CAPSTEAD MORTGAGE CORP
Form 10-Q/A
January 12, 2009

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q/A

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

For the quarterly period ended: September 30, 2008

OR

o **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: 001-08896

CAPSTEAD MORTGAGE CORPORATION

(Exact name of Registrant as specified in its Charter)

Maryland	**75-2027937**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
8401 North Central Expressway, Suite 800, Dallas, TX	**75225**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(214) 874-2323**

Indicate by check mark whether the Registrant (1) has filed all documents and 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 þ NO o

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

Large accelerated filer o	Accelerated filer þ	Non-accelerated filer o	Smaller reporting company o

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) YES o NO þ

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock ($0.01 par value)	58,780,175 as of October 30, 2008

CAPSTEAD MORTGAGE CORPORATION
FORM 10-Q/A
FOR THE QUARTER ENDED SEPTEMBER 30, 2008
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EXPLANATORY NOTE RECLASSIFYING RESTATEMENT

After receiving a request from the Securities and Exchange Commission (the Commission) in a comment letter dated December 18, 2008, management of Capstead Mortgage Corporation (the Company) concluded that the Company s previously filed consolidated statements of operations for the three years ending December 31, 2007 and for the periods included in its Forms 10-Q filed in 2008, should be reclassified and restated to include interest expense from unsecured borrowings with interest expense from repurchase arrangements and similar borrowings in arriving at net interest margin rather than including interest expense from unsecured borrowings as a component of other revenue (expense). Accordingly, the consolidated statements of operations included in this Form 10-Q/A have been restated to reflect interest income from all sources under the caption Interest income and interest expense from all sources under the caption Interest expense. The resulting net interest margin subtotal no longer provides readers of the Company s consolidated financial statements with solely the net interest margin earned on its portfolio of mortgage securities and similar investments after directly-related secured borrowings, but a more all-inclusive measure of net interest margin that includes interest income earned on overnight cash investments and cash margin balances and interest costs associated with the unsecured borrowings.

The reclassifications contained in these restatements do not change the Company s previously reported net income, earnings per share or stockholders equity for any of the aforementioned periods. In addition, the restatements do not impact the Company s consolidated balance sheets, statements of stockholders equity or cash flows for the indicated periods.

The impact of the reclassifications in the consolidated statements of income for the quarter and nine months ended September 30, 2008 and 2007 is summarized as follows:

	Quarter Ended September 30		*Nine Months Ended September 30*	
	2008	***2007***	***2008***	***2007***
Interest income:				
As previously reported	$ 99,205	$ 74,949	$ 302,888	$ 222,886
Reclassification	346	212	1,932	313
As amended	$ 99,551	$ 75,161	$ 304,820	$ 223,199
Interest expense:				
As previously reported	$ (60,032)	$ (66,478)	$ (184,357)	$ (197,174)
Reclassification	(2,186)	(2,186)	(6,560)	(6,560)
As amended	$ (62,218)	$ (68,664)	$ (190,917)	$ (203,734)
Net interest income:				
As previously reported	$ 39,173	$ 8,471	$ 118,531	$ 25,712
Reclassification	(1,840)	(1,974)	(4,628)	(6,247)
As amended	$ 37,333	$ 6,497	$ 113,903	$ 19,465
Other revenue (expense):				
As previously reported	$ (4,491)	$ (11,866)	$ (17,104)	$ (18,345)
Reclassification	1,840	1,974	4,628	6,247

As amended	$ (2,651)	$ (9,892)	$ (12,476)	$ (12,098)
Impact on net income from these restatements	$	$	$	$

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Management believes its previous presentation was based on a reasonable interpretation of the applicable rules of the Commission, and as such, management believes the restatement has had no impact on the conclusion reached at December 31, 2007 that the design and operation of the Company s disclosure controls and procedures were effective. This Form 10-Q/A has been signed as of the current date and all certifications of the Company s Chief Executive Officer and Chief Financial Officer are given as of a current date. Accordingly, this Form 10-Q/A should be read in conjunction with the Company s filings made with the Commission subsequent to the March 5, 2008 filing of the original Form 10-K for the year ended December 31, 2007.

Management and the Audit Committee of the Board of Directors have discussed these matters with the Company s independent registered public accounting firm, Ernst & Young, LLP.

For the convenience of the reader, this Form 10-Q/A sets forth the Company s original Form 10-Q as filed with the SEC on October 30, 2008 (the Original 10-Q) in its entirety, as amended by, and to reflect, the reclassifications required by this restatement. No other attempt has been made in this Form 10-Q/A to update other disclosures presented in the Original 10-Q, except as required to reflect the effects of the restatement. This Form 10-Q/A does not reflect events occurring after the filing of the Original 10-Q or modify or update those disclosures, including the exhibits to the Original 10-Q affected by subsequent events.

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ITEM 1. FINANCIAL STATEMENTS
PART I. ¾ FINANCIAL INFORMATION
CAPSTEAD MORTGAGE CORPORATION
CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts)

	September 30, 2008 (unaudited)	*December 31, 2007*
Assets:		
Mortgage securities and similar investments ($7.7 billion pledged under repurchase arrangements)	$ 7,936,112	$ 7,108,719
Investments in unconsolidated affiliates	3,117	3,117
Interest rate swap agreements at fair value	5,202	
Receivables and other assets	108,502	90,437
Cash and cash equivalents	137,475	6,653
	$ 8,190,408	$ 7,208,926
Liabilities:		
Repurchase arrangements and similar borrowings	$ 7,242,848	$ 6,500,362
Unsecured borrowings	103,095	103,095
Interest rate swap agreements at fair value	8,867	2,384
Common stock dividend payable	32,024	9,786
Accounts payable and accrued expenses	37,171	32,382
	7,424,005	6,648,009
Stockholders equity:		
Preferred stock $0.10 par value; 100,000 shares authorized: $1.60 Cumulative Preferred Stock, Series A, 197 and 202 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively ($3,232 aggregate liquidation preference)	2,755	2,828
$1.26 Cumulative Convertible Preferred Stock, Series B, 15,819 shares issued and outstanding at September 30, 2008 and December 31, 2007 ($180,025 aggregate liquidation preference)	176,705	176,705
Common stock $0.01 par value; 250,000 shares authorized: 58,226 and 40,819 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively	582	408
Paid-in capital	932,113	702,170
Accumulated deficit	(358,155)	(358,155)
Accumulated other comprehensive income	12,403	36,961
	766,403	560,917

	$	8,190,408	$ 7,208,926

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(unaudited)

	Quarter Ended September 30		*Nine Months Ended September 30*	
	2008	***2007***	***2008***	***2007***
		(as Restated, see NOTE 13)		
Interest income:				
Mortgage securities and similar investments	$ 99,205	$ 74,949	$ 302,888	$ 222,886
Other	346	212	1,932	313
	99,551	75,161	304,820	223,199
Interest expense:				
Repurchase arrangements and similar borrowings	(60,032)	(66,478)	(184,357)	(197,174)
Unsecured borrowings	(2,186)	(2,186)	(6,560)	(6,560)
	(62,218)	(68,664)	(190,917)	(203,734)
	37,333	6,497	113,903	19,465
Other revenue (expense):				
Loss from portfolio restructuring		(8,276)	(1,408)	(8,276)
Other revenue (expense)	(45)	62	(61)	1,069
Incentive compensation	(300)		(4,820)	
Other operating expense	(2,306)	(1,678)	(6,187)	(4,891)
	(2,651)	(9,892)	(12,476)	(12,098)
Income (loss) before equity in earnings of unconsolidated affiliates	34,682	(3,395)	101,427	7,367
Equity in earnings of unconsolidated affiliates	64	247	194	1,486
Net income (loss)	$ 34,746	$ (3,148)	$ 101,621	$ 8,853
Net income available (loss attributable) to common stockholders:				
Net income (loss)	$ 34,746	$ (3,148)	$ 101,621	$ 8,853
Less cash dividends paid on preferred stock	(5,062)	(5,064)	(15,189)	(15,192)

	$ 29,684	$ (8,212)	$ 86,432	$ (6,339)
Net income (loss) per common share:				
Basic	$ 0.53	$ (0.43)	$ 1.66	$ (0.33)
Diluted	0.52	(0.43)	1.64	(0.33)
Cash dividends declared per share:				
Common	$ 0.550	$ 0.040	$ 1.660	$ 0.100
Series A Preferred	0.400	0.400	1.200	1.200
Series B Preferred	0.315	0.315	0.945	0.945

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands, unaudited)

	Nine Months Ended September 30	
	2008	***2007***
Operating activities:		
Net income	$ 101,621	$ 8,853
Noncash items:		
Amortization of investment premiums	23,208	17,855
Depreciation and other amortization	184	171
Equity-based compensation costs	948	673
Amounts related to interest rate swap agreements	528	
Loss from portfolio restructuring	1,408	8,276
Net change in receivables, other assets, accounts payable and accrued expenses	17,500	4,968
Net cash provided by operating activities	145,397	40,796
Investing activities:		
Purchases of mortgage securities and similar investments	(2,851,297)	(1,737,579)
Proceeds from sales of mortgage securities and similar investments	766,800	803,363
Principal collections on mortgage securities and similar investments	1,202,737	1,371,343
Investment in unconsolidated affiliates		8,952
Net cash (used in) provided by investing activities	(881,760)	446,079
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	49,296,731	34,888,670
Principal payments on repurchase arrangements and similar borrowings	(48,554,240)	(35,321,353)
Collateral deposits on interest rate swap agreements	(22,756)	
Payment on early termination of interest rate swap agreement	(2,275)	
Capital stock transactions	233,739	1,518
Dividends paid	(84,014)	(16,738)
Net cash provided by (used in) financing activities	867,185	(447,903)
Net change in cash and cash equivalents	130,822	38,972
Cash and cash equivalents at beginning of period	6,653	5,661
Cash and cash equivalents at end of period	$ 137,475	$ 44,633

See accompanying notes to consolidated financial statements.

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CAPSTEAD MORTGAGE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2008
(unaudited)

NOTE 1 ¾ BUSINESS

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a REIT) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as Capstead or the Company. Capstead earns income from investing in real estate-related assets on a leveraged basis. These investments currently consist primarily of a core portfolio of residential adjustable-rate mortgage (ARM) securities issued and guaranteed by government-sponsored entities, either Fannie Mae or Freddie Mac, or by an agency of the federal government, Ginnie Mae (collectively, Agency Securities).

NOTE 2 ¾ BASIS OF PRESENTATION

Interim Financial Reporting and Reclassifications

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2008. For further information refer to the consolidated financial statements and footnotes thereto incorporated by reference in the Company s annual report on Form 10-K for the year ended December 31, 2007. Certain prior year amounts have been reclassified to conform to the current year presentation.

Accounting for Seller-financed Acquisitions of Mortgage Securities

Capstead generally pledges its *Mortgage securities and similar investments* as collateral under repurchase arrangements and a portion of the Company s acquisitions may initially be financed with sellers. The Company records such assets and the related borrowings gross on its balance sheet, and the corresponding interest income and interest expense gross on its income statement. In addition, the asset is typically a security held available-for-sale, and any change in fair value of the asset is recorded as a component of *Accumulated other comprehensive income.* In February 2008 the Financial Accounting Standards Board (FASB) issued Staff Position 140-3 Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP140-3). Under FSP140-3, certain seller-financed acquisitions entered into after December 31, 2008 will not qualify as acquisitions if the related financing is considered sufficiently linked to the acquisition transaction. Any such seller-financed acquisitions that are deemed to be sufficiently linked will be reported net of related financings at fair value with related changes in fair value reported in earnings until such time as the assets are no longer financed with the sellers. Because such linkage does not exist for the Company s typical acquisition transactions and related financings, management does not believe implementing FSP140-3 will have a material effect on Capstead s results of operations, taxable income or financial condition. Also, it is not expected to affect the Company s status as a REIT or cause it to fail to qualify for its exemption under Investment Company Act of 1940 which requires that the Company must, among other things, maintain at least 55% of its assets directly in qualifying real estate interests.

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Accounting for Variable Interests

The FASB recently issued an exposure draft that would amend FASB Interpretation No. 46(R) *Consolidation of Variable Interest Entities* (FIN46(R)), to address concerns raised about FIN46(R) s complexity and reliance on quantitative analyses and to require a greater scope of entities to be evaluated for consolidation using FIN46(R) s provisions. The potential amendments, which would be effective for fiscal years beginning after November 15, 2009, would require an enterprise (including its related party and de facto agents) to determine whether it is the primary beneficiary of an entity primarily through a qualitative assessment, considering if it has both the power to direct matters that significantly affect the entity and the right to receive potentially significant benefits or the obligation to absorb potentially significant losses of the entity. The proposed amendment is not expected to have a material impact on the Company.

Fair Value Measurements

In September 2006 the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS157). SFAS157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS157 s valuation techniques are based on observable and unobservable inputs. Observable inputs reflect readily obtainable data from independent sources, while unobservable inputs are internally derived, reflecting what the reporting entity believes to be market assumptions. SFAS157 classifies these inputs into the following hierarchy:

Level One Inputs Quoted prices for identical instruments in active markets.

Level Two Inputs Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level Three Inputs Instruments with primarily unobservable value drivers.

In February 2007 the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS159). This statement permits, but does not require, entities to measure many financial instruments, including liabilities and certain other items, at fair value with resulting changes in fair value reported in earnings. In adopting SFAS157 and SFAS159 on January 1, 2008, the Company determined that it was not necessary to make any substantive changes to its valuation practices and that currently it will not report changes in fair value of any of its financial assets or liabilities in earnings as allowed under SFAS159. Therefore, the adoption of these standards did not have any impact on the Company s consolidated financial statements.

The Company s holdings of mortgage securities, nearly all of which are classified as held available-for-sale, are measured at fair value on a recurring basis using Level Two Inputs. See NOTE 10 for a discussion of fair value methodology utilized and other related fair value disclosures. The Company s interest rate swap agreements are also measured at fair value on a recurring basis primarily using Level Two Inputs that utilize the standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts based on expected future interest rates derived from observable market interest rate curves. The Company also incorporates both its own nonperformance risk and its counterparties nonperformance risk in determining the fair value of its interest rate swap agreements. In considering the effect of nonperformance risk, the Company considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and has concluded that counterparty risk is not significant to the overall valuation of these agreements. See NOTE 6 for additional fair value disclosures related to these agreements.

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NOTE 3 ¾ EARNINGS (LOSS) PER COMMON SHARE

Basic earnings (loss) per common share is computed by dividing net income (loss), after deducting preferred share dividends, by the weighted average number of common shares outstanding. Diluted earnings (loss) per common share is computed by dividing net income (loss), after deducting dividends on convertible preferred shares when such shares are antidilutive, by the weighted average number of common shares and common share equivalents outstanding, giving effect to equity awards and convertible preferred shares, when such awards and shares are dilutive. For calculation purposes the Series A and B preferred shares are considered dilutive whenever basic earnings per common share exceeds each Series dividend divided by the conversion rate applicable for that period. Components of the computation of basic and diluted earnings (loss) per common share were as follows (in thousands, except per share amounts):

	Quarter Ended September 30		*Nine Months Ended September 30*	
	2008	***2007***	***2008***	***2007***
Numerators for basic earnings (loss) per common share:				
Net income (loss)	$ 34,746	$ (3,148)	$ 101,621	$ 8,853
Less Series A and B preferred share dividends	(5,062)	(5,064)	(15,189)	(15,192)
Income available (loss attributable) to common stockholders	$ 29,684	$ (8,212)	$ 86,432	$ (6,339)
Weighted average common shares outstanding	56,318	19,108	51,991	19,017
Basic earnings (loss) per common share	$ 0.53	$ (0.43)	$ 1.66	$ (0.33)
Numerators for diluted earnings (loss) per common share:				
Net income (loss)	$ 34,746	$ (3,148)	$ 101,621	$ 8,853
Less dividends on antidilutive convertible preferred shares		(5,064)		(15,192)
Income available (loss attributable) to common stockholders	$ 34,746	$ (8,212)	$ 101,621	$ (6,339)
Denominator for diluted earnings (loss) per common share:				
Weighted average common shares outstanding	56,318	19,108	51,991	19,017
Net effect of dilutive equity awards	192		316	
Net effect of dilutive convertible preferred shares	9,842		9,830	
	66,352	19,108	62,137	19,017
Diluted earnings (loss) per common share	$ 0.52	$ (0.43)	$ 1.64	$ (0.33)

Potentially dilutive securities excluded from the calculation of diluted earnings (loss) per common share were as follows (in thousands):

	Quarter Ended September 30		*Nine Months Ended September 30*	
	2008	***2007***	***2008***	***2007***
Equity awards:				
Shares issuable under option awards	40	1,020	10	1,020
Nonvested stock awards	148	281		281
Convertible preferred shares:				
Series A shares		202		202
Series B shares		15,819		15,819

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NOTE 4 ¾ MORTGAGE SECURITIES AND SIMILAR INVESTMENTS

Mortgage securities and similar investments and related weighted average rates classified by collateral type and interest rate characteristics were as follows (dollars in thousands):

	Principal Balance	*Investment Premiums (Discounts)*	*Basis*	*Carrying Amount* [(a)]	*Net WAC* [(b)]	*Average Yield* [(b)]
September 30, 2008						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$ 10,762	$ 29	$ 10,791	$ 10,812	6.65%	6.50%
ARMs	7,331,953	98,264	7,430,217	7,445,344	5.48	4.97
Ginnie Mae ARMs	411,779	2,117	413,896	416,635	5.21	5.04
	7,754,494	100,410	7,854,904	7,872,791	5.47	4.98
Residential mortgage loans:						
Fixed-rate	6,028	(8)	6,020	6,020	7.14	6.89
ARMs	9,176	80	9,256	9,256	5.87	5.79
	15,204	72	15,276	15,276	6.37	6.23
Commercial real estate loans	43,233	(12)	43,221	43,221	8.12	9.48
Collateral for structured financings	4,746	78	4,824	4,824	8.11	7.82
	$ 7,817,677	$ 100,548	$ 7,918,225	$ 7,936,112	5.49	5.00
December 31, 2007						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$ 13,079	$ 36	$ 13,115	$ 13,138	6.63%	6.43%
ARMs	6,382,773	89,017	6,471,790	6,507,447	6.36	5.78
Ginnie Mae ARMs	515,091	2,465	517,556	521,288	5.87	5.62
	6,910,943	91,518	7,002,461	7,041,873	6.33	5.77
Residential mortgage loans:						
Fixed-rate	7,412	(3)	7,409	7,409	7.05	7.14
ARMs	11,097	96	11,193	11,193	7.18	7.05
	18,509	93	18,602	18,602	7.13	7.08
	43,435	(439)	42,996	42,996	10.46	12.21

Commercial real estate loans						
Collateral for structured financings	5,162	86	5,248	5,248	8.14	8.07
	$ 6,978,049	$ 91,258	$ 7,069,307	$ 7,108,719	6.36	5.80

(a) Includes mark-to-market for securities classified as available-for-sale, if applicable (see NOTE 10).

(b) Net WACs, or weighted average coupons, net of servicing and other fees, are presented as of the indicated balance sheet date. Average Yields are presented for the quarter then ended calculated including the amortization of investment premiums and excluding unrealized gains and losses.

Agency Securities carry an implied AAA rating and therefore limited credit risk. Residential mortgage loans held by the Company were previously collateral underlying private residential mortgage pass-through securities formed before 1995 when Capstead operated a mortgage conduit. These loans are now carried as whole loans on the Company s balance sheet with the related credit risk borne by the Company. Commercial real estate loans are subordinate loans that carry credit risk associated with specific commercial real estate collateral. Collateral for structured financings consists of private residential mortgage pass-through securities pledged to secure these securitizations. The related credit risk is borne by bondholders of the securitization to which the collateral is pledged. The maturity of mortgage securities is directly affected by the rate of principal prepayments on the underlying mortgage loans.

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Fixed-rate investments are either residential mortgage loans or Agency Securities backed by mortgage loans with fixed rates of interest. Adjustable-rate investments generally are ARM Agency Securities backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities either (i) adjust annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate (CMT) or the one-year London interbank offered rate (LIBOR), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indexes such as one-month LIBOR or the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the loans.

Commercial real estate loans consist of (a) $4.8 million in subordinated loans accruing interest at 18% and scheduled to pay off over the next nine months through townhome and land sales, pursuant to an extension entered into in September 2008, and (b) $38.4 million in subordinated loans accruing interest at a margin over one-month LIBOR on a luxury hotel property in the Caribbean that matured October 9, 2008. A pre-workout letter reserving all rights of the lending group was executed prior to maturity to allow additional time to reach a resolution for the financing of this property.

NOTE 5 ¾ INVESTMENTS IN UNCONSOLIDATED AFFILIATES

To facilitate the issuance of *Unsecured borrowings*, in September and December 2005 and in September 2006 Capstead formed and capitalized a series of three Delaware statutory trusts through the issuance to the Company of the trusts common securities totaling $3.1 million (see NOTE 7). The Company s equity in the earnings of the trusts consists solely of the common trust securities pro rata share in interest accruing on *Unsecured borrowings* issued to the trusts.

NOTE 6 ¾ REPURCHASE ARRANGEMENTS AND SIMILAR BORROWINGS, INCLUDING RELATED HEDGING ACTIVITY

Repurchase arrangements and similar borrowings, classified by type of collateral and maturities, and related weighted average interest rates were as follows (dollars in thousands):

	September 30, 2008		*December 31, 2007*	
Collateral Type	*Borrowings Outstanding*	*Average Rate**	*Borrowings Outstanding*	*Average Rate**
Borrowings with maturities of 30 days or less:				
Agency Securities	$ 5,694,868	3.25%	$ 4,963,674	4.93%
Residential mortgage loans			14,352	6.12
	5,694,868	3.25	4,978,026	4.93
Borrowings with maturities greater than 30 days:				
Agency Securities (31 to 90 days)	415,736	4.09		
Agency Securities (91 to 360 days)	1,127,420	5.05	368,694	4.92
Agency Securities (greater than 360 days)			1,127,420	5.05
	1,543,156	4.79	1,496,114	5.02
Similar borrowings:				
Commercial real estate loans			20,974	6.88
Collateral for structured financings	4,824	8.11	5,248	8.14

	$ 7,242,848	3.58	$ 6,500,362	4.96

* *Average Rate is presented as of the indicated balance sheet date and does not include the effects of interest rate swap agreements held as cash flow hedges on a designated portion of 30-day borrowings (see below). After giving effect to these cash flow hedges, the Average Rate was 3.75% at September 30, 2008.*

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Capstead generally pledges its *Mortgage securities and similar investments* as collateral under uncommitted repurchase arrangements with investment banking firms and commercial banks, the terms and conditions of which are negotiated on a transaction-by-transaction basis. Interest rates on these borrowings are generally based on a margin over the federal funds target rate or a corresponding interest rate for longer-term borrowings and amounts available to be borrowed are dependent upon the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates, credit quality and liquidity conditions within the investment banking, mortgage finance and real estate industries. In response to declines in fair value of pledged securities, lenders may require the Company to post additional collateral or pay down borrowings to re-establish agreed upon collateral requirements, referred to as margin calls. The commercial real estate loan borrowing, which matured on August 9, 2008, accrued interest at a margin over one-month LIBOR. The maturity of outstanding structured financings is directly affected by the rate of principal prepayments on the related mortgage pass-through securities pledged as collateral and are currently subject to redemption by the residual bondholders.

Prior to changes in credit market conditions during the fall of 2007, Capstead made use of longer-dated repurchase arrangements to effectively lock in financing spreads on a portion of its investments in longer-to-reset ARM Agency Securities for a significant portion of the fixed-rate terms of these investments. As of September 30, 2008, these longer-term committed borrowings consisted of a series of repurchase arrangements totaling $1.41 billion with remaining terms of from two to 11 months, an average maturity of seven months and an average interest rate of 5.01%. Capstead had $82 million of its capital at risk with its largest single counterparty (Cantor Fitzgerald & Company) related to $1.33 billion of these borrowings. Late in 2007 the Company began using two-year term, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements for this purpose. As of September 30, 2008 the Company s swap position consisted of 15 swap agreements with an aggregate notional amount of $1.90 billion, an average remaining term of 16 months and an average fixed-rate of 3.44%. The interest rate swap agreements have been designated as cash flow hedges of the variability of the underlying benchmark interest rate of certain current and forecasted 30-day repurchase arrangements. This hedge relationship in effect establishes a relatively stable fixed borrowing rate on the designated borrowings with the variable-rate payments to be received on the swap agreements generally offsetting interest accruing on the designated borrowings that reset monthly to market rates, leaving the fixed-rate payments to be paid on the swap agreements as the Company s effective borrowing rate, subject to certain adjustments.

As of September 30, 2008, an asset for $5.2 million and a liability for $8.9 million were recorded on the Company s balance sheet representing the fair value of the swap agreements at quarter-end. Included in *Other revenue* is a holding gain of $81,000 realized prior to designating one of these agreements as a cash flow hedge during the first quarter of 2008 and included in *Accumulated other comprehensive income* at September 30, 2008 is a net unrealized loss of $3.9 million that arose while the swap agreements were designated as cash flow hedges. In March 2008 a $100 million notional amount swap agreement was terminated for a realized loss of $2.3 million, which is being amortized to earnings over the remaining 15 month term of the derivative (the related amortized balance in *Accumulated other comprehensive income* was $1.6 million as of September 30, 2008). During the quarter and nine months ended September 30, 2008 the effect of the Company s hedging program utilizing swap agreements was an increase in *Interest expense* of $4.2 million and $6.8 million, respectively, consisting of net accrued cash outflows of $3.8 million and $6.2 million, respectively, measured hedge ineffectiveness of $24,000 and $19,000, respectively, and includes amortization of the terminated swap agreement of $342,000 and $591,000, respectively.

The weighted average effective interest rate on *Repurchase arrangements and similar borrowings* was 3.26% for third quarter 2008 including the effects of the swap agreements. The weighted average maturity of these borrowings was 2.0 months at September 30, 2008, with an average effective repricing period of 4.9 months including the effects of the interest rate swap agreements.

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NOTE 7 ¾ UNSECURED BORROWINGS

Unsecured borrowings consist of 30-year junior subordinated notes issued in September 2005, December 2005 and September 2006 by Capstead to Capstead Mortgage Trust I, Trust II and Trust III, respectively. These unconsolidated affiliates of the Company were formed to issue $3.1 million of the trusts common securities to Capstead and to privately place $100 million of preferred securities with unrelated third party investors. Included in *Receivables and other assets* are $2.7 million in remaining issue costs associated with these transactions. Note balances and related weighted average interest rates as of September 30, 2008 and December 31, 2007 (calculated including issue cost amortization) were as follows (dollars in thousands):

	Borrowings Outstanding	***Average Rate***
Junior subordinated notes:		
Capstead Mortgage Trust I	$ 36,083	8.31%
Capstead Mortgage Trust II	41,238	8.46
Capstead Mortgage Trust III	25,774	8.78
	$ 103,095	8.49

The junior subordinated notes pay interest to the trusts quarterly calculated at fixed rates of 8.19% to 8.685% for ten years from issuance and subsequently at prevailing three-month LIBOR rates plus 3.30% to 3.50% for 20 years, reset quarterly. The trusts remit dividends pro rata to the common and preferred trust securities based on the same terms as the subordinated notes provided that payments on the trusts common securities are subordinate to payments on the related preferred securities. The Capstead Mortgage Trust I notes and trust securities mature in October 2035 and are redeemable, in whole or in part, without penalty, at the Company s option anytime on or after October 30, 2010. The Capstead Mortgage Trust II notes and trust securities mature in December 2035 and are redeemable, in whole or in part, without penalty, at the Company s option anytime on or after December 15, 2015. The Capstead Mortgage Trust III notes and trust securities mature in September 2036 and are redeemable, in whole or in part, without penalty, at the Company s option anytime on or after September 15, 2016. The weighted average effective interest rate for *Unsecured borrowings* (calculated including issue cost amortization) was 8.49% during the quarter ended September 30, 2008.

NOTE 8 ¾ RECENT COMMON EQUITY RAISES

In February 2008 Capstead completed its third public offering since September 2007 raising $126.7 million in new common equity capital, after underwriting discounts and offering expenses, through the issuance of 8.6 million common shares at a price of $15.50 per share and during the nine months ended September 30, 2008. In addition, the Company raised $107.0 million, after expenses, under its continuous offering program by issuing 8.6 million common shares at an average price of $12.39 per share, including proceeds of $25.2 million, after expenses, during the third quarter through the issuance of 2.2 million common shares at an average price of $11.72 per share. Year-to-date, these issuances increased common equity capital by $233.7 million. Subsequent to quarter-end and through the filing date of this report, the Company further increased its common equity capital by $5.6 million, after expenses, through the issuance of 555,000 common shares at an average sales price of $10.08 per share under the continuous offering program. The Company may raise more capital in future periods subject to market conditions and blackout periods associated with the dissemination of earnings and dividend announcements and other important company-specific news. The accompanying September 30, 2008 financial statements and related disclosures do not reflect the effects of shares issued subsequent to quarter-end.

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NOTE 9 ¾ COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) is net income (loss) plus other comprehensive loss. Other comprehensive loss currently consists of the change in unrealized gain on mortgage securities classified as available-for-sale and amounts related to derivative financial instruments held as cash flow hedges. As of September 30, 2008, the *Accumulated other comprehensive income* component of *Stockholders equity* consisted of $17.9 million in net unrealized gains on mortgage securities held available-for-sale, $3.9 million in net unrealized losses on interest rate swap agreements held as cash flow hedges and a net unamortized balance of $1.6 million associated with terminated cash flow hedges. The following provides information regarding the components of comprehensive income (loss) (in thousands):

	Quarter Ended September 30		*Nine Months Ended September 30*	
	2008	***2007***	***2008***	***2007***
Net income (loss)	$ 34,746	$ (3,148)	$ 101,621	$ 8,853
Other comprehensive income (loss):				
Amounts related to cash flow hedges:				
Change in net unrealized losses	(1,501)		(1,344)	
Early termination of interest rate swap agreement			(2,275)	
Reclassification adjustment for amounts included in net income (loss)	341	(8)	586	(31)
Amounts related to available-for-sale securities:				
Reclassification adjustments for amounts included in net income (loss)		5,941	1,408	5,941
Change in net unrealized gains	(23,440)	(11,803)	(22,933)	(9,694)
Other comprehensive loss	(24,600)	(5,870)	(24,558)	(3,784)
Comprehensive income (loss)	$ 10,146	$ (9,018)	$ 77,063	$ 5,069

NOTE 10 ¾ DISCLOSURES REGARDING FAIR VALUES OF MORTGAGE SECURITIES AND SIMILAR INVESTMENTS

Fair values of most of Capstead s *Mortgage securities and similar investments* are influenced by changes in, and market expectations for changes in, interest rates and market liquidity conditions, as well as other factors beyond the control of management. Fair values are estimated at each balance sheet date considering recent trading activity for similar investments and pricing levels indicated by lenders in connection with designating collateral for repurchase arrangements, provided such pricing levels are considered indicative of actual market clearing transactions. Currently, only investments in mortgage securities classified as available-for-sale are reported at fair value on the Company s balance sheet with unrealized gains and losses recorded as a component of *Accumulated other comprehensive income* in *Stockholders equity.*

Fair value disclosures for investments classified as available-for-sale were as follows (in thousands):

	Basis	***Gross Unrealized Gains***	***Gross Unrealized Losses***	***Fair Value***
As of September 30, 2008				
Agency Securities	$7,844,348	$32,884	$14,997	$7,862,235
As of December 31, 2007				

Agency Securities	$6,989,619	$42,090	$ 2,678	$7,029,031

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Fair value disclosures for investments classified as held-to-maturity were as follows (in thousands):

	Basis	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Fair Value*
As of September 30, 2008				
Collateral released from structured financings (Agency Securities)	$ 10,557	$ 273	$	$ 10,830
Collateral for structured financings	4,824			4,824
	$ 15,381	$ 273	$	$ 15,654
As of December 31, 2007				
Collateral released from structured financings (Agency Securities)	$ 12,842	$ 340	$	$ 13,182
Collateral for structured financings	5,248			5,248
	$ 18,090	$ 340	$	$ 18,430

Disclosures for investments in an unrealized loss position were as follows (in thousands):

	September 30, 2008		*December 31, 2007*	
	Fair Value	*Unrealized Loss*	*Fair Value*	*Unrealized Loss*
Securities in an unrealized loss position:				
One year or greater	$ 163,144	$ 1,891	$ 281,708	$ 1,907
Less than one year	2,995,961	13,106	417,656	771
	$ 3,159,105	$ 14,997	$ 699,364	$ 2,678

Managing a leveraged portfolio of primarily ARM Agency Securities remains the core focus of Capstead s investment strategy and management expects these securities will be held to maturity absent a major shift in the Company s investment focus. By focusing on investing in relatively short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically modest compared to investments in longer-duration assets. These declines can be recovered in a relatively short period of time as the coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment or the mortgage loans prepay. Consequently, any such declines in value generally would not constitute other-than-temporary impairments in value necessitating impairment charges.

Over the last 15 months, deteriorating conditions in the overall credit markets have led to heightened concerns related to credit risk associated with the mortgage loans underlying Agency Securities and the continued availability of sufficient financing to maintain then existing leverage levels for the mortgage REIT industry. From a credit risk perspective, the real or implied federal government guarantee associated with Agency Securities, particularly in light of the recent conservatorship of Fannie Mae and Freddie Mac, helps ensure that fluctuations in value due to credit risk associated with the underlying mortgage loans will be limited. From a market liquidity perspective, Capstead has responded to contracting market liquidity since the fall of 2007 by reducing portfolio leverage (secured borrowings divided by long-term investment capital) through (a) raising $439.7 million in new common equity capital, (b) selling a limited amount of mortgage securities in the fall of 2007 and again in March 2008, and (c) when appropriate,

curtailing the replacement of portfolio runoff. As a result of these efforts, the Company has lowered its portfolio leverage substantially, which together with maintaining higher than usual cash balances and expanding the number of lending counterparties with whom the Company routinely does business, has provided the Company with financial flexibility to address challenging credit market conditions. In March 2008 the Company sold Agency Securities with a cost basis of $768.2 million recognizing a loss from portfolio restructuring totaling $1.4 million (gross realized losses of $2.7 million, net of gross realized gains of $1.3 million). No investments were sold during the second and third quarters of 2008. Management believes it is appropriate to maintain the Company s leverage

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near the lower end of its targeted range of eight to 12 times long-term investment capital, which consists of *Stockholders equity* and *Unsecured borrowings*, net of related investments in statutory trusts. However, should market conditions warrant, the Company will take actions similar to those demonstrated over the previous 15 months in order to maintain sufficient financial flexibility to address ongoing market stresses.

NOTE 11 ¾ LONG-TERM INCENTIVE AND OTHER PLANS

Capstead sponsors long-term incentive plans to provide for the issuance of stock awards, option awards and other incentive-based equity awards to directors and employees (collectively, the Plans). As of September 30, 2008, the Plans had 1,498,957 common shares remaining available for future issuance. The Company also sponsors a qualified defined contribution retirement plan for all employees and a nonqualified deferred compensation plan for certain of its officers. In general the Company matches up to 50% of a participant s voluntary contribution up to a maximum of 6% of a participant s compensation and discretionary contributions of up to another 3% of compensation regardless of participation in the plans. All Company contributions are subject to certain vesting requirements. Contribution expenses were $42,000 and $109,000 for the quarter and nine months ended September 30, 2008, respectively.

In 2005 stock awards for a total of 172,600 common shares were issued to directors and employees (average grant date fair value: $7.86 per share) that vest in four annual installments, subject to certain restrictions, including continuous service. In December 2006 stock awards for a total of 197,500 common shares were issued to employees (grant date fair value: $8.19 per share) that vest in four annual installments beginning January 2, 2008, subject to similar restrictions. Also during 2006, stock awards for 21,457 common shares were issued to a new employee and certain directors (average grant date fair value: $6.86 per share), 6,457 shares of which were vested at grant with the remaining shares vesting proportionally over three years, subject to similar restrictions. In 2007, stock awards totaling 6,000 common shares were issued to directors that vested April 15, 2008 (grant date fair value $9.81). In December 2007, stock awards totaling 150,000 common shares were issued to employees that vest in six annual installments beginning January 2, 2009 (grant date fair value $13.05) subject to similar restrictions.

Stock award activity during the nine months ended September 30, 2008 is summarized below:

	Number of Shares	***Weighted Average Grant Date Fair Value***
Stock awards outstanding as of December 31, 2007	431,200	$ 9.82
Grants*	6,000	12.87
Forfeitures	(3,875)	10.70
Vested	(94,851)	8.10
Stock awards outstanding as of September 30, 2008	338,474	10.35

* *In May 2008, stock awards totaling 6,000 common shares were issued to directors that vest April 15, 2009.*

Option awards currently outstanding have contractual terms and vesting requirements at the grant date of up to ten years and generally have been issued with strike prices equal to the quoted market prices of the Company s common shares on the date of grant. The fair value of each option award is estimated on the date of grant using a Black-Scholes

option pricing model. The Company estimates option exercises, expected holding periods and forfeitures based on past experience and current expectations for option performance and employee/director attrition. The risk-free rate is based on market rates for the expected life of the option. Expected dividends are based on historical experience and expectations for future performance. Expected volatility is based on historical experience.

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During 2005 option awards granted to directors and employees totaled 430,000 shares with an average price of $7.85 and an average fair value of $0.61 per share, which was determined using average expected terms of four years, volatility factors of 27%, dividend yields of 10% and risk-free rates of 3.76%. During 2006 option awards granted to directors and employees totaled 258,000 shares with an average price of $7.43 and an average fair value of $0.78 per share, which was determined using average expected terms of four years, volatility factors of 31%, dividend yields of 10% and risk-free rates of 4.91%. During 2007 option awards granted to directors and employees totaled 220,500 shares with an average price of $10.46 and an average fair value of $0.89 per share, which was determined using average expected terms of four years, volatility factors of 27%, dividend yields of 10% and risk-free rates of 4.60%. Option award activity during the nine months ended September 30, 2008 is summarized below:

	Number of Shares	***Weighted Average Exercise Price***
Option awards outstanding as of December 31, 2007	948,656	$ 11.47
Grants (average fair value $2.08)*	30,000	12.87
Forfeitures	(1,875)	10.06
Expirations	(133,224)	29.91
Exercises	(287,807)	7.62
Option awards outstanding as of September 30, 2008	555,750	9.12

* *Option awards granted during 2008 to directors were valued with average expected terms of four years, volatility factors of 50%, dividend yields of 12% and risk-free rates of 2.91%.*

The weighted average remaining contractual term, average exercise price and aggregate intrinsic value for the 215,875 exercisable option awards outstanding as of September 30, 2008 was eight years, $8.94 and $468,000, respectively. The total intrinsic value of option awards exercised during the nine months ended September 30, 2008 was $2.8 million. No option awards were exercised during the third quarter of 2008. Unrecognized compensation costs for all unvested equity awards totaled $3.0 million as of September 30, 2008, to be expensed over a weighted average period of two years.

In September 2008 Capstead implemented a performance-based compensation program that provides for cash payments equal to the per share dividend amount declared on the Company s common stock multiplied by a notional amount of non-vesting or phantom common shares for a predetermined term (DER grants). DER grants are not attached to any stock or option awards and only have the right to receive the same cash distributions as the Company s common stockholders are entitled to during the related term. In connection with implementing this program, initial grants totaling 225,000 phantom common shares with four-year terms beginning July 1, 2008 were made to certain

executive officers.

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NOTE 12¾ NET INTEREST INCOME ANALYSIS

The following summarizes interest income, interest expense and weighted average interest rates as restated for the reclassification of other interest income and interest expense on unsecured borrowings see NOTE 13 (dollars in thousands):

	Quarter Ended September 30					
	2008		*2007*		*Related Changes in*	
	Amount	*Average Rate*	*Amount*	*Average Rate*	*Average Rate**	*Volume**
Interest income:						
Mortgage securities and similar investments	$ 99,205	5.00%	$ 74,949	5.67%	$ (9,700)	$ 33,956
Other	346	2.31	212	5.23	(172)	306
	99,551	4.98	75,161	5.67	(9,872)	34,262
Interest expense:						
Repurchase arrangements and similar borrowings	(60,032)	3.26	(66,478)	5.25	(29,751)	23,305
Unsecured borrowings	(2,186)	8.49	(2,186)	8.49		
	(62,218)	3.34	(68,664)	5.31	(29,751)	23,305
	$ 37,333	1.64	$ 6,497	0.36	$ 19,879	$ 10,957

	Nine Months Ended September 30					
	2008		*2007*		*Related Changes in*	
	Amount	*Average Rate*	*Amount*	*Average Rate*	*Average Rate**	*Volume**
Interest income:						
Mortgage securities and similar investments	$ 302,888	5.32%	$ 222,886	5.58%	$ (10,825)	$ 90,827
Other	1,932	3.00	313	5.22	(187)	1,806
	304,820	5.30	223,199	5.58	(11,012)	92,633
Interest expense:						
Repurchase arrangements and similar borrowings	(184,357)	3.49	(197,174)	5.22	(76,310)	63,493
Unsecured borrowings	(6,560)	8.49	(6,560)	8.49		
	(190,917)	3.56	(203,734)	5.28	(76,310)	63,493
	$ 113,903	1.74	$ 19,465	0.30	$ 65,298	$ 29,140

* *The change in interest income and interest expense due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.*

NOTE 13 ¾ RESTATEMENT TO RECLASSIFY INTEREST INCOME, INTEREST EXPENSE AND OTHER INCOME (EXPENSE)

After receiving a request from the Securities and Exchange Commission in a comment letter dated December 18, 2008, management concluded that the Company s previously filed consolidated statements of operations for the three years ending December 31, 2007 and for the periods included in its Forms 10-Q filed in 2008, should be reclassified and restated to include interest expense from unsecured borrowings with interest expense from repurchase arrangements and similar borrowings in arriving at net interest margin rather than including interest expense from unsecured borrowings within *Other revenue (expense).* Accordingly, the consolidated statements of operations for these periods have been restated to reflect interest income from all sources under the caption *Interest income* and interest expense from all sources under the caption *Interest expense.* The resulting net interest margin subtotal no longer

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provides readers of the Company s consolidated financial statements with solely the net interest margin earned on its portfolio of *Mortgage securities and similar investments* after directly-related secured borrowings, but a more all-inclusive measure of net interest margin that includes interest income earned on overnight cash investments and cash margin balances and interest costs associated with the unsecured borrowings.

The reclassifications contained in these restatements do not change the Company s previously reported net income, earnings per share or stockholders equity for any of the periods presented. In addition, the restatements do not impact the Company s consolidated balance sheets, statements of stockholders equity or cash flows for these periods.

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

Explanatory Note See NOTE 13 to the consolidated financial statements for an explanation of the reclassifying restatement of interest income, interest expense and other revenue (expense) reflected throughout this filing.

FINANCIAL CONDITION

Overview

Capstead Mortgage Corporation (together with its subsidiaries, Capstead or the Company) operates as a self-managed real estate investment trust for federal income tax purposes (a REIT) and is based in Dallas, Texas. Capstead earns income from investing its long-term investment capital in real estate-related assets on a leveraged basis. Capstead s core investment strategy is to conservatively manage a leveraged portfolio of residential adjustable-rate mortgage (ARM) securities issued and guaranteed by government-sponsored entities, either Fannie Mae or Freddie Mac, or by an agency of the federal government, Ginnie Mae (collectively, Agency Securities). Agency Securities carry an implied AAA rating with limited, if any, credit risk. Management believes this strategy can produce attractive risk-adjusted returns over the long term while virtually eliminating credit risk and reducing, but not eliminating, sensitivity to changes in interest rates.

Capstead increased its long-term investment capital by 31% during the nine months ended September 30, 2008 to $866 million by raising nearly $234 million in new common equity capital through an underwritten public offering that closed in February 2008 and through its continuous offering program. As a result of these common equity raises, book value per common share increased by $0.77 to $10.02 per common share during this period. The Company s long-term investment capital consists of common stockholders equity together with $179 million of perpetual preferred stockholders equity (recorded amount) and $100 million of long-term unsecured borrowings (net of related investments in statutory trusts). Subsequent to quarter-end, the Company raised an additional $6 million in new common equity capital under its continuous offering program.

Over the last 15 months, deteriorating conditions in the overall credit markets have led to heightened concerns related to credit risk associated with the mortgage loans underlying Agency Securities and the continued availability of sufficient financing to maintain then existing leverage levels for the mortgage REIT industry. From a credit risk perspective, the real or implied federal government guarantee associated with Agency Securities, particularly in light of the recent conservatorship of Fannie Mae and Freddie Mac, helps ensure that fluctuations in value due to credit risk associated with the underlying mortgage loans will be limited. From a market liquidity perspective, Capstead has responded to contracting market liquidity since the fall of 2007 by reducing portfolio leverage (secured borrowings divided by long-term investment capital) through (a) raising nearly $440 million in new common equity capital, (b) selling a limited amount of mortgage securities in the fall of 2007 and again in March 2008 (none during the second and third quarters of 2008), and (c) when appropriate, curtailing the replacement of portfolio runoff. As a result of these efforts, the Company has lowered its portfolio leverage substantially, which together with maintaining higher than usual cash balances and expanding the number of lending counterparties with whom the Company routinely does business, has provided the Company with financial flexibility to address challenging credit market conditions. Management believes it is appropriate to maintain the Company s leverage near the lower end of its targeted range of eight to 12 times long-term investment capital. However, should market conditions warrant, the Company will take actions similar to those demonstrated over the previous 15 months in order to maintain sufficient financial flexibility to address ongoing market stresses.

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Financing spreads (the difference between yields on the Company s investments and rates on related secured borrowings) averaged 174 basis points during the third quarter of 2008, down from 205 basis points earned during the second quarter of 2008. This decline of 31 basis points was primarily attributable to lower yields on acquisitions and lower coupon interest rates on mortgage loans underlying ARM securities that reset in recent periods and was exacerbated by the recent deterioration in credit market conditions, which began to increase borrowing rates on the Company s short-term borrowings late in the third quarter.

The size and composition of Capstead s investment portfolios depend on investment strategies being implemented by management, the availability of investment capital and overall market conditions, including the availability of attractively priced investments and suitable financing to appropriately leverage the Company s investment capital. Market conditions are influenced by, among other things, current levels of and expectations for future levels of short-term interest rates, mortgage prepayments and market liquidity.

Risk Factors and Critical Accounting Policies

Under the captions Risk Factors and Critical Accounting Policies are discussions of risk factors and critical accounting policies affecting Capstead s financial condition and results of operations that are an integral part of this discussion and analysis. Readers are strongly urged to consider the potential impact of these factors and accounting policies on the Company and its financial results.

Recent Common Equity Offerings

In February 2008 Capstead completed its third public offering since September 2007 raising nearly $127 million in new common equity capital, after underwriting discounts and offering expenses, through the issuance of 8.6 million common shares at a price of $15.50 per share and during the nine months ended September 30, 2008. In addition, the Company raised $107 million, after expenses, under its continuous offering program by issuing 8.6 million common shares at an average price of $12.39 per share, including proceeds of over $25 million, after expenses, during the third quarter through the issuance of 2.2 million common shares at an average price of $11.72. Year-to-date, these issuances increased common equity capital by nearly $234 million and were accretive to year-end book value by $1.27 per common share. Subsequent to quarter-end, the Company further increased its common equity capital by nearly $6 million, after expenses, through the issuance of 555,000 common shares at an average sales price of $10.08 per share under the continuous offering program. The Company may raise more capital in future periods, subject to market conditions and blackout periods associated with the dissemination of earnings and dividend announcements and other important company-specific news. The accompanying September 30, 2008 financial statements and related disclosures do not reflect the effects of shares issued subsequent to quarter-end.

Book Value per Common Share

As of September 30, 2008, Capstead s book value per common share (calculated assuming liquidation preferences for the Series A and B preferred shares) was $10.02, a decrease of $0.40 from June 30, 2008 and an increase of $0.77 from December 31, 2007. With the deterioration of credit market conditions late in the third quarter, the fair value of Capstead s mortgage investments declined by quarter-end as yields on Agency Securities widened relative to benchmark interest rate swap yields. This trend of wider spreads has continued into the fourth quarter. Nearly all of the Company s mortgage investments and all of its interest rate swap agreements are reflected at fair value on the Company s balance sheet and are therefore included in the calculation of book value per common share. The fair value of these positions is impacted by credit market conditions, including changes in interest rates and the availability of financing at reasonable rates and leverage levels (i.e., credit market liquidity). The Company s investment strategy attempts to mitigate these risks by focusing almost exclusively on investments in ARM Agency

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Securities, which are considered to have little, if any, credit risk and are collateralized by ARM loans that have interest rates that reset periodically to more current levels. Because of these characteristics, the fair value of Capstead s portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to portfolios that contain a significant amount of non-agency mortgage securities and/or fixed-rate mortgage securities of any type, which generally results in a more stable book value per common share. The following table progresses book value per common share during 2008:

	Quarter Ended			*Nine Months Ended*
	March 31	*June 30*	*September 30*	*September 30*
Book value per common share, beginning of period	$ 9.25	$ 9.40	$ 10.42	$ 9.25
Accretion attributed to capital transactions	0.95	0.35	0.05	1.27
Dividend distributions in excess of earnings	(0.02)	(0.02)	(0.04)	(0.08)
Accumulated other comprehensive income items:				
Change in value of mortgage securities	(0.18)	0.20	(0.40)	(0.37)
Change in value of interest rate swap agreements held as cash flow hedges	(0.55)	0.49	(0.01)	(0.01)
Termination of cash flow hedge	(0.05)			(0.04)
Book value per common share, end of period	$ 9.40	$ 10.42	$ 10.02	$ 10.02

Residential Mortgage Investments

Managing a large portfolio of residential mortgage investments consisting primarily of ARM Agency Securities is the core focus of Capstead s investment strategy. As of September 30, 2008, residential mortgage investments totaled $7.89 billion, up from $7.07 billion at year-end, and consisted of over 99% ARM Agency Securities. Residential mortgage investments held by Capstead that are not agency-guaranteed were limited to $20 million as of September 30, 2008 and consist of well-seasoned, low loan to value mortgage loans remaining from a conduit operation operated by the Company in the early 1990 s. The Company holds the related credit risk associated with $15 million of these loans, and the rest of these investments are held as collateral for structured financings whereby the related credit risk is borne by the securitizations bondholders.

Agency Securities carry an implied AAA-rating with limited credit risk, particularly given the placement of Fannie Mae and Freddie Mac into conservatorship by the federal government in early September 2008. By focusing on investing in relatively short-duration and highly liquid ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration, fixed-rate assets. These declines can be recovered in a relatively short period of time as the coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment. Additionally, mortgage coupon resets tend to allow for the recovery of financing spreads diminished during periods of rising interest rates. Over the last 15 months, deteriorating conditions in the overall credit markets have led to heightened concerns related to credit risk associated with the mortgage loans underlying Agency Securities and the continued availability of sufficient financing to maintain then existing leverage levels for the mortgage REIT industry. From a credit risk perspective, the real or implied federal government guarantee associated with Agency Securities, particularly in light of the recent conservatorship of Fannie Mae and Freddie Mac, helps ensure that fluctuations in value due to credit risk associated with the underlying mortgage loans will be limited. From a market liquidity perspective, Capstead has responded to contracting market liquidity since the fall of 2007 by reducing portfolio leverage (secured borrowings divided by long-term investment capital) through (a) raising nearly $440 million in new common equity

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capital, (b) selling a limited amount of mortgage securities and (c) when appropriate, curtailing the replacement of portfolio runoff. As a result of these efforts, the Company has lowered its portfolio leverage from 11.50 to one at June 30, 2007 to 8.36 to one at September 30, 2008, which together with maintaining higher than usual cash balances and expanding the number of lending counterparties with whom the Company routinely does business, has provided the Company with financial flexibility to address challenging credit market conditions.

In connection with these efforts, in March 2008 Capstead sold Agency Securities with a cost basis of $768 million recognizing a loss from portfolio restructuring totaling $1.4 million. No investments were sold during the second and third quarters of 2008. In addition, the number of lending counterparties the Company had borrowings outstanding with has been increased to 17 as of September 30, 2008, up from 14 at year-end and ten at September 30, 2007. Management believes it is appropriate to maintain the Company s leverage near the lower end of its targeted range of eight to 12 times long-term investment capital. However, should market conditions warrant, the Company will take actions similar to those demonstrated over the previous 15 months in order to maintain sufficient financial flexibility to address ongoing market stresses.

ARM securities are backed by residential mortgage loans that have coupon interest rates that adjust at least annually to a margin over a current short-term interest rate index or begin doing so after an initial fixed-rate period subject to periodic and lifetime limits, referred to as caps. See NOTE 4 to the accompanying consolidated financial statements for additional information regarding interest rate resets on the Company s investments. The Company classifies its ARM securities based on each security s average number of months until coupon reset (months-to-roll). Current-reset ARM securities have a months-to-roll of 18 months or less while longer-to-reset ARM securities have a months-to-roll of greater than 18 months. As of September 30, 2008, the Company s ARM securities featured the following average current and fully-indexed weighted average coupon rates, net of servicing and other fees (WAC), net margins, periodic and lifetime caps, and months-to-roll (dollars in thousands):

ARM Type	*Basis**	*Net WAC*	*Fully Indexed WAC*	*Average Net Margins*	*Average Periodic Caps*	*Average Lifetime Caps*	*Months To Roll*
Current-reset ARMs:							
Agency Securities:							
Fannie Mae/Freddie Mac	$ 4,143,054	5.00%	4.34%	1.86%	4.06%	10.49%	4.3
Ginnie Mae	413,896	5.21	3.28	1.53	1.00	9.97	5.3
Residential mortgage loans	9,256	5.87	6.09	2.05	1.52	11.15	4.5
	4,566,206	5.02	4.25	1.83	3.78	10.45	4.4
Longer-to-reset ARMs:							
Agency Securities:							
Fannie Mae/Freddie Mac	3,287,163	6.07	5.55	1.67	2.69	11.56	37.5
	$ 7,853,369	5.46	4.80	1.76	3.32	10.91	18.2

* *Basis represents the Company s investment*

(unpaid principal balance plus unamortized investment premium) before unrealized gains and losses. As of September 30, 2008, the ratio of basis to related unpaid principal balance for the Company s ARM securities was 101.30. This table excludes $6 million in fixed-rate residential mortgage loans, $11 million in fixed-rate Agency Securities and $5 million in private residential mortgage pass-through securities held as collateral for structured financings.

Capstead typically finances its current-reset ARM securities using 30-day borrowings that reset monthly at a margin over the federal funds rate although when available at attractive terms, maturities on a portion of these borrowings may be extended to up to 90 days. Prior to the credit market turmoil that began last fall, the Company used longer-dated repurchase arrangements to effectively lock in financing spreads on investments in longer-to-reset ARM securities for a significant portion of the fixed-rate terms of these investments. As of September 30, 2008, these longer-term committed borrowings consisted of a series of

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repurchase arrangements totaling $1.41 billion with remaining terms of from two to 11 months and an average maturity of seven months. As of quarter-end, the Company had borrowings with 17 repurchase agreement counterparties, up from 14 at year-end and is pursuing further counterparty relationships. Borrowings under repurchase arrangements supporting residential mortgage investments totaled $7.24 billion at September 30, 2008.

In November 2007 the Company began using two-year term, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements to effectively lock in fixed rates on a portion of its 30-day borrowings because longer-term committed borrowings were no longer available at attractive terms. Under the terms of the interest rate swap agreements held by Capstead as of September 30, 2008, the Company pays fixed rates of interest averaging 3.44% on notional amounts totaling $1.90 billion with an average maturity of 16 months. Variable payments received by the Company under these agreements tend to offset interest accruing on a like amount of the Company s 30-day borrowings leaving the fixed-rate payments to be paid on the swap agreements as the Company s effective borrowing rate, subject to certain adjustments. The Company intends to continue to manage interest rate risk associated with holdings of longer-to-reset ARM securities by utilizing suitable derivative financial instruments (Derivatives) such as interest rate swap agreements as well as longer-dated committed borrowings if available at attractive terms.

Acquisitions of Agency Securities during the three and nine months ended September 30, 2008 totaled $511 million and $2.80 billion in principal amount, respectively, while portfolio runoff totaled $411 million and $1.20 billion for the same period. Portfolio runoff declined modestly to an annualized rate of 19% during the third quarter of 2008 compared to 20% during the second quarter of 2008 and year-to-date, reflecting the current difficult conditions in the residential mortgage lending environment, including national trends toward declining home values and tighter mortgage loan underwriting standards. These factors are expected to continue to plague homeowners seeking to sell their homes or refinance their mortgages, which may allow the Company to experience more favorable runoff trends than would otherwise occur. Since Capstead typically purchases investments at a premium to the asset s unpaid principal balance, high levels of mortgage prepayments can put downward pressure on ARM security yields because the level of mortgage prepayments impacts how quickly these investment premiums are written off against earnings as portfolio yield adjustments.

Commercial Real Estate-related Assets

Since the spring of 2000 Capstead periodically augmented its core investment strategy with investments in credit-sensitive commercial real estate-related assets that can earn attractive risk-adjusted returns. Over the years these alternative investments have included a portfolio of net-leased senior living centers as well as commercial mortgage securities and subordinated loans supported by interests in commercial real estate. In all instances the overall level of capital committed to these investments has been relatively modest, primarily because the related risk-adjusted returns on additional investments have not been compelling.

In light of overall credit market conditions, management has concluded that it will not pursue investments in commercial real estate-related assets beyond its existing investments in order to focus its efforts on the Company s core portfolio of ARM Agency Securities. As of September 30, 2008, Capstead s investments in commercial real estate-related assets consisted of (a) $5 million in subordinated loans to a Dallas, Texas-based developer scheduled to pay off over the next nine months through townhome and land sales, pursuant to an extension entered into during the third quarter, and (b) $38 million in subordinated loans on a luxury hotel property in the Caribbean that matured October 9, 2008. A pre-workout letter reserving all rights of the lending group was executed prior to maturity to allow additional time to reach a resolution for the financing of this property.

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Utilization of Long-term Investment Capital and Potential Liquidity

Capstead finances a majority of its holdings of residential mortgage securities with investment banking firms and commercial banks using repurchase arrangements with the balance, or margin, supported by the Company s long-term investment capital. Long-term investment capital includes preferred and common equity capital as well as unsecured borrowings, net of the Company s investment in related statutory trusts accounted for as unconsolidated affiliates. Assuming potential liquidity is available, borrowings can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Consequently, the actual level of cash and cash equivalents carried on the Company s balance sheet is less important than the potential liquidity inherent in the Company s investment portfolios. Potential liquidity is affected by, among other things, real (or perceived) changes in market value of assets pledged; principal prepayments; collateral requirements of the Company s lenders; and general conditions in the investment and commercial banking, mortgage finance and real estate industries. Future levels of portfolio leverage will be dependent upon many factors, including the size and composition of the Company s investment portfolios (see Liquidity and Capital Resources).

Capstead s utilization of long-term investment capital and its estimated potential liquidity were as follows as of September 30, 2008 in comparison with December 31, 2007 (in thousands):

	Investments ***(a)***	***Related Borrowings***	***Capital Employed*** ***(a)***	***Potential Liquidity*** ***(a)***
Residential mortgage securities	$ 7,892,891	$ 7,242,848	$ 650,043	$ 240,382
Commercial real estate-related assets	43,221		43,221	
	$ 7,936,112	$ 7,242,848	693,264	240,382
Other assets, net of other liabilities			205,141	137,475
Second quarter common dividend			(32,024)	(32,024) ***(b)***
			$ 866,381	$ 345,833
Balances as of December 31, 2007	$ 7,108,719	$ 6,500,362	$ 660,895	$ 371,196

(a) Investments are stated at carrying amounts on the Company s balance sheet, which generally reflects management s estimate of fair value as of the indicated dates. Potential liquidity is based on

management s estimate of the fair value of unpledged mortgage securities as of the indicated dates adjusted for other sources (uses) of liquidity, cash and cash equivalents, and dividends payable.

(b) *The third quarter common dividend was declared September 11, 2008 and paid October 20, 2008 to stockholders of record as of September 30, 2008.*

In order to prudently and efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund margin calls (requirements to pledge additional collateral or pay down borrowings), including margin calls resulting from monthly principal payments (that are not remitted to the Company for 20 to 45 days after any given month-end), and anticipated declines in the market value of pledged assets under stressed market conditions. During the third quarter the Company maintained its portfolio leverage at the lower end of its targeted range of eight to twelve times long-term investment capital and maintained higher than usual cash balances, which has provided the Company with financial flexibility to address challenging credit market conditions. Management believes it is appropriate to maintain the Company s leverage near the lower end of its targeted range of eight to 12 times long-term investment capital. However, should market conditions warrant, the Company will take actions similar to those demonstrated over the previous 15 months in order to maintain sufficient financial flexibility to address ongoing market stresses.

Accounting for Seller-Financed Acquisitions of Mortgage Securities

Capstead generally pledges its *Mortgage securities and similar investments* as collateral under repurchase arrangements and a portion of the Company s acquisitions may initially be financed with sellers. The Company records such assets and the related borrowings gross on its balance sheet, and the corresponding interest income and interest expense gross on its income statement. In addition, the asset is typically a

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security held available-for-sale, and any change in fair value of the asset is recorded as a component of *Accumulated other comprehensive income.* In February 2008 the Financial Accounting Standards Board (FASB) issued Staff Position 140-3 Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP140-3). Under FSP140-3, certain seller-financed acquisitions entered into after December 31, 2008 will not qualify as acquisitions if the related financing is considered sufficiently linked to the acquisition transaction. Any such seller-financed acquisitions that are deemed to be sufficiently linked will be reported net of related financings at fair value with related changes in fair value reported in earnings until such time as the assets are no longer financed with the sellers. Because such linkage does not exist for the Company s typical acquisition transactions and related financings, management does not believe implementing FSP140-3 will have a material effect on Capstead s results of operations, taxable income or financial condition. Also, it is not expected to affect the Company s status as a REIT or cause it to fail to qualify for its exemption under Investment Company Act of 1940 which requires that the Company must, among other things, maintain at least 55% of its assets directly in qualifying real estate interests.

Accounting for Variable Interests

The FASB recently issued an exposure draft that would amend FASB Interpretation No. 46(R) "*Consolidation of Variable Interest Entities* (FIN46(R)), to address concerns raised about FIN46(R) s complexity and reliance on quantitative analyses and to require a greater scope of entities to be evaluated for consolidation using FIN46(R) s provisions. The potential amendments, which would be effective for fiscal years beginning after November 15, 2009, would require an enterprise (including its related party and de facto agents) to determine whether it is the primary beneficiary of an entity primarily through a qualitative assessment, considering if it has both the power to direct matters that significantly affect the entity and the right to receive potentially significant benefits or the obligation to absorb potentially significant losses of the entity. The proposed amendment is not expected to have a material impact on the Company.

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RESULTS OF OPERATIONS

Comparative income statement data (in thousands, except for per share data) and key portfolio statistics (dollars in millions) were as follows:

	Quarter Ended September 30		*Nine Months Ended September 30*	
	2008	***2007***	***2008***	***2007***
		(as Restated. See Explanatory Note)		
Income statement data:				
Mortgage securities and similar investments (interest income, net of directly-related interest expense)				
Residential mortgage investments	$ 38,198	$ 8,257	$ 115,901	$ 25,250
Commercial real estate investments	975	214	2,630	462
	39,173	8,471	118,531	25,712
Other interest income	346	212	1,932	313
Interest expense on unsecured borrowings	(2,186)	(2,186)	(6,560)	(6,560)
	37,333	6,497	113,903	19,465
Other revenue (expense):				
Loss from portfolio restructuring		(8,276)	(1,408)	(8,276)
Other revenue (expense)	(45)	62	(61)	1,069
Incentive compensation	(300)		(4,820)	
Other operating expense	(2,306)	(1,678)	(6,187)	(4,891)
	34,682	(3,395)	101,427	7,367
Equity in earnings of unconsolidated affiliates	64	247	194	1,486
Net income (loss)	$ 34,746	$ (3,148)	$ 101,621	$ 8,853
Net income available (loss attributable) to common stockholders, after payment of preferred share dividends	$ 29,684	$ (8,212)	$ 86,432	$ (6,339)
Net income (loss) per common share:				
Basic	$ 0.53	$ (0.43)	$ 1.66	$ (0.33)
Diluted	0.52	(0.43)	1.64	(0.33)
Weighted average common shares outstanding:				
Basic	56,318	19,108	51,991	19,017
Diluted	66,352	19,108	62,137	19,017
Key portfolio statistics *(excludes overnight balances and unsecured borrowings)*:				
Average yields:				
Residential mortgage investments	4.98%	5.66%	5.30%	5.57%
Commercial real estate investments	9.48	18.62	9.99	18.28
Total average yields	5.00	5.67	5.32	5.58

Average rate of related borrowings	3.26	5.25	3.49	5.22
Average financing spread	1.74	0.42	1.83	0.36
Average portfolio balances:				
Residential mortgage investments	$ 7,885	$ 5,281	$ 7,549	$ 5,324
Commercial real estate investments	43	5	43	3
	7,928	5,286	7,592	5,327
Average related borrowings	7,196	4,959	6,942	4,985
Average capital deployed	$ 732	$ 327	$ 650	$ 342
Average portfolio runoff rate	19%	30%	20%	30%

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Net margins and average financing spreads on Capstead s mortgage securities and similar investments for the three and nine months ended September 30, 2008 were significantly higher than during the same periods of the prior year reflecting higher financing spreads primarily attributable to lower borrowing rates and larger average holdings of ARM Agency Securities.

As a result of a prolonged Federal Reserve rate tightening effort that increased the federal funds rate 425 basis points over a two year period to 5.25% by June 2006, financing spreads fell significantly before beginning to recover in 2007 as coupon interest rates on a portion of the mortgages underlying the Company s current-reset ARM securities reset to higher prevailing interest rates. Portfolio yields continued increasing throughout 2007 to peak at an average rate of 5.80% during the fourth quarter of 2007 before beginning to trend lower during 2008 primarily as a result of lower yielding portfolio acquisitions as well as lower resets on current-reset ARM securities as market interest rates declined. Meanwhile borrowing rates began declining rapidly beginning early in the fourth quarter of 2007 in response to the Federal Reserve s aggressive actions starting in mid-September 2007 to reduce its target for the federal funds rate by a total of 325 basis points by April 30, 2008. This illustrates how the Company is impacted immediately when short-term interest rates rise (and fall) while current-reset ARM security yields change slowly in comparison because coupon interest rates on the underlying mortgage loans may only reset once a year and the amount of each reset can be limited or capped.

Since the fall of 2007, Capstead increased its long-term investment capital by over $439 million with the issuance of new common equity capital raised through three follow-on equity offerings and the Company s continuous offering program. This capital was deployed into additional holdings of ARM Agency Securities contributing to substantially higher average outstanding balances of residential mortgage securities during the three and nine months ended September 30, 2008 compared to the same periods of the prior year. This contributed to the higher net margins earned thus far in 2008 even as the Company reduced its portfolio leverage to the low end of its targeted range of eight to twelve times long-term investment capital.

Other interest income benefited during 2008 from higher overnight investment balances even as rates earned on these balances declined with the reductions in short-term interest rates discussed above.

Earnings from commercial real estate investments benefited from higher outstanding balances primarily due to the consolidation in November 2007 of a $38 million loan and related borrowings after acquiring full ownership of a commercial real estate loan joint venture previously accounted for as an unconsolidated affiliate.

With the recurrence of credit market liquidity constraints in March 2008, the Company sold ARM Agency Securities with a cost basis of $768 million for a modest loss from portfolio restructuring of $1.4 million. In connection with this restructuring, the Company realized a $2.3 million loss on the termination of a $100 million swap agreement designated as a cash flow hedge for accounting purposes which is being amortized to earnings as a component of interest expense over the remaining term of the Derivative.

Other revenue declined in 2008 compared to 2007 primarily because 2007 included the release of funds held in trust related to the Company s holdings of residential mortgage loans that were previously designated as collateral for structural financings.

Incentive compensation accruals in 2008 relate to the Company s incentive compensation program which allows for a 10% participation in annual earnings, as adjusted, in excess of a benchmark amount calculated based on average common stockholders equity for the year, after certain adjustments, using the average 10-year U.S. Treasury Rate plus 200 basis points. In September, the board of directors of the Company limited incentive compensation payouts under this formula to a maximum of $6 million for

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2008 resulting in a lower expense charge for incentive compensation during the third quarter of 2008 than was recorded earlier in 2008. No incentive compensation was earned in 2007. Other operating expense for the three and nine months ended September 30, 2008 increased over the same periods in 2007 primarily as a result of higher compensation and professional service-related costs.

Equity in earnings of unconsolidated affiliates for the three and nine months ended September 30, 2008 reflects Capstead s interest in three statutory trusts formed to issue $3 million in trust common securities to the Company and $100 million of trust preferred securities to unrelated third parties and consists solely of the trust common securities pro rata share in interest on $103 million in junior subordinated notes issued by the Company to the statutory trusts (reflected as unsecured borrowings on the Company s balance sheet and interest in unsecured borrowings on its statement of income). Results for the same period in 2007 also included the Company s equity in the earnings of the commercial real estate loan joint venture described above.

Interest Rate Sensitivity on Operating Results

Capstead performs earnings sensitivity analysis using an income simulation model to estimate the effects that specific interest rate changes can reasonably be expected to have on future earnings. All investments, borrowings and any Derivatives held are included in this analysis. The sensitivity of components of other revenue (expense) to changes in interest rates is included as well, although no asset sales are assumed. The model incorporates management s assumptions regarding the level of mortgage prepayments for a given interest rate change using market-based estimates of prepayment speeds for the purpose of amortizing investment premiums. These assumptions are developed through a combination of historical analysis and expectations for future pricing behavior under normal market conditions unaffected by changes in market liquidity.

Capstead had the following estimated earnings sensitivity profile as of September 30, 2008 and December 31, 2007, respectively (dollars in thousands):

	Federal Funds Rate	***10-year U.S. Treasury Rate***	***Immediate Change In:****				
			Down 1.00%	Down 1.00%	Flat	Up 1.00%	Up 1.00%
30-day to one-year rates							
			Down 1.00%	Flat	Down 1.00%	Flat	Up 1.00%
10-year U.S. Treasury rate							
Projected 12-month earnings change:							
September 30, 2008	2.00%	3.83%	$10,800	$15,700	$(10,100)	$(18,400)	$(13,200)
December 31, 2007	4.25	4.60	10,800	15,600	(9,800)	(17,300)	(12,400)

* *Sensitivity of earnings to changes in interest rates is determined*

relative to the actual rates at the applicable date. Note that the projected 12-month earnings change is predicated on acquisitions of similar assets sufficient to replace runoff. There can be no assurance that suitable investments will be available for purchase at attractive prices or if investments made will behave in the same fashion as assets currently held.

Income simulation modeling is the primary tool used by management to assess the direction and magnitude of changes in net margins on investments resulting solely from changes in interest rates. Key assumptions in the model include mortgage prepayment rates, adequate levels of market liquidity, changes in market conditions, portfolio leverage levels, and management s investment capital plans. These assumptions are inherently uncertain and, as a result, the model cannot precisely estimate net margins or precisely predict the impact of higher or lower interest rates on net margins. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and other changes in market conditions, management strategies and other factors.

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LIQUIDITY AND CAPITAL RESOURCES

Capstead s primary sources of funds are borrowings under repurchase arrangements and monthly principal and interest payments on its investments. Other sources of funds may include proceeds from debt and equity offerings and asset sales. The Company generally uses its liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage its long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on the balance sheet is less important than the Company s potential liquidity available under its borrowing arrangements. The table included under Financial Condition Utilization of Long-term Investment Capital and Potential Liquidity and accompanying discussion illustrates management s estimate of additional funds potentially available to the Company as of September 30, 2008 and its perspective on the appropriate level of portfolio leverage to employ under current market conditions. The Company currently believes that it has sufficient liquidity and capital resources available for the acquisition of additional investments when considered appropriate, repayments on borrowings and the payment of cash dividends as required for Capstead s continued qualification as a REIT. It is the Company s policy to remain strongly capitalized and conservatively leveraged.

In response to the growth of Capstead s residential mortgage investments portfolio and to recent turbulent market conditions, the Company has pursued additional lending counterparties in order to further increase its financial flexibility and ability to withstand periods of contracting liquidity in the credit markets. Currently the Company has uncommitted repurchase facilities with a variety of lending counterparties to finance this portfolio, subject to certain conditions, and had borrowings outstanding with 17 of these counterparties as of September 30, 2008, up from 14 at December 31, 2007 and ten in September 2007, when the current episodes of contracting credit market liquidity began. Borrowings under repurchase arrangements secured by residential mortgage investments totaled $7.24 billion as of September 30, 2008. Borrowings supporting current-reset ARM securities routinely have maturities of 30 to 90 days, and prior to August 2007, the Company financed a significant portion of its investments in longer-to-reset ARM securities with longer-term arrangements. As of September 30, 2008, these longer-term committed borrowings consisted of a series of repurchase arrangements totaling $1.41 billion entered into prior to September 2007 with remaining terms of from two to 11 months and an average maturity of seven months. Interest rates on borrowings under repurchase arrangements are generally based on a margin over the federal funds rate (or a corresponding benchmark rate for longer-term arrangements) and related terms and conditions are negotiated on a transaction-by-transaction basis. Amounts available to be borrowed under these arrangements are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the investment banking, mortgage finance and real estate industries.

Late in 2007 Capstead began using two-year term, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements to effectively lock in fixed rates on a portion of its 30-day borrowings because longer-term committed borrowings were no longer available at attractive terms. As of September 30, 2008 these swap agreements had notional amounts totaling $1.90 billion and were designated as cash flow hedges for accounting purposes of a like amount of the Company s 30-day borrowings. The Company intends to continue to manage interest rate risk associated with holdings of longer-to-reset ARM securities by utilizing suitable Derivatives such as interest rate swap agreements.

In February 2008 Capstead completed its third public offering since September 2007 raising nearly $127 million in new common equity capital, after underwriting discounts and offering expenses. In addition, during the nine months ended September 30, 2008 the Company raised $107 million, after expenses, under its continuous offering program, including proceeds of over $25 million, after expenses,

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during the third quarter. Year-to-date, these issuances increased common equity capital by nearly $234 million. Subsequent to quarter-end, the Company further increased its common equity capital by nearly $6 million, after expenses, under the continuous offering program. The Company may raise more capital in future periods, subject to market conditions and blackout periods associated with the dissemination of earnings and dividend announcements and other important company-specific news. The accompanying September 30, 2008 financial statements and related disclosures do not reflect the effects of shares issued subsequent to quarter-end.

RISK FACTORS

An investment in debt or equity securities issued by Capstead involves various risks. An investor should carefully consider the following risk factors in conjunction with the other information contained in this document before purchasing the Company s debt or equity securities. The risks discussed herein can adversely affect the Company s business, liquidity, operating results, prospects and financial condition, causing the market price of the Company s debt or equity securities to decline, which could cause an investor to lose all or part of his/her investment. The risk factors described below are not the only risks that may affect the Company. Additional risks and uncertainties not presently known to the Company also may adversely affect its business, liquidity, operating results, prospects and financial condition.

Risks Related to Capstead s Business

Loss of the implied AAA rating of Agency Securities could negatively affect Capstead s financial condition and earnings. Agency Securities have an implied AAA rating because payments of principal and interest on these securities are guaranteed by government-sponsored entities (GSEs), either Fannie Mae or Freddie Mac, or by an agency of the federal government, Ginnie Mae. Only the guarantees by Ginnie Mae are explicitly backed by the full faith and credit of the federal government, although in connection with the conservatorship of Fannie Mae and Freddie Mac on September 7, 2008 by the Federal Housing Finance Agency, the federal government has provided these GSEs with substantial financial backing in the form of secured lending facilities that expire in December 2009 and preferred equity capital. These and other steps being taken by the federal government are designed to support market stability and mortgage availability by providing additional confidence to investors in Agency Securities during the current housing correction. It is anticipated that the new Congress and Administration will address what the long-term role of the federal government in general, and the GSEs in particular, will play in the housing markets. The actual or perceived credit quality of Agency Securities could be negatively affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between the GSEs and the federal government or otherwise reduce the amount of mortgage securities the GSEs own or guarantee.

Periods of illiquidity in the mortgage markets may reduce amounts available to be borrowed under Capstead s repurchase arrangements, which could negatively impact the Company s financial condition and earnings. Capstead generally finances its mortgage securities and similar investments by pledging them as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis. The amount borrowed under a repurchase arrangement is limited to a percentage of the estimated market value of the pledged collateral and is specified at the inception of the transaction. The portion of the pledged collateral held by the lender that is not advanced under the repurchase arrangement is referred to as margin collateral and the resulting margin percentage is required to be maintained throughout the term of the borrowing. If the market value of the pledged collateral as determined by the Company s lenders declines, the Company may be subject to margin calls wherein the lender requires the Company to pledge additional collateral to reestablish the agreed-upon margin percentage. Because market illiquidity tends to put downward pressure on asset prices, Capstead may be presented with substantial margin calls during such periods. If the Company is unable or unwilling to pledge additional collateral, the Company s lenders can liquidate the Company s collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

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Periods of rising interest rates may reduce amounts available to be borrowed under Capstead s repurchase arrangements, which could negatively impact the Company s financial condition and earnings. Because rising interest rates tend to put downward pressure on asset prices, Capstead may be presented with substantial margin calls during such periods. If the Company is unable or unwilling to pledge additional collateral, the Company s lenders can liquidate the Company s collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

If Capstead is unable to negotiate favorable terms and conditions on future repurchase arrangements with one or more of the Company s counterparties, the Company s financial condition and earnings could be negatively impacted. The terms and conditions of each repurchase arrangement are negotiated on a transaction-by-transaction basis, and these borrowings generally are renewed, or rolled, at maturity. Key terms and conditions of each transaction include interest rates, maturity dates, asset pricing procedures and margin requirements. The Company cannot assure investors that it will be able to continue to negotiate favorable terms and conditions on its future repurchase arrangements. Also, during periods of market illiquidity or due to perceived credit quality deterioration of the collateral pledged, a lender may require that less favorable asset pricing procedures be employed or the margin requirement be increased. Under these conditions, the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

Most of Capstead s borrowings under repurchase arrangements routinely have maturities of 30- to 90-days. Interest rates on these borrowings are generally based on a margin over the federal funds rate. The Company s ability to achieve its investment objectives depends on its ability to renew or replace maturing borrowings on a continuous basis. If the Company were not able to renew or replace maturing borrowings, it would be forced to sell some of its assets under possibly adverse market conditions, which may adversely affect its profitability.

This risk is increased if Capstead relies significantly on any single counterparty for a significant portion of its repurchase arrangements. As of September 30, 2008, the Company s largest single counterparty (Cantor Fitzgerald & Company) accounted for $1.33 billion in repurchase arrangements that had an average maturity of seven months.

Capstead s use of repurchase arrangements to borrow money may give the Company s lenders greater rights in the event of bankruptcy. Borrowings made under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. This may make it difficult for the Company to recover its pledged assets if a lender files for bankruptcy. In addition, if the Company ever files for bankruptcy, lenders under the Company s repurchase arrangements may be able to avoid the automatic stay provisions of the U.S. Bankruptcy Code and take possession of, and liquidate, the Company s collateral under these arrangements without delay.

Capstead may sell assets for various reasons, including a change in the Company s investment focus, which could increase earnings volatility. Capstead may periodically sell assets to enhance its liquidity during periods of market illiquidity or rising interest rates. Additionally the Company may change its investment focus requiring it to sell some portion of its existing investments. Transactional gains or losses resulting from any such asset sales, or from terminating any related longer-dated repurchase arrangements, will likely increase the Company s earnings volatility.

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Changes in interest rates, whether increases or decreases, may adversely affect Capstead s earnings. Capstead s earnings currently depend primarily on the difference between the interest received on its mortgage securities and similar investments and the interest paid on its related borrowings. The Company typically finances all of its current-reset ARM securities and a portion of its longer-to-reset ARM securities at 30-day interest rates that are based on a margin over the federal funds rate. Because only a portion of the ARM loans underlying the Company securities reset each month and the term of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan, in a rising short-term interest rate environment, interest rates on related borrowings can rise to levels that may exceed yields on these securities, contributing to lower or even negative financing spreads and adversely affecting earnings. At other times, during periods of relatively low short-term interest rates, declines in the indices used to reset ARM loans may negatively affect yields on the Company s ARM securities as the underlying ARM loans reset at lower rates. If declines in these indices exceed declines in the Company s borrowing rates, its earnings would be adversely affected.

The average life of Capstead s longer-to-reset ARM securities could extend beyond the life of related longer-dated fixed-rate borrowings and interest rate swap positions more than anticipated. Longer-to-reset ARM securities held by Capstead consist almost exclusively of a combination of well-seasoned and relatively newly issued hybrid ARMs with initial coupon interest rates that are fixed for five years. As of September 30, 2008 the weighted average months-to-roll for this portion of our portfolio was 37.5 months with a significantly shorter average expected life based on mortgage prepayment expectations. Prior to changes in market conditions during the fall of 2007, Capstead made use of longer-dated repurchase arrangements to effectively lock in financing spreads on a portion of its investments in longer-to-reset ARM Agency Securities for a significant portion of the fixed-rate terms of these investments. Late in 2007 the Company began using two-year term interest rate swap agreements for this purpose. In a rising interest rate environment, the weighted average life of the Company s longer-to-reset ARM securities could extend beyond the terms of related longer-dated borrowings and swap positions more than originally anticipated. This could have a negative impact on financing spreads and earnings as related borrowing costs would no longer be fixed during the remaining fixed-rate term of these investments and may also cause a decline in fair value of these assets without a corresponding increase in value from related longer-dated borrowings or swap positions.

An increase in prepayments may adversely affect Capstead s earnings. When short- and long-term interest rates are at nearly the same levels (i.e., a flat yield curve environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of these investments; therefore, the actual yields the Company realizes can be lower due to faster amortization of investment premiums.

The lack of availability of suitable investments at attractive pricing may adversely affect Capstead s earnings. Pricing of investments is determined by a number of factors including interest rate levels and expectations, market liquidity conditions, and competition among investors for these investments, many of whom have greater financial resources and lower return requirements than Capstead. To the extent the proceeds from prepayments on Capstead s mortgage securities and similar investments are not reinvested or cannot be reinvested at a rate of return at least equal to the rate previously earned on those investments, the Company s earnings may be adversely affected. Capstead cannot assure investors that the Company will be able to acquire suitable investments at attractive pricing and in a timely manner to replace portfolio runoff as it occurs or that the Company will maintain the current composition of its investments, consisting primarily of ARM Agency Securities.

Capstead may invest in Derivatives such as interest rate swap agreements to mitigate or hedge the Company s interest rate risk on its longer-to-reset ARM securities, which may negatively affect the Company s liquidity, financial condition or earnings. The Company may invest in such instruments from

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time to time with the goal of achieving more stable financing spreads on the longer-to-reset ARM securities component of its mortgage securities and similar investment portfolio. However, these activities may not have the desired beneficial impact on the Company s liquidity, financial condition or earnings. For instance, the pricing of longer-to-reset ARM securities and the pricing of the related Derivatives may deteriorate at the same time leading to margin calls on both the longer-to-reset ARM securities and the Derivatives, negatively impacting the Company s liquidity and stockholders equity. In addition, counterparties could fail to honor their commitments under the terms of the Derivatives or have their credit quality downgraded impairing the value of the Derivatives. Should Capstead be required to sell its Derivatives under such circumstances, the Company may incur losses. No such hedging activity can completely insulate the Company from the risks associated with changes in interest rates and prepayment rates.

Derivatives held may fail to qualify for hedge accounting introducing potential volatility to Capstead s earnings. The Company typically qualifies Derivatives held as cash flow hedges for accounting purposes in order to record the effective portion of the change in fair value of Derivatives as a component of stockholders equity rather than in earnings. If the hedging relationship for any Derivative held ceases to qualify for hedge accounting treatment for any reason, including failing documentation and ongoing hedge effectiveness requirements, the Company would be required to record in earnings the total change in fair value of any such Derivative. This could introduce a potentially significant amount of volatility to earnings reported by the Company.

Capstead may be unable to invest the net proceeds raised in a debt or equity securities offering on acceptable terms, which could affect the Company s earnings. Capstead will have broad authority to use the net proceeds from any sale of its debt or equity securities to either invest in additional mortgage securities and similar investments on a leveraged basis or provide additional liquidity to the Company for paying any margin calls that may be made by its repurchase arrangement counterparties. Capstead cannot assure investors that the Company will be able to use any such proceeds to invest in additional mortgage securities and similar investments or that other investments that meet its investment criteria will be available for the Company to purchase at attractive prices.

Capstead is dependent on its executives and employees and the loss of one or more of its executive officers could harm the Company s business and its prospects. As a self-managed REIT, Capstead is dependent on the efforts of its key officers and employees, most of whom have significant experience in the mortgage industry. Although most of the Company s named executive officers and many of its other employees are parties to severance agreements, the Company s key officers and employees are not subject to employment agreements with non-compete clauses, nor has Capstead acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on the Company s operations.

Commercial real estate-related assets may expose investors to greater risks of loss than residential mortgage investments. The repayment of a loan secured by an income-producing property is typically dependent upon the successful operation of the related real estate project and the ability of the applicable property to produce net operating income rather than upon the liquidation value of the underlying real estate. The repayment of loans secured by development properties is typically dependent upon the successful development of the property for its intended use and (a) the subsequent lease-up such that the development becomes a successful income-producing property or (b) the subsequent sale of some or all of the property for adequate consideration. In the event cash flows from operating or developing a commercial property are insufficient to cover all debt service requirements, junior liens generally absorb the shortfall. As a result, declines in current or anticipated cash flows, among other factors, can lead to declines in value of the underlying real estate large enough that the aggregate outstanding balances of senior and junior liens could exceed the value of the real estate. In the event of default, the junior lienholder may need to make payments on the senior loans to preserve its rights to the underlying real estate and prevent foreclosure. Because the senior lienholders generally have priority on proceeds from liquidating the underlying real estate, junior lienholders may not recover all or any of their investment.

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Additionally, Capstead may leverage its commercial real estate-related assets through the use of secured borrowing arrangements, the availability of which may be predicated on the fair value of the underlying collateral. Similar to residential mortgage investments financed with repurchase arrangements, declines in the value of commercial real estate collateral could lead to increased margin calls, or loss of financing altogether, reducing the Company s liquidity and potentially leading to losses from the sale of such investments under adverse market conditions.

Risks Related to Capstead s Status as a REIT and Other Tax Matters

If Capstead does not qualify as a REIT, the Company will be subject to tax as a regular corporation and face substantial tax liability. Capstead has elected to be taxed as a REIT for federal income purposes and intends to continue to so qualify. Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could jeopardize the Company s REIT status. Furthermore, new tax legislation, administrative guidance or court decisions, in each instance potentially with retroactive effect, could make it more difficult or impossible for the Company to qualify as a REIT. If Capstead fails to qualify as a REIT in any tax year, then:

The Company would be taxed as a regular domestic corporation, which, among other things, means that the Company would be unable to deduct dividends paid to its stockholders in computing taxable income and would be subject to federal income tax on its taxable income at regular corporate rates.

Any resulting tax liability could be substantial and would reduce the amount of cash available for distribution to stockholders, and Capstead would not be required to make distributions of the Company s income.

Unless Capstead were entitled to relief under applicable statutory provisions, the Company would be disqualified from treatment as a REIT for the subsequent four taxable years following the year during which the Company lost its qualification, and, thus, the Company s cash available for distribution to stockholders would be reduced for each of the years during which the Company did not qualify as a REIT.

Even if Capstead remains qualified as a REIT, the Company may face other tax liabilities that reduce its earnings. Even if Capstead remains qualified for taxation as a REIT, the Company may be subject to certain federal, state and local taxes on its income and assets. For example:

The Company will be required to pay tax on any undistributed REIT taxable income.

The Company may be required to pay the alternative minimum tax on any items of tax preference.

The Company may operate taxable REIT subsidiaries that are required to pay taxes on any taxable income earned.

Complying with REIT requirements may cause Capstead to forego otherwise attractive opportunities. To qualify as a REIT for federal income tax purposes, Capstead must continually satisfy tests concerning, among other things, the sources of its income, the nature and diversification of its assets, the amounts that it distributes to its stockholders, and the ownership of its stock. The Company may be required to make distributions to stockholders at disadvantageous times or when it does not have funds readily available for distribution. As a result, compliance with the REIT requirements may hinder the Company s ability to operate solely on the basis of maximizing profits.

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Complying with REIT requirements may limit Capstead s ability to hedge effectively. The REIT provisions of the Internal Revenue Code may limit Capstead s ability to hedge mortgage securities and related borrowings by requiring it to limit its income in each year from qualified hedges, together with any other income not generated from qualified real estate assets, to no more than 25% of the Company s gross income. In addition, the Company must limit its aggregate income from nonqualified hedging transactions, from providing certain services, and from other non-qualifying sources to not more than 5% of its annual gross income. As a result, the Company may have to limit its use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than the Company would otherwise incur. If the Company were to violate the 25% or 5% limitations, it may have to pay a penalty tax equal to the amount of gross income in excess of those limitations, multiplied by a fraction intended to reflect its profitability. If the Company fails to satisfy the REIT gross income tests, unless its failure was due to reasonable cause and not due to willful neglect, the Company could lose its REIT status for federal income tax purposes.

Complying with REIT requirements may force Capstead to liquidate otherwise attractive investments. To qualify as a REIT, Capstead must also ensure that at the end of each calendar quarter at least 75% of the value of its assets consists of cash, cash items, United States government securities and qualified REIT real estate assets. The remainder of the Company s investments in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of the Company s assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 20% of the value of its total securities can be represented by securities of one or more taxable REIT subsidiaries. If the Company fails to comply with these requirements at the end of any calendar quarter, it must correct such failure within 30 days after the end of the calendar quarter to avoid losing its REIT status and suffering adverse tax consequences. As a result, the Company may be required to liquidate otherwise attractive investments.

Complying with REIT requirements may force Capstead to borrow to make distributions to stockholders. As a REIT, Capstead must distribute at least 90% of its annual taxable income (subject to certain adjustments) to its stockholders. To the extent that the Company satisfies the distribution requirement, but distributes less than 100% of its taxable income, the Company will be subject to federal corporate income tax on its undistributed taxable income. In addition, the Company will be subject to a 4% nondeductible excise tax if the actual amount that it pays out to its stockholders in a calendar year is less than a minimum amount specified under the federal tax laws. From time to time, the Company may generate taxable income greater than its net income for financial reporting purposes or its taxable income may be greater than the Company s cash flow available for distribution to stockholders. If the Company does not have other funds available in these situations, it could be required to borrow funds, sell investments at disadvantageous prices or find another alternative source of funds to make distributions sufficient to enable it to pay out enough of its taxable income to satisfy the distribution requirement and to avoid corporate income tax and the 4% excise tax in a particular year. These alternatives could increase the Company s costs or reduce its long-term investment capital.

Capstead may be subject to adverse legislative or regulatory tax changes that could reduce the market price of the Company s securities. At any time, the federal income tax laws governing REITs or the administrative interpretations of those laws may change. Any such changes in laws or interpretations thereof may apply retroactively and could adversely affect Capstead or its stockholders. For example, the Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the maximum rate of tax applicable to individuals on dividend income from regular C corporations from 38.6% to 15.0%. This reduced substantially the so-called double taxation (that is, taxation at both the corporate and stockholder levels) that has generally applied to corporations that are not taxed as REITs. Generally, dividends from REITs will not qualify for the dividend tax reduction. As such, investors may view stocks of non-REIT dividend

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paying corporations as more attractive relative to shares of REITs than was the case previously. Capstead cannot predict any impact on the value of its securities from adverse legislative or regulatory tax changes such as the Jobs and Growth Tax Act of 2003.

An investment in Capstead s securities has various federal, state and local income tax risks that could affect the value of an investor s investment. The Company strongly urges investors to consult their own tax advisor concerning the effects of federal, state and local income tax law on an investment in the Company s securities, because of the complex nature of the tax rules applicable to REITs and their stockholders.

Risk Factors Related to Capstead s Corporate Structure

There are no assurances of Capstead s ability to pay dividends in the future. Capstead intends to continue paying quarterly dividends and to make distributions to its stockholders in amounts such that all or substantially all of the Company s taxable income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable the Company to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. However, the Company s ability to pay dividends may be adversely affected by the risk factors described in this filing. All distributions will be made at the discretion of the Company s board of directors and will depend upon its earnings, its financial condition, maintenance of its REIT status and such other factors as the board may deem relevant from time to time. There are no assurances of the Company s ability to pay dividends in the future. In addition, some of the Company s distributions may include a return of capital.

Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect Capstead s results of operations. The Investment Company Act of 1940 exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Capstead believes that it conducts its business in a manner that allows the Company to avoid registration as an investment company under the Investment Company Act of 1940. If the Company were to be regulated as an investment company, its ability to use leverage would be substantially reduced and it would be unable to conduct business as described in this filing.

The Securities and Exchange Commission, or SEC, staff s position generally requires Capstead to maintain at least 55% of its assets directly in qualifying real estate interests to be able to be exempted from regulation as an investment company. To constitute a qualifying real estate interest under this 55% requirement, a real estate interest must meet various criteria. In satisfying this 55% requirement, the Company may treat mortgage securities issued with respect to an underlying pool to which it holds all issued certificates as qualifying real estate interests. Mortgage securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as securities separate from the underlying mortgage loans and, thus, may not qualify for purposes of the 55% requirement. If the SEC or its staff adopts a contrary interpretation of its current treatment, the Company could be required to sell a substantial amount of its securities or other non-qualified assets under potentially adverse market conditions.

Pursuant to Capstead s charter, its board of directors has the ability to limit ownership of the Company s capital stock, to the extent necessary to preserve its REIT qualification. For the purpose of preserving Capstead s REIT qualification, its charter gives the board the ability to repurchase outstanding shares of the Company s capital stock from existing stockholders if the directors determine in good faith that the concentration of ownership by such individuals, directly or indirectly, would cause the Company to fail to qualify or be disqualified as a REIT. Constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of outstanding stock by an individual or

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entity could cause that individual or entity to own constructively a greater concentration of the Company s outstanding stock than is acceptable for REIT purposes, thereby giving the board the ability to repurchase any excess shares.

Because provisions contained in Maryland law and Capstead s charter may have an anti-takeover effect, investors may be prevented from receiving a control premium for their shares. Provisions contained in Capstead s charter and Maryland general corporation law may have effects that delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a control premium for their shares. For example, these provisions may defer or prevent tender offers for the Company s common stock or purchases of large blocks of the Company s common stock, thereby limiting the opportunities for its stockholders to receive a premium for their common stock over then-prevailing market prices. These provisions include the following:

Repurchase Rights. The repurchase rights granted to Capstead s board of directors in the Company s charter limits related investors, including, among other things, any voting group, from owning common stock if the concentration owned would jeopardize the Company s REIT status.

Classification of preferred stock: Capstead s charter authorizes the board to issue preferred stock in one or more classes and to establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval. The issuance of preferred stock could have the effect of delaying or preventing someone from taking control of the Company, even if a change in control were in its stockholders best interests.

Maryland statutory law provides that an act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director. Hence, directors of a Maryland corporation are not required to act in takeover situations under the same standards as apply in Delaware and other corporate jurisdictions.

Capstead may change its policies without stockholder approval. Capstead s board of directors and management determine all of its policies, including its investment, financing and distribution policies and may amend or revise these policies at any time without a vote of the Company s stockholders. Policy changes could adversely affect the Company s financial condition, results of operations, the market price of its common stock and/or preferred stock or the Company s ability to pay dividends or distributions.

CRITICAL ACCOUNTING POLICIES

Management s discussion and analysis of financial condition and results of operations is based upon Capstead s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that can affect the reported amounts of assets, liabilities (including contingencies), revenues and expenses, as well as related disclosures. These estimates are based on available internal and market information and appropriate valuation methodologies believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the expected useful lives and carrying values of assets and liabilities which can materially affect the determination of net income (loss) and book value per common share. Actual results may differ from these estimates under different assumptions or conditions.

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Management believes the following are critical accounting policies in the preparation of Capstead s consolidated financial statements that involve the use of estimates requiring considerable judgment:

Amortization of Investment Premiums on Financial Assets Investment premiums on financial assets are recognized in earnings as adjustments to interest income by the interest method over the estimated lives of the related assets. For most of Capstead s financial assets, estimates and judgments related to future levels of mortgage prepayments are critical to this determination. Mortgage prepayment expectations can vary considerably from period to period based on current and projected changes in interest rates and other factors such as portfolio composition. Management estimates mortgage prepayments based on past experiences with specific investments within the portfolio, and current market expectations for changes in the interest rate environment. Should actual runoff rates differ materially from these estimates, investment premiums would be expensed at a different pace.

Fair Value and Impairment Accounting for Financial Assets Most of Capstead s investments are financial assets held in the form of mortgage securities that are classified as available-for-sale and recorded at fair value on the balance sheet with unrealized gains and losses recorded in *Stockholders equity* as a component of *Accumulated other comprehensive income*. As such, these unrealized gains and losses enter into the calculation of book value per common share, a key financial metric used by investors in evaluating the Company. Fair values fluctuate with current and projected changes in interest rates, prepayment expectations and other factors such as market liquidity conditions. Considerable judgment is required interpreting market data to develop estimated fair values, particularly in circumstances of deteriorating credit quality and market liquidity (see NOTE 10 to the accompanying consolidated financial statements for discussion of how Capstead values its financial assets). Generally, gains or losses are recognized in earnings only if sold; however, if a decline in fair value of an individual asset below its amortized cost occurs that is determined to be other than temporary, the difference between amortized cost and fair value would be included in *Other revenue (expense)* as an impairment charge.

Derivatives Accounting The Company uses Derivatives from time to time for risk management purposes. When held, Derivatives are recorded as assets or liabilities and carried at fair value. The accounting for changes in fair value of each Derivative held depends on whether it has been designated as an accounting hedge, as well as the type of hedging relationship identified. To qualify as cash flow hedges for accounting purposes, at the inception of the hedge relationship the Company must anticipate and document that the hedge relationship will be highly effective and monitor ongoing effectiveness on at least a quarterly basis. As long as the hedge relationship remains effective, the effective portion of changes in fair value of the Derivative are recorded in *Accumulated other comprehensive income* and the ineffective portion is recorded in earnings. Changes in fair value of Derivatives not held as accounting hedges, or for which the hedge relationship is deemed to no longer be highly effective, are recorded in earnings as a component of *Other revenue (expense)*.

Late in 2007 the Company began using interest rate swap agreements in hedge relationships accounted for as cash flow hedges in order to hedge variability in borrowing rates due to changes in the underlying benchmark interest rate related to a designated portion of its current and anticipated future 30-day borrowings. Variable-rate payments to be received on the swap agreements and any measured hedge ineffectiveness are recorded in *Interest expense* as an offset to interest owed on the hedged borrowings that reset to market rates generally on a monthly basis while fixed-rate swap payments to be made are also recorded in *Interest expense* resulting in an effectively fixed borrowing rate on these borrowings, subject to certain adjustments. See NOTE 6 to the

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accompanying consolidated financial statements and Financial Conditions Residential Mortgage Investments for additional information regarding the Company s use of Derivatives and its related risk management policies.

FORWARD LOOKING STATEMENTS

This document contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) that inherently involve risks and uncertainties. Capstead s actual results and liquidity can differ materially from those anticipated in these forward-looking statements because of changes in the level and composition of the Company s investments and other factors. These factors may include, but are not limited to, changes in general economic conditions, the availability of suitable investments from both an investment return and regulatory perspective, the availability of new investment capital, the availability of financing at reasonable levels and terms to support investing on a leveraged basis, fluctuations in interest rates and levels of mortgage prepayments, deterioration in credit quality and ratings, the effectiveness of risk management strategies, the impact of differing levels of leverage employed, liquidity of secondary markets and credit markets, increases in costs and other general competitive factors. In addition to the above considerations, actual results and liquidity related to investments in loans secured by commercial real estate are affected by borrower performance under operating or development plans, lessee performance under lease agreements, changes in general as well as local economic conditions and real estate markets, increases in competition and inflationary pressures, changes in the tax and regulatory environment including zoning and environmental laws, uninsured losses or losses in excess of insurance limits and the availability of adequate insurance coverage at reasonable costs, among other factors.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISKS

The information required by this Item is incorporated by reference to the information included in Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations.

ITEM 4. CONTROLS AND PROCEDURES

As of September 30, 2008, an evaluation was performed under the supervision and with the participation of the Company s management, including the Chief Executive Officer (CEO) and Chief Financial Officer (CFO), of the effectiveness of the design and operation of the Company s disclosure controls and procedures. Based on that evaluation, the Company s management, including the CEO and CFO, concluded that the Company s disclosure controls and procedures were effective as of September 30, 2008. There have been no significant changes in the Company s internal controls or in other factors that could significantly affect internal controls subsequent to September 30, 2008.

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PART II. OTHER INFORMATION
ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits: The following Exhibits are presented herewith:

Exhibit 12 Computation of Ratio of Income from Continuing Operations (before fixed charges) to Combined Fixed Charges and Preferred Stock Dividends.

Exhibit 31.1 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002

Exhibit 31.2 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002

Exhibit 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K:

Current Report on Form 8-K dated July 24, 2008 furnishing the press release announcing second quarter 2008 results.

Current Report on Form 8-K dated July 28, 2008 announcing a conference call and audio webcast to discuss second quarter financial results with the investment community.

Current Report on Form 8-K dated August 1, 2008 to file a presentation to the investment community.

Current Report on Form 8-K dated August 26, 2008 to file a second quarter 2008 investor fact sheet.

Current Report on Form 8-K dated September 11, 2008 furnishing certain compensation matters for the Company s named executive officers effective July 1, 2008.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CAPSTEAD MORTGAGE CORPORATION
Registrant

Date: January 12, 2009

By: /s/ ANDREW F. JACOBS
Andrew F. Jacobs
President and Chief Executive Officer

Date: January 12, 2009

By: /s/ PHILLIP A. REINSCH
Phillip A. Reinsch
Executive Vice President and Chief Financial Officer