounted cash flow methodology. The following are summary descriptions, for the various categories of financial instruments, of the valuation methodologies management uses in determining fair value of the Company's financial instruments in such categories. Management utilizes such methodologies to assign a good faith fair value (the estimated price that, in an orderly transaction at the valuation date, would be received to sell an asset, or paid to transfer a liability, as the case may be) to each such financial instrument. Valuations for fixed-rate RMBS pass-throughs issued by a U.S. government agency or government-sponsored enterprise, or "GSE," are typically based on observable pay-up data (pay-ups are price premiums for specified categories of fixed-rate pools relative to their TBA counterparts) or models that use observable market data, such as interest rates and historical prepayment speeds, and are validated against third-party valuations. With respect to the Company's other RMBS investments and TBAs, management seeks to obtain at least one third-party valuation, and often obtains multiple valuations when available. Management has been able to obtain third-party valuations on the vast majority of these instruments and expects to continue to solicit third-party valuations in the future. Management 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, and while management generally does not adjust the valuations it receives, management may challenge or reject a valuation when, based on its validation criteria, management determines that such valuation is unreasonable or erroneous. Furthermore, based on its validation criteria, management may determine that the average of the third-party valuations received for a given instrument does not result in what management believes to be the fair value of such instrument, and in such circumstances

management may override this average with its own good faith valuation. The validation criteria may take into account output from management's own models, recent trading activity in the same or similar instruments, and valuations received from third parties. The use of proprietary models requires the use of a significant amount of judgment and the application of various assumptions including, but not limited to, assumptions concerning future prepayment rates and default rates.

Given their relatively high level of price transparency, Agency RMBS pass-throughs and TBAs are typically designated as Level 2 assets. Non-Agency RMBS and Agency interest only and inverse interest only RMBS are generally classified as either

Level 2 or Level 3 based on the analysis of available market data and/or third-party valuations. Furthermore, the methodology used by the third-party valuation providers is reviewed at least annually by management, so as to ascertain whether such providers are utilizing observable market data to determine the valuations that they provide. Interest rate swaps and swaptions are typically valued based on internal models that use observable market data, including applicable interest rates in effect as of the measurement date; the model-generated valuations are then typically compared to counterparty valuations for reasonableness. These financial derivatives are generally designated as Level 2 instruments.

In valuing its derivatives, the Company also considers the creditworthiness of both the Company and its counterparties, along with collateral provisions contained in each derivative agreement.

The Company's repurchase and reverse repurchase agreements are carried at cost, which approximates fair value. Repurchase agreements and reverse repurchase agreements are classified as Level 2 assets and liabilities based on the adequacy of the collateral and their short term nature.

The Company's valuation process, including the application of validation criteria, is overseen by the Manager's Valuation Committee ("Valuation Committee"). The Valuation Committee includes senior level executives from various departments within the Manager, and each quarter the Valuation Committee reviews and approves the valuations of the Company's investments. The valuation process also includes a monthly review by the Company's third party administrator. The goal of this review is to replicate various aspects of the Company's valuation process based on the Company's documented procedures.

Because of the inherent uncertainty of valuation, the estimated fair value of the Company's financial instruments 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.

(C) Accounting for Securities: Purchases and sales of investments are recorded on trade date and realized and unrealized gains and losses are calculated based on identified cost.

The Company has chosen to make a fair value election pursuant to ASC 825-10, Financial Instruments, for its 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, 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 securities.

(D) Interest Income: Coupon interest income on investment securities is accrued based on the outstanding principal balance or notional amount and the current coupon rate on each security. The Company amortizes purchase premiums and accretes purchase discounts on its fixed-income securities. For RMBS that are deemed to be of high credit quality at the time of purchase, premiums and discounts are generally amortized/accreted into interest income over the life of such securities using the effective interest method. An effective yield retroactive to the time of purchase is periodically recomputed based on actual prepayments and changes in projected prepayment activity, and a catch-up adjustment, or "Catch-up Premium Amortization Adjustment," is made to amortization to reflect the cumulative impact of the change in effective yield. For RMBS that are deemed not to be of high credit quality at the time of purchase, interest income is recognized based on the effective interest method. For purposes of determining the effective interest rate, management estimates the future expected cash flows of its investment holdings based on assumptions including, but not limited to, assumptions for future prepayment rates, default rates, and loss severities (each of which may in turn incorporate various macro-economic assumptions, such as future housing prices). These assumptions are re-evaluated not less than quarterly. Principal write-offs are generally treated as realized losses. Changes in projected cash flows, as applied to the current amortized cost of the security, may result in a prospective change in the yield/interest income recognized on such securities.

The Company's accretion of discounts and amortization of premiums on securities for U.S. federal and other tax purposes is likely to differ from the 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 and cash equivalents typically include amounts held

in an interest bearing overnight account and amounts held in money market funds, and these balances generally exceed insured limits. The Company holds its cash at institutions that it believes to be highly creditworthy.

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

(G) Financial Derivatives: The Company enters into various types of financial derivatives subject to its investment guidelines, which include restrictions associated with maintaining its qualification as a REIT. The Company's financial 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 financial derivative transactions may require the Company or the counterparty to post or receive additional collateral. In the case of cleared financial derivatives, the clearinghouse becomes the Company's counterparty and a futures commission merchant 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 financial derivatives that have been utilized by the Company to date are interest rate swaps, TBAs, swaptions, and futures.

Swaps: The Company enters into interest rate swaps. Interest rate swaps are contractual agreements whereby one party pays a floating interest rate on a notional principal amount and receives a fixed-rate payment on the same notional principal, or vice versa, for a fixed period of time. The Company enters into interest rate swap contracts primarily to mitigate interest rate risk. The Company is subject to interest rate risk exposure in the normal course of pursuing its investment objectives.

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 transacts in the forward settling TBA 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 mitigate 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 by the Company 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. 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 enters into swaption contracts. It may purchase or write put, call, straddle, or other similar options contracts. The Company enters into options contracts primarily to help mitigate interest rate risk. When the Company purchases an options contract, 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 contracts that expire unexercised are recognized on the expiration date as realized losses. If an options contract 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 options contract, 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 contracts that expire unexercised are recognized on the expiration date as realized gains. If an options contract 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 contracts 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 options contract, regardless of whether or not the options contract is exercised. Unrealized gains or (losses) resulting from the options contract being marked-to-market are included in Change in net unrealized gains (losses) on financial derivatives in the Consolidated Statement of Operations. Realized gains or (losses) are included in Realized gains (losses) on financial derivatives in the Consolidated Statement of Operations.



**Futures Contracts:** The Company enters into Eurodollar futures contracts and U.S. Treasury 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. Unrealized gains or (losses) are included in Change in net unrealized gains (losses) on financial derivatives in the Consolidated Statement of Operations.

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. Realized gains or (losses) are included in Realized gains (losses) on financial derivatives in the Consolidated Statement of Operations.

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.

**(H) 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 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 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/or securities having a value not less than the repurchase price, including accrued interest, of the repurchase agreement. Repurchase agreements are carried at their contractual amounts, which approximate fair value due to their short-term nature.

**(I) Reverse Repurchase Agreements:** The Company enters 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 interest rate on 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. Reverse repurchase agreements are carried at their contractual amounts, which approximate fair value due to their short-term nature.

Repurchase and reverse repurchase agreements that are conducted with the same counterparty can be reported on a net basis if they meet the requirements of ASC 210-20, Balance Sheet Offsetting. There are currently no repurchase and reverse repurchase agreements reported on a net basis in the Company's consolidated financial statements.

**(J) Securities Sold Short:** The Company may purchase or engage in short sales of U.S. Treasury securities to mitigate the potential impact of changes in interest rates on the performance of its portfolio. When the Company sells securities short, it typically satisfies its security delivery settlement obligation by obtaining the security sold short from the same or a different counterparty. The Company generally is required to deliver cash or securities as collateral to the counterparty for the Company's obligation to return the borrowed security.

The Company has chosen to make a fair value election pursuant to ASC 825-10, Financial Instruments, for its securities sold short. 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, securities sold short 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 securities. A realized gain or loss will be recognized upon the termination of a short sale if the market price is less or greater than the proceeds originally received. Such realized gain or loss is recorded on the Company's Consolidated Statement of Operations in Net realized gains (losses) on securities.

**(K) Offering Costs/Deferred Offering Costs/Underwriters' Discounts:** Offering costs, underwriters' discounts and commissions and fees, are charged against shareholders' equity within Additional paid-in-capital. Offering costs typically include legal, accounting, and other fees associated with the cost of raising equity capital.

(L) Share Based Compensation: The Company applies the provisions of ASC 718, Compensation—Stock Compensation ("ASC 718"), with regard to its equity incentive plan. 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 the

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financial statements. The cost is measured based on the fair value, at the grant date, of the equity or liability instruments issued and is amortized over the vesting period. Restricted shares issued to the Company's independent directors and partially dedicated personnel are participating securities and receive dividends prior to vesting. Fair value for such awards is based on the closing stock price on the New York Stock Exchange at the grant date. The vesting period for restricted share awards is typically one to two years. Shares issued to the Company's independent directors and partially dedicated personnel are subject to tax withholding upon vesting. The Company's independent directors and partially dedicated personnel are permitted to forfeit a portion of their vested shares to pay such withholding tax. Forfeited shares decrease the total number of shares issued and outstanding and are immediately retired upon settlement.

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

(N) Expenses: Expenses are recognized as incurred on the Consolidated Statement of Operations.

(O) 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.

(P) Share Repurchases: Common shares that are repurchased by the Company subsequent to issuance are immediately retired upon settlement and decrease the total number of shares issued and outstanding. The cost of such share repurchases is charged against Additional paid-in-capital on the Company's Consolidated Balance Sheet.

(Q) Income Taxes: The Company has elected to be taxed as a REIT under Sections 856 to 860 of the Code. As a REIT, the Company is generally not subject to corporate-level federal and state income tax on net income it distributes to its shareholders. To qualify as a REIT, the Company must meet a number of organizational and operational requirements, including the distribution of at least 90% of its annual taxable income to shareholders. Even if the Company qualifies as a REIT, it may be subject to certain federal, state, local and foreign taxes on its income and property and to federal income and excise taxes on its undistributed taxable income. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, it will be subject to U.S. federal, state, and local income taxes and may be precluded from qualifying as a REIT for the four taxable years following the year in which the Company fails to qualify as a REIT.

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 or litigation processes, 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 50% likely of being realized upon ultimate settlement. The Company did not have any unrecognized tax benefits resulting from tax positions related to the current period or to 2017, 2016, or 2015 (its open tax years). 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, 2017, 2016, and 2015 (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.

(R) Recent Accounting Pronouncements: In August 2018, the Financial Accounting Standards Board, or "FASB," issued ASU 2018-13, Fair Value Measurement—Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement ("ASU 2018-13"). This amends ASC 820, Fair Value Measurement, to remove or modify various current disclosure requirements related to fair value measurement. Additionally ASU 2018-13 requires certain additional disclosures around fair value measurement. ASU 2018-13 is effective for annual periods beginning after December 15, 2019 and interim periods within those years, with early adoption permitted. Entities are permitted to

early adopt any removed or modified disclosures and delay adoption of the additional disclosures until their effective date. The Company has elected to early adopt the removal and modification of various disclosure requirements in accordance with ASU 2018-13; early adoption has not had a material impact on the Company's consolidated financial statements. The Company has elected not to early adopt the additional disclosure requirements. The adoption of additional disclosures, as required under ASU 2018-13, is not expected to have a material impact on the Company's consolidated financial statements.

In June 2018, the FASB issued ASU 2018-07, Compensation—Stock Compensation—Improvements to Nonemployee Share-Based Payment Accounting ("ASU 2018-07"). This amends ASC 718, Compensation—Stock Compensation, to simplify several aspects of accounting for nonemployee share-based payment transactions. ASU 2018-07 is effective for annual periods beginning after December 15, 2019 and interim periods beginning after December 15, 2020 with early adoption permitted. The adoption of ASU 2018-07 is not expected to have a material impact on the Company's consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows—Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). This amends ASC 230, Statement of Cash Flows, to clarify how certain cash receipts and payments should be classified on the statement of cash flows. The updates that most affect the Company relate to classifying each separately identifiable source or use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows and identifying such receipts and payments as operating, investing, or financing activities. ASU 2016-15 is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019, with early adoption permitted. The Company has elected to early adopt ASU 2016-15. The adoption of ASU 2016-15 did not 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 September 30, 2018 and December 31, 2017, 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 GSE. 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

September 30, 2018:

(\$ in thousands)

	Current Principal	Unamortized Premium (Discount)	Amortized Cost	Gross Unrealized			Weighted Average		
				Gains	Losses	Fair Value	Coupon	Yield	Life (Years) <sup>(1)</sup>
Agency RMBS:									
15-year fixed-rate mortgages	\$145,249	\$ 6,070	\$151,319	\$1	\$(5,551)	\$145,769	3.42%	2.38%	4.58
20-year fixed-rate mortgages	7,687	600	8,287	—	(421)	7,866	4.00%	2.54%	6.02
30-year fixed-rate mortgages	1,273,788	61,785	1,335,573	92	(38,053)	1,297,612	4.11%	3.27%	8.39
Adjustable rate mortgages	18,513	1,222	19,735	2	(686)	19,051	3.95%	2.59%	4.08
Reverse mortgages	70,938	6,572	77,510	12	(2,473)	75,049	4.54%	2.89%	5.79
Interest only securities	n/a	n/a	17,601	1,743	(660)	18,684	4.44%	8.07%	4.79
Total Agency RMBS	1,516,175	76,249	1,610,025	1,850	(47,844)	1,564,031	4.09%	3.21%	7.62
Non-Agency RMBS	14,418	(4,510)	9,908	2,045	(1)	11,952	4.38%	6.74%	5.59
Total RMBS	\$1,530,593	\$ 71,739	\$1,619,933	\$3,895	\$(47,845)	\$1,575,983	4.09%	3.23%	7.61

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.

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December 31, 2017:

(\$ in thousands)

	Current Principal	Unamortized Premium (Discount)	Amortized Cost	Gross Unrealized			Weighted Average		
				Gains	Losses	Fair Value	Coupon	Yield	Life (Years) <sup>(1)</sup>
Agency RMBS:									
15-year fixed-rate mortgages	\$ 170,998	\$ 7,553	\$ 178,551	\$ 28	\$ (1,805 )	\$ 176,774	3.38%	2.31%	4.75
20-year fixed-rate mortgages	8,712	682	9,394	—	(164 )	9,230	4.00%	2.55%	6.02
30-year fixed-rate mortgages	1,303,584	76,681	1,380,265	1,929	(12,605 )	1,369,589	3.96%	3.06%	8.18
Adjustable rate mortgages	28,087	1,862	29,949	30	(421 )	29,558	3.87%	2.58%	4.70
Reverse mortgages	64,608	6,293	70,901	259	(543 )	70,617	4.53%	2.79%	6.09
Interest only securities	n/a	n/a	13,197	382	(1,374 )	12,205	4.36%	5.64%	3.28
Total Agency RMBS	1,575,989	93,071	1,682,257	2,628	(16,912 )	1,667,973	3.95%	2.98%	7.38
Non-Agency RMBS	21,995	(6,717 )	15,278	2,846	(99 )	18,025	3.58%	8.39%	7.94
Total RMBS	\$ 1,597,984	\$ 86,354	\$ 1,697,535	\$ 5,474	\$ (17,011)	\$ 1,685,998	3.94%	3.03%	7.39

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.

By Estimated Weighted Average Life

As of September 30, 2018:

(\$ 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 <sup>(1)</sup>									
Less than three years	\$4,376	\$4,451	4.12 %	\$1,132	\$ 1,517	4.51 %	\$5,033	\$ 4,259	5.28 %
Greater than three years and less than seven years	312,760	323,265	4.00 %	17,552	16,084	4.43 %	2,611	2,465	5.84 %
Greater than seven years and less than eleven years	1,208,634	1,244,869	4.08 %	—	—	— %	4,308	3,184	2.69 %
Greater than eleven years	19,577	19,839	3.99 %	—	—	— %	—	—	— %
Total	\$ 1,545,347	\$ 1,592,424	4.07 %	\$ 18,684	\$ 17,601	4.44 %	\$ 11,952	\$ 9,908	4.38 %

(1) Average lives of RMBS are generally shorter than stated contractual maturities.

As of December 31, 2017:

(\$ 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 <sup>(1)</sup>									
Less than three years	\$7,931	\$7,935	3.70 %	\$3,357	\$ 4,253	4.15 %	\$—	\$—	— %
Greater than three years and less than seven	419,295	423,248	3.93 %	8,848	8,944	4.51 %	9,625	9,062	5.00 %

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years

Greater than seven years

and less than eleven	1,221,160	1,230,479	3.92 %	—	—	—	%	5,892	3,697	2.14 %
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years

Greater than eleven

years	7,382	7,398	3.68 %	—	—	—	%	2,508	2,519	2.18 %
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Total	\$1,655,768	\$1,669,060	3.92 %	\$12,205	\$13,197	4.36 %	\$18,025	\$15,278	3.58 %
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(1) Average lives of RMBS are generally shorter than stated contractual maturities.

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The following table reflects the components of interest income on the Company's RMBS for the three- and nine-month periods ended September 30, 2018 and 2017:

(\$ in thousands)	Three-Month Period Ended September 30, 2018			Nine-Month Period Ended September 30, 2018		
	Coupon Interest	Net Amortization	Interest Income	Coupon Interest	Net Amortization	Interest Income
Agency RMBS	\$16,744	\$ (4,029 )	\$12,715	\$50,341	\$ (11,485 )	\$38,856
Non-Agency RMBS	362	44	406	680	282	962
Total	\$17,106	\$ (3,985 )	\$13,121	\$51,021	\$ (11,203 )	\$39,818
(\$ in thousands)	Three-Month Period Ended September 30, 2017			Nine-Month Period Ended September 30, 2017		
	Coupon Interest	Net Amortization	Interest Income	Coupon Interest	Net Amortization	Interest Income
Agency RMBS	\$16,880	\$ (4,646 )	\$12,234	\$43,373	\$ (8,983 )	\$34,390
Non-Agency RMBS	186	172	358	593	445	1,038
Total	\$17,066	\$ (4,474 )	\$12,592	\$43,966	\$ (8,538 )	\$35,428

For the three-month periods ended September 30, 2018 and 2017 the Catch-up Premium Amortization Adjustment was \$(0.4) million and \$(0.7) million, respectively. For nine-month periods ended September 30, 2018 and 2017 the Catch-up Premium Amortization Adjustment was \$(0.1) million and \$1.6 million, respectively.



## 4. Valuation

The following tables present the Company's financial instruments measured at fair value on:  
September 30, 2018:

(In thousands)

Description	Level 1	Level 2	Level 3	Total
Assets:				
Mortgage-backed securities, at fair value:				
Agency RMBS:				
15-year fixed-rate mortgages	\$—	\$145,769	\$—	\$145,769
20-year fixed-rate mortgages	—	7,866	—	7,866
30-year fixed-rate mortgages	—	1,297,612	—	1,297,612
Adjustable rate mortgages	—	19,051	—	19,051
Reverse mortgages	—	75,049	—	75,049
Interest only securities	—	14,576	4,108	18,684
Non-Agency RMBS	—	4,319	7,633	11,952
Mortgage-backed securities, at fair value	—	1,564,242	11,741	1,575,983
Financial derivatives—assets, at fair value:				
TBAs	—	1,447	—	1,447
Interest rate swaps	—	18,189	—	18,189
Futures	3,413	—	—	3,413
Total financial derivatives—assets, at fair value	3,413	19,636	—	23,049
Total mortgage-backed securities and financial derivatives—assets, at fair value	\$3,413	\$1,583,878	\$11,741	\$1,599,032
Liabilities:				
U.S. Treasury securities sold short, at fair value	\$—	\$(26,367)	\$—	\$(26,367)
Financial derivatives—liabilities, at fair value:				
TBAs	—	(320)	—	(320)
Interest rate swaps	—	(13)	—	(13)
Total financial derivatives—liabilities, at fair value	—	(333)	—	(333)
Total U.S. Treasury securities sold short and financial derivatives—liabilities, at fair value	\$—	\$(26,700)	\$—	\$(26,700)

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December 31, 2017:

(In thousands)

Description	Level 1	Level 2	Level 3	Total
<b>Assets:</b>				
Mortgage-backed securities, at fair value:				
Agency RMBS:				
15-year fixed-rate mortgages	\$—	\$176,774	\$—	\$176,774
20-year fixed-rate mortgages	—	9,230	—	9,230
30-year fixed-rate mortgages	—	1,369,589	—	1,369,589
Adjustable rate mortgages	—	29,558	—	29,558
Reverse mortgages	—	70,617	—	70,617
Interest only securities	—	9,951	2,254	12,205
Non-Agency RMBS				
Mortgage-backed securities, at fair value	—	1,674,912	11,086	1,685,998
Financial derivatives—assets, at fair value:				
TBAs	—	402	—	402
Interest rate swaps	—	8,038	—	8,038
Swaptions	—	181	—	181
Futures	171	—	—	171
Total financial derivatives—assets, at fair value	171	8,621	—	8,792
Total mortgage-backed securities and financial derivatives—assets, at fair value	\$171	\$1,683,533	\$11,086	\$1,694,790
<b>Liabilities:</b>				
U.S. Treasury securities sold short, at fair value	\$—	\$(81,289)	\$—	\$(81,289)
Financial derivatives—liabilities, at fair value:				
TBAs	—	(735)	—	(735)
Interest rate swaps	—	(1,128)	—	(1,128)
Total financial derivatives—liabilities, at fair value	—	(1,863)	—	(1,863)
Total U.S. Treasury securities sold short and financial derivatives—liabilities, at fair value	\$—	\$(83,152)	\$—	\$(83,152)

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 September 30, 2018:

(In thousands)	Non-Agency RMBS	Agency RMBS
Beginning balance as of June 30, 2018	\$ 6,993	\$3,626
Purchases	—	—
Proceeds from sales	—	—
Principal repayments	(369)	—
(Amortization)/accretion, net	62	(251)
Net realized gains (losses)	—	(11)
Change in net unrealized gains (losses)	289	62
<b>Transfers:</b>		
Transfers into level 3	658	1,598
Transfers out of level 3	—	(916)
Ending balance as of September 30, 2018	\$ 7,633	\$4,108



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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 September 30, 2018, as well as Level 3 financial instruments disposed of by the Company during the three-month period ended September 30, 2018. For Level 3 financial instruments held by the Company as of September 30, 2018, change in net unrealized gains (losses) of \$0.3 million and \$0.2 million, for the three-month period ended September 30, 2018 relate to non-Agency RMBS and Agency RMBS, respectively.

At September 30, 2018, the Company transferred \$0.9 million of RMBS from Level 3 to Level 2 and \$2.3 million of RMBS from Level 2 to Level 3. Transfers between these hierarchy levels were based on the availability of sufficient observable inputs to meet Level 2 versus Level 3 criteria. The level designation of each financial instrument is reassessed at the end of each period, and is based on pricing information received from third party pricing sources.

Three-month period ended September 30, 2017:

(In thousands)	Non-Agency Agency	
	RMBS	RMBS
Beginning balance as of June 30, 2017	\$ 6,450	\$2,525
Purchases	2,508	—
Proceeds from sales	—	—
Principal repayments	(260 )	—
(Amortization)/accretion, net	100	(277 )
Net realized gains (losses)	4	(106 )
Change in net unrealized gains (losses)	82	(13 )
Transfers:		
Transfers into level 3	2,400	777
Transfers out of level 3	—	(500 )
Ending balance as of September 30, 2017	\$ 11,284	\$2,406

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 September 30, 2017, as well as Level 3 financial instruments disposed of by the Company during the three-month period ended September 30, 2017. For Level 3 financial instruments held by the Company as of September 30, 2017, change in net unrealized gains (losses) of \$0.3 million and \$(12) thousand, for the three-month period ended September 30, 2017 relate to non-Agency RMBS and Agency RMBS, respectively.

At September 30, 2017, the Company transferred \$0.5 million of RMBS from Level 3 to Level 2 and \$3.2 million of RMBS from Level 2 to Level 3. Transfers between these hierarchy levels were based on the availability of sufficient observable inputs to meet Level 2 versus Level 3 criteria. The level designation of each financial instrument is reassessed at the end of each period, and is based on pricing information received from third party pricing sources.

Nine-month period ended September 30, 2018:

(In thousands)	Non-Agency Agency	
	RMBS	RMBS
Beginning balance as of December 31, 2017	\$ 8,832	\$2,254
Purchases	—	160
Proceeds from sales	(3,638 )	—
Principal repayments	(593 )	—
(Amortization)/accretion, net	197	(884 )
Net realized gains (losses)	1,254	(177 )
Change in net unrealized gains (losses)	(660 )	536
Transfers:		
Transfers into level 3	2,241	2,219
Transfers out of level 3	—	—

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Ending balance as of September 30, 2018      \$ 7,633      \$4,108

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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 September 30, 2018, as well as Level 3 financial instruments disposed of by the Company during the nine-month period ended September 30, 2018. For Level 3 financial instruments held by the Company as of September 30, 2018, change in net unrealized gains (losses) of \$0.3 million and \$0.7 million, for the nine-month period ended September 30, 2018 relate to non-Agency RMBS and Agency RMBS, respectively.

At September 30, 2018, the Company transferred \$4.5 million of RMBS from Level 2 to Level 3. Transfers between these hierarchy levels were based on the availability of sufficient observable inputs to meet Level 2 versus Level 3 criteria. The level designation of each financial instrument is reassessed at the end of each period, and is based on pricing information received from third party pricing sources.

Nine-month period ended September 30, 2017:

(In thousands)	Non-Agency Agency	
	RMBS	RMBS
Beginning balance as of December 31, 2016	\$ 6,498	\$ 12,347
Purchases	4,324	2,621
Proceeds from sales	(2,866 )	—
Principal repayments	(675 )	—
(Amortization)/accretion, net	236	(2,469 )
Net realized gains (losses)	184	(180 )
Change in net unrealized gains (losses)	1,009	(1,369 )
Transfers:		
Transfers into level 3	4,414	—
Transfers out of level 3	(1,840 )	(8,544 )
Ending balance as of September 30, 2017	\$ 11,284	\$ 2,406

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 as of September 30, 2017, as well as Level 3 financial instruments disposed of by the Company during the nine-month period ended September 30, 2017. For Level 3 financial instruments held by the Company as of September 30, 2017, change in net unrealized gains (losses) of \$1.4 million and \$(0.3) million, for the nine-month period ended September 30, 2017 relate to non-Agency RMBS and Agency RMBS, respectively.

At September 30, 2017, the Company transferred \$10.4 million of RMBS from Level 3 to Level 2 and \$4.4 million of RMBS from Level 2 to Level 3. Transfers between these hierarchy levels were based on the availability of sufficient observable inputs to meet Level 2 versus Level 3 criteria. The level designation of each financial instrument is reassessed at the end of each period, and is based on pricing information received from third party pricing sources.

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The following tables identify the significant unobservable inputs that affect the valuation of the Company's Level 3 assets and liabilities as of September 30, 2018 and December 31, 2017:

September 30, 2018:

Description	Fair Value (In thousands)	Valuation Technique	Significant Unobservable Input	Range		Weighted Average <sup>(1)</sup>	
				Min	Max		
Non-Agency RMBS	\$ 6,387	Market quotes	Non-Binding Third-Party Valuation	\$53.49	\$90.37	\$ 76.94	
Non-Agency RMBS	1,246	Discounted Cash Flows	Yield	3.7	% 4.9	% 4.1	%
			Projected Collateral Prepayments	51.7	% 66.5	% 60.4	%
			Projected Collateral Losses	4.4	% 9.3	% 6.4	%
			Projected Collateral Recoveries	10.3	% 11.9	% 10.8	%
			Projected Collateral Scheduled Amortization	18.0	% 28.0	% 22.4	%
Agency RMBS–Interest Only Securities	4,108	Option Adjusted Spread ("OAS")	LIBOR OAS <sup>(2)</sup>	548	1,426	634	100.0 %
			Projected Collateral Prepayments	31.7	% 69.4	% 58.4	%
			Projected Collateral Scheduled Amortization	30.6	% 68.3	% 41.6	%
							100.0 %

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

(2) Shown in basis points.

December 31, 2017:

Description	Fair Value (In thousands)	Valuation Technique	Significant Unobservable Input	Range		Weighted Average <sup>(1)</sup>	
				Min	Max		
Non-Agency RMBS	\$ 2,258	Market quotes	Non-Binding Third-Party Valuation	\$57.84	\$87.45	\$ 78.02	
Non-Agency RMBS	6,574	Discounted Cash Flows	Yield	4.6	% 5.1	% 4.8	%
			Projected Collateral Prepayments	19.2	% 44.9	% 26.5	%
			Projected Collateral Losses	0.9	% 20.1	% 9.2	%
			Projected Collateral Recoveries	8.8	% 31.5	% 22.5	%
			Projected Collateral Scheduled Amortization	33.1	% 47.5	% 41.8	%
						100.0	%

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Agency RMBS–Interest Only Securities	2,254	Option Adjusted Spread ("OAS")	LIBOR OAS <sup>(2)</sup>	627	1,408	781		
			Projected Collateral Prepayments	43.8	% 88.1	% 71.2	%	
			Projected Collateral Scheduled Amortization	11.9	% 56.2	% 28.8	%	
						100.0	%	

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

(2) Shown in basis points.



Third-party non-binding valuations are validated by comparing such valuations 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.

The following table summarizes the estimated fair value of all other financial instruments not included in the disclosures above as of September 30, 2018 and December 31, 2017:

(In thousands)	September 30, 2018		December 31, 2017	
	Fair Value	Carrying Value	Fair Value	Carrying Value
Other financial instruments				
Assets:				
Cash and cash equivalents	\$41,016	\$ 41,016	\$56,117	\$ 56,117
Due from brokers	27,044	27,044	26,754	26,754
Reverse repurchase agreements	26,769	26,769	81,461	81,461
Liabilities:				
Repurchase agreements	1,500,632	1,500,632	1,597,206	1,597,206
Due to brokers	8,298	8,298	489	489

Cash and cash equivalents includes cash held in an interest bearing overnight account for which fair value equals the carrying value and cash held in money market accounts which are liquid in nature and for which fair value equals the carrying value; such assets are considered Level 1 assets. Due from brokers and Due to brokers include collateral transferred to or received from counterparties, along with receivables and payables for open and/or closed derivative positions. These receivables and payables are short term in nature and any collateral transferred consists primarily of cash; fair value of these items approximates carrying value and such items are considered Level 1 assets and liabilities. The Company's repurchase and reverse repurchase agreements are carried at cost, which approximates fair value due to their short term nature. Repurchase agreements and reverse repurchase agreements are classified as Level 2 assets and liabilities based on the adequacy of the collateral and their short term nature.

##### 5. Financial Derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. Specifically, the Company's primary source of 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 the Company's 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, futures, swaptions, and TBAs. Additionally, from time to time, the Company may use short positions in U.S. Treasury securities to mitigate its interest rate risk.



The following table details the fair value of the Company's holdings of financial derivatives as of September 30, 2018 and December 31, 2017:

	September 30, 2018	December 31, 2017
	(In thousands)	
Financial derivatives—assets, at fair value:		
TBA securities purchase contracts	\$33	\$ 26
TBA securities sale contracts	1,414	376
Fixed payer interest rate swaps	18,189	7,475
Fixed receiver interest rate swaps	—	563
Swaptions	—	181
Futures	3,413	171
Total financial derivatives—assets, at fair value	23,049	8,792
Financial derivatives—liabilities, at fair value:		
TBA securities purchase contracts	(295 )	(266 )
TBA securities sale contracts	(25 )	(469 )
Fixed payer interest rate swaps	(13 )	(1,128 )
Total financial derivatives—liabilities, at fair value	(333 )	(1,863 )
Total, net	\$22,716	\$ 6,929

#### Interest Rate Swaps

The following tables provide information about the Company's fixed payer interest rate swaps as of September 30, 2018 and December 31, 2017:

September 30, 2018:

Maturity	Notional Amount	Fair Value	Weighted Average		Remaining Years to Maturity
			Pay Rate	Receive Rate	
	(In thousands)				
2020	\$86,000	\$1,529	1.60%	2.33 %	1.57
2021	133,400	3,332	1.89	2.34	2.66
2022	68,480	2,245	2.00	2.34	3.68
2023	23,600	1,193	1.88	2.34	4.61
2024	8,900	454	1.99	2.34	5.51
2025	47,722	1,398	2.57	2.33	6.42
2026	40,885	4,189	1.63	2.34	7.96
2027	30,000	1,659	2.29	2.35	8.59
2028	126,063	1,949	2.92	2.33	9.82
2043	12,380	228	2.99	2.33	24.63
Total	\$577,430	\$18,176	2.17%	2.33 %	5.77

December 31, 2017:

Maturity	Notional Amount	Fair Value	Weighted Average		Remaining Years to Maturity
			Pay Rate	Receive Rate	
	(In thousands)				
2018	\$65,990	\$187	0.97%	1.38%	0.43
2019	19,540	165	1.41	1.60	1.51
2020	131,900	1,514	1.60	1.41	2.39
2021	131,400	1,194	1.88	1.40	3.41
2022	79,044	736	1.97	1.39	4.48
2023	54,200	873	1.93	1.37	5.47
2024	8,900	142	1.99	1.34	6.26
2025	15,322	196	2.04	1.37	7.13
2026	40,885	2,230	1.63	1.36	8.71
2027	48,010	235	2.30	1.40	9.38
2043	12,380	(1,125)	2.99	1.41	25.38
Total	\$607,571	\$6,347	1.77%	1.40%	4.54

The following table provides information about the Company's fixed receiver interest rate swaps as of December 31, 2017. The Company did not hold any fixed receiver interest rate swaps as of September 30, 2018.

December 31, 2017:

Maturity	Notional Amount	Fair Value	Weighted Average		Remaining Years to Maturity
			Pay Rate	Receive Rate	
	(In thousands)				
2025	\$9,700	\$563	1.36%	3.00%	7.54
Total	\$9,700	\$563	1.36%	3.00%	7.54

## Interest Rate Swaptions

The following tables provide information about the Company's swaptions as of December 31, 2017. The Company did not hold any swaptions as of September 30, 2018.

December 31, 2017:

Option Type	Fair Value	Months to Expiration	Underlying Swap		
			Notional Amount	Term (Years)	Fixed Rate
(\$ in thousands)					
Fixed Payer	\$181	7.0	\$10,000	10	2.40%

## Futures

The following tables provide information about the Company's short positions in futures as of September 30, 2018 and December 31, 2017.

September 30, 2018:

Description	Notional Amount	Fair Value	Remaining Months to Expiration
(\$ in thousands)			
U.S. Treasury Futures	\$(246,700)	\$3,413	2.92

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December 31, 2017:

Description	Notional Amount	Fair Value	Remaining Months to Expiration
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(\$ in thousands)

U.S. Treasury Futures	\$ (25,800)	\$ 171	2.63
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TBAs

The Company transacts in the forward settling 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 generally liquid, have quoted market prices, and represent the most actively traded class of MBS. The Company primarily uses TBAs to mitigate 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.

As of September 30, 2018 and December 31, 2017, the Company had outstanding contracts to purchase ("long positions") and sell ("short positions") TBA securities as follows:

TBA Securities	September 30, 2018				December 31, 2017			
	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	\$ 16,800	\$ 16,503	\$ 16,536	\$ 33	\$ 37,355	\$ 38,065	\$ 38,091	\$ 26
Liabilities	111,229	113,076	112,781	(295)	75,789	79,570	79,304	(266)
	128,029	129,579	129,317	(262)	113,144	117,635	117,395	(240)
Sale contracts:								
Assets	(343,137)	(344,620)	(343,206)	1,414	(358,279)	(372,219)	(371,843)	376
Liabilities	(9,811)	(9,856)	(9,881)	(25)	(328,576)	(341,134)	(341,603)	(469)
	(352,948)	(354,476)	(353,087)	1,389	(686,855)	(713,353)	(713,446)	(93)
Total TBA securities, net	\$ (224,919)	\$ (224,897)	\$ (223,770)	\$ 1,127	\$ (573,711)	\$ (595,718)	\$ (596,051)	\$ (333)

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

(2) Cost basis represents the forward price to be paid (received) 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.

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

The table below details the average notional values of the Company's financial derivatives, using absolute value of month end notional values, for the nine-month period ended September 30, 2018 and the year ended December 31, 2017:

Derivative Type	Nine-Month Period Ended	Year Ended December
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September 31, 2017

30, 2018

(In thousands)

Interest rate swaps	\$596,159	\$549,907
TBAs	624,974	796,813
Futures	231,870	30,092
Swaptions	7,000	4,615

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Gains and losses on the Company's financial derivatives for the three- and nine-month periods ended September 30, 2018 and 2017 are summarized in the tables below:

Derivative Type	Three-Month Period Ended September 30, 2018					
	Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) on 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) on Other Than Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) on Financial Derivatives
(In thousands)						
Interest rate swaps	\$ 1,281	\$ 2,096	\$ 3,377	\$ (893 )	\$ 2,383	\$ 1,490
Swaptions	(249 )	(249 )	(249 )	(221 )	(221 )	(221 )
TBAs	(692 )	(692 )	(692 )		2,100	2,100
Futures	1,622	1,622	1,622		1,237	1,237
Total	\$ 1,281	\$ 2,777	\$ 4,058	\$ (893 )	\$ 5,499	\$ 4,606

Derivative Type	Three-Month Period Ended September 30, 2017					
	Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) on 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) on Other Than Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) on Financial Derivatives
(In thousands)						
Interest rate swaps	\$ 957	\$ (76 )	\$ 881	\$ (1,657 )	\$ 808	\$ (849 )
Swaptions	—	—	—	(37 )	(37 )	(37 )
TBAs	(3,475 )	(3,475 )	(3,475 )	(179 )	(179 )	(179 )
Futures	(387 )	(387 )	(387 )	376	376	376
Total	\$ 957	\$ (3,938 )	\$ (2,981 )	\$ (1,657 )	\$ 968	\$ (689 )

Derivative Type	Nine-Month Period Ended September 30, 2018					
	Net Realized Gains (Losses) on Periodic Settlements of Interest Rate Swaps	Net Realized Gains (Losses) on 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) on Other Than Accrued Periodic Settlements of Interest Rate Swaps	Change in Net Unrealized Gains (Losses) on Financial Derivatives
(In thousands)						
Interest rate swaps	\$ 957	\$ (76 )	\$ 881	\$ (1,657 )	\$ 808	\$ (849 )
Swaptions	—	—	—	(37 )	(37 )	(37 )
TBAs	(3,475 )	(3,475 )	(3,475 )	(179 )	(179 )	(179 )
Futures	(387 )	(387 )	(387 )	376	376	376
Total	\$ 957	\$ (3,938 )	\$ (2,981 )	\$ (1,657 )	\$ 968	\$ (689 )

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	Swaps				Rate Swaps	
(In thousands)						
Interest rate swaps	\$1,072	\$ 5,065	\$ 6,137	\$ (932 )	\$ 12,167	\$ 11,235
Swaptions		(249 )	(249 )		68	68
TBAs		10,151	10,151		1,460	1,460
Futures		272	272		3,242	3,242
Total	\$1,072	\$ 15,239	\$ 16,311	\$ (932 )	\$ 16,937	\$ 16,005

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Nine-Month Period Ended September 30, 2017

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

Interest rate swaps	\$7	\$(71)	\$(64)	\$(1,801)	\$(870)	\$(2,671)
Swaptions	—	—	—	(37)	(37)	(37)
TBAs	(9,363)	(9,363)	—	936	936	—
Futures	(1,028)	(1,028)	—	470	470	—
Total	\$7	\$(10,462)	\$(10,455)	\$(1,801)	\$499	\$(1,302)

From time to time, the Company uses short positions in U.S. Treasury securities as a component of its interest rate hedging portfolio. As of September 30, 2018, the Company held short positions in U.S. Treasury securities, with a principal amount of \$26.8 million and a fair value of \$26.4 million. As of December 31, 2017, the Company held short positions in U.S. Treasury securities, with a principal amount of \$82.5 million and a fair value of \$81.3 million. Such securities are included on the Company's Consolidated Balance Sheet under the caption U.S. Treasury securities sold short, at fair value.

#### 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. 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. In the event of increases in fair value of the transferred securities, the Company generally can require the counterparty to post collateral with it in the form of cash or securities. The Company is generally permitted to sell or re-pledge any securities posted by the counterparty as collateral; however, upon termination of the repurchase agreement, or other circumstance in which the counterparty is no longer required to post such margin, the Company must return to the counterparty the same security that had been posted. The contractual amount (loan amount) of the Company's repurchase agreements approximates fair value, based on the short-term nature of the debt and the adequacy of the collateral.

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 September 30, 2018 and December 31, 2017, the Company had outstanding borrowings under repurchase agreements with 12 and 15 counterparties, respectively.

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The following table details the Company's outstanding borrowings under repurchase agreements as of September 30, 2018 and December 31, 2017:

Remaining Days to Maturity	September 30, 2018			December 31, 2017		
	Borrowings Outstanding (In thousands)	Weighted Average Interest Rate	Remaining Days to Maturity	Borrowings Outstanding	Weighted Average Interest Rate	Remaining Days to Maturity
30 days or less	\$346,841	2.21 %	15	\$410,628	1.41 %	15
31-60 days	721,514	2.25	45	906,602	1.46	46
61-90 days	342,650	2.36	77	273,665	1.60	74
91-120 days	89,627	2.30	108	6,311	1.61	120
Total	\$1,500,632	2.27 %	49	\$1,597,206	1.47 %	43

Repurchase agreements involving underlying investments that the Company 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.

As of September 30, 2018 and December 31, 2017, the fair value of RMBS transferred as collateral under outstanding borrowings under repurchase agreements was \$1.6 billion and \$1.7 billion, respectively. Collateral transferred under outstanding borrowings as of September 30, 2018 includes RMBS in the amount of \$52.5 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, 2017 includes RMBS in the amount of \$21.5 million that were sold prior to year end but for which such sale had not yet settled. In addition as of September 30, 2018, the Company posted to repo counterparties net cash collateral of \$25.3 million and additional securities with a fair value of \$0.4 million, and received from repo counterparties securities with a fair value of \$1.1 million, as a result of margin calls with various repo counterparties. As of December 31, 2017, the Company posted to repo counterparties net cash collateral of \$18.7 million and additional securities with a fair value of \$2.5 million as a result of margin calls with various repo counterparties. Amount at risk represents the 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 our repurchase agreements were greater than 10% of shareholders' equity as of September 30, 2018. There was no counterparty for which the amount at risk was greater than 10% of shareholders' equity as of December 31, 2017.

September 30, 2018:

Counterparty	Amount at Risk <sup>(1)</sup> (In thousands)	Weighted Average Remaining Days to Maturity	Percentage of Shareholders' Equity
Royal Bank of Canada	\$ 17,085	64	10.0 %

(1) Amounts at risk exclude, in aggregate, \$0.1 million of net accrued interest, defined as accrued interest on securities held as collateral less interest payable on cash borrowed.

#### 7. Offsetting of Assets and Liabilities

The Company records certain financial instruments at fair value as described in Note 2. 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.

The following tables present information about certain assets and liabilities representing financial instruments as of September 30, 2018 and December 31, 2017. 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.

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September 30, 2018:

Description	Amount of Assets (Liabilities) Presented in the Consolidated Balance Sheet <sup>(1)</sup>	Financial Instruments for Offset	Financial Instruments Transferred or Pledged as Collateral <sup>(2)(3)</sup>	Cash Collateral (Received) Pledged <sup>(2)(3)</sup>	Net Amount
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(In thousands)

Assets:

Financial derivatives—assets	\$ 23,049	\$ (310 )	\$ —	\$ (8,223 )	\$ 14,516
Reverse repurchase agreements	26,769	(26,769 )	—	—	—

Liabilities:

Financial derivatives—liabilities	(333 )	310	—	22	(1 )
Repurchase agreements	(1,500,632 )	26,769	1,448,524	25,339	—

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

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, the Company has reduced the amount of financial instruments transferred or pledged as collateral related to the Company's repurchase agreements and cash collateral pledged on the Company's financial derivative assets and liabilities. Total financial instruments transferred or pledged as collateral on the Company's repurchase agreements as of September 30, 2018 were \$1.55 billion. As of September 30, 2018 total cash collateral on financial derivative assets and liabilities excludes \$0.6 million and \$0.9 million respectively of net excess cash collateral.

(2) 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, 2017:

Description	Amount of Assets (Liabilities) Presented in the Consolidated Balance Sheet <sup>(1)</sup>	Financial Instruments for Offset	Financial Instruments Transferred or Pledged as Collateral <sup>(2)(3)</sup>	Cash Collateral (Received) Pledged <sup>(2)(3)</sup>	Net Amount
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(In thousands)

Assets:

Financial derivatives—assets	\$ 8,792	\$ (1,046 )	\$ —	\$ —	\$ —
Reverse repurchase agreements	81,461	(81,461 )	—	—	—

Liabilities:

Financial derivatives—liabilities	(1,863 )	1,046	—	697	(120 )
Repurchase agreements	(1,597,206 )	81,461	1,497,038	18,707	—

(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 the Company has reduced the amount of financial instruments transferred or pledged as collateral related to the Company's repurchase agreements and cash collateral pledged on the Company's financial derivative assets and liabilities. Total financial instruments transferred or pledged as collateral on the Company's repurchase agreements as of December 31, 2017 were \$1.66 billion. As of December 31, 2017 total cash collateral on financial derivative assets and liabilities excludes \$5.4 million and \$1.4 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. 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 outstanding dilutive instruments, such as share options and warrants, if any, 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 September 30, 2018 and 2017, 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 nine-month periods ended September 30, 2018 and 2017:

(In thousands except for share amounts)	Three-Month Period Ended September 30,		Nine-Month Period Ended September 30,	
	2018	2017	2018	2017
Numerator:				
Net income (loss)	\$946	\$ 6,340	\$(1,221)	\$ 9,996
Denominator:				
Basic and diluted weighted average shares outstanding	12,693,081	13,106,106	12,875,884	11,017,363
Basic and diluted earnings per share	\$0.07	\$ 0.48	\$(0.09)	\$ 0.91

## 9. Related Party Transactions

### Management Agreement

The Company is party to the Management Agreement, which has a current term that expires on September 24, 2019, and has been, and will continue to 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, 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.

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 September 30, 2018 and 2017, the total management fee incurred was \$0.6 million and \$0.7 million, respectively. For each of the nine-month periods ended September 30, 2018 and 2017, the total management fee incurred was \$2.0 million.

### 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 have overlapping ownership and are under common control.

### 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 nine-month periods ended September 30, 2018 and 2017, the Company reimbursed the Manager \$1.8 million and \$1.6 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 as of the month-end preceding the date of the notice of termination or non-renewal of the Management Agreement.

**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.

**10. 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 September 30, 2018 and December 31, 2017, there were 12,703,474 and 13,340,217 common shares outstanding, respectively. No preferred shares have been issued.

During the three-month periods ended September 30, 2018 and 2017, the Board of Directors authorized dividends totaling \$0.37 per share and \$0.40 per share, respectively. Total dividends declared during the three-month periods ended September 30, 2018 and 2017 were \$4.7 million and \$5.3 million. During the nine-month periods ended September 30, 2018 and 2017, the Board of Directors authorized dividends totaling \$1.11 per share and \$1.20 per share, respectively. Total dividends declared during the nine-month periods ended September 30, 2018 and 2017 were \$14.2 million and \$13.9 million, respectively.

On September 12, 2018, the Company's Board of Trustees authorized the issuance of 13,144 shares to its independent trustees pursuant to director share award agreements. Such shares will vest and become non-forfeitable on September 11, 2019.

Detailed below is a roll forward of the Company's common shares outstanding for the three- and nine-month periods ended September 30, 2018 and 2017:

	Three-Month Period Ended September 30,		Nine-Month Period Ended September 30,	
	2018	2017	2018	2017
Common Shares Outstanding (6/30/2018, 6/30/2017, 12/31/2017, and 12/31/2016, respectively)	12,712,050	12,367,598	13,340,217	9,130,897
Share Activity:				
Shares issued	—	958,230	—	4,194,968
Restricted shares issued	13,144	9,976	13,144	9,976
Shares repurchased	(21,720 )	—	(649,887 )	—
Forfeiture of common shares to satisfy tax withholding obligations	—	—	—	(37 )
Common Shares Outstanding (9/30/2018, 9/30/2017, 9/30/2018, and 9/30/2017, respectively)	12,703,474	13,335,804	12,703,474	13,335,804
Unvested restricted shares outstanding (9/30/2018, 9/30/2017, 9/30/2018, and 9/30/2017, respectively)	19,113	16,515	19,113	16,515

The below table provides details on the Company's restricted shares granted pursuant to share award agreements which are unvested at September 30, 2018:

Grant Recipient	Number of Restricted Shares Granted	Grant Date	Vesting Date <sup>(1)</sup>
Independent trustees:	13,144	September 12, 2018	September 11, 2019
Partially dedicated employees:	2,630	December 12, 2017	December 12, 2018
	1,783	December 12, 2017	December 12, 2019
	1,556	December 13, 2016	December 13, 2018

(1) Date at which such restricted shares will vest and become non-forfeitable.

As of September 30, 2018, there were 327,317 shares available for future issuance under the Company's 2013 Equity Incentive Plan.

On June 13, 2018, the Company's Board of Trustees approved the adoption of a share repurchase program under which the Company is authorized to repurchase up to 1.2 million common shares. 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, including through Rule 10b5-1 plans. Repurchases are at the Company's discretion, subject to applicable law, share availability, price and its financial performance, among other considerations. This program superseded the program that was previously adopted on February 6, 2018. During the three-month period ended September 30, 2018, the Company purchased 21,720 of its common shares at an aggregate cost of \$0.2 million, and an average price per share of \$10.82. During the nine-month period ended September 30, 2018, the Company purchased 649,887 of its common shares at an aggregate cost of \$7.3 million, and an average price per share of \$11.16. From inception of the current share repurchase program adopted on June 13, 2018 through September 30, 2018, the Company purchased 21,720 of its common shares at an aggregate cost of \$0.2 million, and an average price per share of \$10.82.

#### 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 or deemed 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 time limits prescribed by the Internal Revenue Code, which may extend into the subsequent taxable year.

#### 11. 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. The Company provides current directors and officers with a limited indemnification against liabilities arising in connection with the performance of their duties to the Company.

In the normal course of business the Company may also enter into contracts that contain a variety of representations, warranties, and general indemnifications. The Company's maximum exposure under these arrangements, including future claims that may be made against the Company that have not yet occurred, is unknown. The Company has not incurred any costs to defend lawsuits or settle claims related to these indemnification agreements. The Company has no liabilities recorded for these agreements as of September 30, 2018 and December 31, 2017 and management is not aware of any significant contingencies at September 30, 2018.

## 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, or the "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, or the "Securities Act," and Section 21E of the Securities Exchange Act of 1934, as amended, or the "Exchange Act," 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 operations, business strategies, performance, financial condition, liquidity and prospects, 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, results of operations and strategies may vary materially from those expressed or implied 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 of and dependence on leverage; future changes with respect to the Federal National Mortgage Association, or "Fannie Mae," and Federal Home Loan Mortgage Corporation, or "Freddie Mac," and related events, including the lack of certainty as to the future roles of these entities and the U.S. Government in the mortgage market 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; changes in government regulations affecting our business; our ability to maintain our exclusion from registration under the Investment Company Act of 1940, as amended, or the "Investment Company Act"; and risks associated with investing in real estate 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, 2017, could cause our actual results to differ materially from those projected or implied 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 consisting primarily of residential mortgage-backed securities, or "RMBS," for which the principal and interest payments are guaranteed by a U.S. government agency or a U.S. government-sponsored entity, or "Agency RMBS," and, to a lesser extent, RMBS that do not carry such guarantees, or "non-Agency RMBS," such as RMBS backed by prime jumbo, Alternative A-paper, manufactured housing, and subprime residential mortgage loans. We also may opportunistically acquire and manage other types of residential mortgage-related and real estate-related asset classes, such as residential mortgage loans, mortgage servicing rights, or "MSRs," and credit risk transfer securities, or "CRTs." 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 Management Group, L.L.C., an investment management firm and registered investment adviser with a 23-year history of investing in a broad spectrum of mortgage-backed securities, or "MBS," and related derivatives, with an emphasis on the RMBS market, and the Blackstone Tactical Opportunity Funds, or the "Blackstone Funds." As of September 30, 2018, the Blackstone Funds owned approximately 24% of our outstanding common shares. We are externally managed and advised by our Manager, an affiliate of Ellington.

We use leverage in our Agency RMBS strategy and, while we have not done so meaningfully 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 September 30, 2018, we had outstanding borrowings under repurchase agreements in the amount of \$1.5 billion with 12 counterparties.

We have elected 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 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, or the "Investment Company Act."

As of September 30, 2018, our book value per share was \$13.40, as compared to \$13.70 as of June 30, 2018 and \$14.45 as of December 31, 2017.

#### Trends and Recent Market Developments

##### Market Overview

In September, the U.S. Federal Reserve, or the "Federal Reserve," raised the target range for the federal funds rate by 0.25%, to 2.00%–2.25%, its third rate increase in 2018. LIBOR rates, which drive many of our financing costs, increased in sympathy, with one-month LIBOR increasing 17 basis points to end the third quarter at 2.26%.

Three-month LIBOR increased 6 basis points to 2.40%. The spread between one- and three-month LIBOR narrowed to 14 basis points, down from 25 basis points at the end of the prior quarter.

In July and October of 2018, the Federal Reserve continued to increase the amount of the tapering of its reinvestments in line with the schedule it laid out in September 2017. The tapering of Agency RMBS purchases increased to \$16 billion per month in July and to \$20 billion per month in October. The tapering of U.S. Treasury purchases increased to \$24 billion per month in July and to \$30 billion per month in October.

The yield curve flattened for the seventh consecutive quarter: the 2-year U.S. Treasury yield rose 29 basis points to end the third quarter at 2.82%, while the 10-year U.S. Treasury yield increased 20 basis points to 3.06%. The spread between the 2-year and 10-year tightened to just 24 basis points, as compared to 33 basis points at the end of the second quarter and 85 basis points a year ago.

Mortgage rates increased in the third quarter, with the Freddie Mac survey 30-year mortgage rate rising 17 basis points to end the quarter at 4.72%.

Overall Agency RMBS prepayment rates continued to be muted during the quarter. The Mortgage Bankers Association's Refinance Index, which measures refinancing application volumes, fell 5% quarter over quarter, dropping to its lowest seasonally-adjusted level in more than 17 years.

- U.S. GDP growth for the second quarter was revised upward to 4.2%, the best quarterly growth rate in GDP since 2014. Total unemployment fell to 3.7% in September 2018, compared to 4.2% a year earlier.

During the third quarter, interest rates continued to rise and the yield curve flattened further, as the short end of the yield curve rose faster than the long end for the fifth consecutive quarter. The Federal Reserve raised rates again in September, citing continued strength of the economy, but this time it removed the word "accommodative" from its monetary stance, which may signal that the Federal Reserve views its current target range for the federal funds rate as having a more neutral, as opposed to stimulative, effect on the economy. During the quarter, the 10-year U.S.

Treasury traded within a tight 29-basis point range.

The Federal Reserve also continued to increase the tapering of reinvestments according to schedule, although in October the tapering reached its scheduled cap. Going forward and barring any unforeseen circumstances, the pace of the Federal Reserve's tapering is expected to remain constant as its portfolio runs off. Globally, trade policy actions—both threatened and actual—continued to pose a risk to growth going forward.

Volatility was low in the third quarter, and domestic equities and corporate credit performed well. For the quarter, the S&P 500 Index rose 7.2% while the Bloomberg Barclays U.S. Corporate Bond Investment Grade and High Yield Indices both generated strong total returns. On the other hand, rising rates continued to be a headwind for RMBS, and despite the low volatility, the Bloomberg Barclays U.S. MBS Agency Fixed Rate Index generated a negative return of 12 basis points for the quarter. The Bloomberg Barclays U.S. MBS Agency Fixed Rate Index did, however, generate an excess return (on a duration-adjusted basis) of 17 basis points for the quarter over the Bloomberg Barclays U.S. Treasury Index.

##### Portfolio Overview and Outlook

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As of September 30, 2018, our mortgage-backed securities portfolio consisted of \$1.451 billion of fixed-rate Agency "specified pools," \$19.1 million of Agency RMBS backed by adjustable rate mortgages, or "Agency ARMs," \$75.0 million of

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Agency reverse mortgage pools, \$18.7 million of Agency interest only securities, or "Agency IOs," and \$12.0 million of non-Agency RMBS. Specified pools are fixed-rate Agency pools consisting of mortgages with special characteristics, such as mortgages with low loan balances, mortgages backed by investor properties, mortgages originated through the government-sponsored "Making Homes Affordable" refinancing programs, and mortgages with various other characteristics.

Our overall RMBS portfolio decreased by 0.3% to \$1.576 billion as of September 30, 2018, as compared to \$1.580 billion as of June 30, 2018. Even though our portfolio was slightly smaller by quarter end, our equity base was also smaller and our overall debt-to-equity ratio, adjusted for unsettled purchases and sales, increased slightly to 8.7:1 as of September 30, 2018 from 8.6:1 as of June 30, 2018. Our debt-to-equity ratio may fluctuate period over period based on portfolio management decisions, market conditions, capital markets activities, and the timing of security purchase and sale transactions.

With Agency RMBS yield spreads remaining near their two-year widest levels in the third quarter, we covered a portion of our TBA short positions. We continue to maintain a smaller short TBA position that we use for hedging purposes, as well as a larger long TBA portfolio held for investment purposes, compared to how we were positioned in previous years. As of September 30, 2018, we had short TBAs of \$353.1 million, as compared to \$448.6 million as of June 30, 2018 and \$713.4 million as of December 31, 2017. Also as of September 30, 2018, we had \$129.3 million of long TBAs held for investment purposes, as compared to \$153.7 million as of June 30, 2018 and \$113.1 million as of December 31, 2017. As a result, our net mortgage assets-to-equity ratio—which we define as the net aggregate market value of our mortgage-backed securities (including the underlying market values of our long and short TBA positions) divided by total shareholders' equity—increased quarter over quarter to 7.9:1 from 7.4:1, and so remains meaningfully higher than as of December 31, 2017, when this ratio was 5.7:1, as well as compared to the quarter-end average over the past three years ended December 31, 2017 of 5.7:1. TBAs are forward-settling Agency RMBS where the mortgage pass-through certificates to be delivered are "To-Be-Announced."

With Agency RMBS prices declining again during the third quarter, our long portfolio had significant realized and unrealized losses. Partially offsetting these losses were significant gains on our interest rate swaps, futures, and TBA short positions as interest rates rose. Specified pools outperformed TBAs in the quarter due to weaker TBA dollar rolls, which also benefited our results. Short positions in TBAs continue to represent a significant portion of our interest rate hedging portfolio.

Average pay-ups on our specified pools decreased slightly to 0.56% as of September 30, 2018, as compared to 0.58% as of June 30, 2018. Pay-ups are price premiums for specified pools relative to their TBA counterparts. Additionally, our GNMA portfolio continued to benefit from declining prepayment speeds, which we largely attributed to recent policy changes.

We expect to continue to target specified pools that, taking into account their particular composition and based on our prepayment projections, should: (1) generate attractive yields relative to other Agency RMBS and U.S. Treasury securities, (2) 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, proprietary prepayment models, and extensive databases remain essential tools in our implementation of this strategy.

Our non-Agency RMBS performed well during the quarter, driven by strong net interest income and net realized and unrealized gains. Fundamentals underlying non-Agency RMBS continue to remain strong, led by a stable housing market. Our total investment in non-Agency RMBS was relatively unchanged period over period at \$12.0 million as of both September 30, 2018 and June 30, 2018. To the extent that more attractive entry points develop in non-Agency RMBS, we may increase our capital allocation to this sector.

The following table summarizes prepayment rates for our portfolio of fixed-rate specified pools (excluding those backed by reverse mortgages) for the three-month periods ended September 30, 2018, June 30, 2018, March 31, 2018, and December 31, 2017.

	Three-Month Period Ended			
	September 30, 2018	June 30, 2018	March 31, 2018 <sup>(2)</sup>	December 31, 2017 <sup>(2)</sup>
Three-Month Constant Prepayment Rates <sup>(1)</sup>	8.4%	8.2%	7.0%	7.5%

- (1) Excludes Agency fixed-rate RMBS without any prepayment history.
- (2) Prior period calculation methodology has been conformed to current period calculation methodology.



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The following table provides details about the composition of our portfolio of fixed-rate specified pools (excluding those backed by reverse mortgages) as of September 30, 2018 and June 30, 2018.

	September 30, 2018			June 30, 2018			
	Coupon	Current Principal Value	Fair Value	Weighted Average Loan Age (Months)	Current Principal Value	Fair Value	Weighted Average Loan Age (Months)
		(In thousands)			(In thousands)		
Fixed-rate Agency RMBS:							
15-year fixed-rate mortgages:							
	3.00	\$31,429	\$31,103	34	\$33,950	\$33,794	30
	3.50	106,246	106,915	30	105,006	106,351	29
	4.00	7,574	7,751	44	8,124	8,354	41
Total 15-year fixed-rate mortgages		145,249	145,769	31	147,080	148,499	30
20-year fixed-rate mortgages:							
	4.00	7,687	7,866	39	8,143	8,421	36
30-year fixed-rate mortgages:							
	2.50	875	807	63	884	826	60
	3.00	35,542	34,222	33	34,373	33,433	31
	3.03	444	428	75	448	438	72
	3.25	1,084	1,078	21	1,089	1,094	18
	3.28	224	214	75	367	356	72
	3.50	287,329	284,311	27	352,436	352,655	24
	3.75	3,266	3,264	14	3,282	3,310	11
	4.00	516,291	524,555	23	519,265	532,807	21
	4.50	270,341	280,687	22	253,475	265,372	24
	5.00	99,592	105,253	20	75,145	79,930	23
	5.50	47,694					