Armour Residential REIT, Inc.
Form 10-Q
November 02, 2016

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

FORM 10-Q

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

For the Quarterly Period Ended September 30, 2016
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

ARMOUR RESIDENTIAL REIT, INC.
(Exact name of registrant as specified in its charter)

Maryland	001-34766	26-1908763
(State or other jurisdiction of incorporation or organization)	(Commission File Number)	(I.R.S. Employer Identification No.)

3001 Ocean Drive, Suite 201, Vero Beach, FL 32963
(Address of principal executive offices)(zip code)

(772) 617-4340
(Registrant’s telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES x 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.

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

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

The number of outstanding shares of the Registrant’s common stock as of November 1, 2016 was 36,713,354.

ARMOUR Residential REIT, Inc. and Subsidiaries
TABLE OF CONTENTS

PART I. Financial Information	3
Item 1. Financial Statements	3
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	34
Item 3. Quantitative and Qualitative Disclosures about Market Risk	54
Item 4. Controls and Procedures	56
PART II. Other Information	57
Item 1. Legal Proceedings	57
Item IA. Risk Factors	58
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	58
Item 3. Defaults Upon Senior Securities	58
Item 4. Mine Safety Disclosures	58
Item 5. Other Information	59
Item 6. Exhibits	59

ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts)
(Unaudited)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

	September 30, 2016	December 31, 2015
Assets		
Cash	$401,825	$289,925
Cash collateral posted to counterparties	281,397	263,799
Agency Securities, available for sale, at fair value (including pledged securities of $6,913,094 at September 30, 2016 and $12,109,868 at December 31, 2015)	7,041,228	12,461,556
Non-Agency Securities, trading, at fair value (including pledged securities of $1,001,319 at September 30, 2016 and $0 at December 31, 2015)	1,001,319	—
Interest-Only Securities, trading, at fair value	95,918	—
Derivatives, at fair value	10,194	999
Principal payments receivable	—	37
Accrued interest receivable	19,271	34,500
Prepaid and other	3,850	4,461
Total Assets	$8,855,002	$13,055,277
Liabilities and Stockholders' Equity		
Liabilities:		
Repurchase agreements	$7,360,670	$11,570,481
Cash collateral posted by counterparties	15,496	—
Derivatives, at fair value	243,223	233,301
Accrued interest payable- repurchase agreements	6,025	7,724
Accounts payable and other accrued expenses	9,271	18,605
Total Liabilities	$7,634,685	$11,830,111
Commitments and contingencies (Note 10)		
Stockholders' Equity:		
Preferred stock, $0.001 par value, 50,000 shares authorized;		
8.250% Series A Cumulative Preferred Stock; 2,181 issued and outstanding ($54,514 aggregate liquidation preference)	2	2
7.875% Series B Cumulative Preferred Stock; 5,650 issued and outstanding ($141,250 aggregate liquidation preference)	6	6
Common stock, $0.001 par value, 125,000 shares authorized, 36,713 and 36,682 shares issued and outstanding at September 30, 2016 and December 31, 2015	37	37
Additional paid-in capital	2,560,021	2,559,361
Accumulated deficit	(1,505,020)	(1,266,938)
Accumulated other comprehensive income (loss)	165,271	(67,302)
Total Stockholders' Equity	$1,220,317	$1,225,166
Total Liabilities and Stockholders' Equity	$8,855,002	$13,055,277

See notes to condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)
(Unaudited)

	For the Quarter Ended		For the Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Interest Income:				
Agency Securities, net of amortization of premium and fees	$44,544	$85,643	$178,733	$276,896
Non-Agency Securities, including discount accretion	12,969	—	23,148	—
Interest-Only Securities	852	—	855	—
Total Interest Income	$58,365	$85,643	$202,736	$276,896
Interest expense- repurchase agreements	(17,040)	(14,431)	(54,464)	(42,539)
Net Interest Income	$41,325	$71,212	$148,272	$234,357
Other Income (Loss):				
Realized gain on sale of Agency Securities (reclassified from Other comprehensive income (loss))	2,421	69	18,937	1,562
Gain on Non-Agency Securities	39,522	—	53,795	—
Loss on Interest-Only Securities	(1,105)	—	(2,348)	—
Bargain purchase price on acquisition of JAVELIN	—	—	6,484	—
Subtotal	$40,838	$69	$76,868	$1,562
Realized gain (loss) on derivatives (1)	19,816	(17,400)	(338,804)	(69,280)
Unrealized gain (loss) on derivatives	25,824	(266,074)	2,907	(287,905)
Subtotal	$45,640	$(283,474)	$(335,897)	$(357,185)
Total Other Income (Loss)	$86,478	$(283,405)	$(259,029)	$(355,623)
Expenses:				
Management fees	6,521	6,851	19,549	20,595
Professional fees	1,090	878	4,756	2,329
Insurance	283	174	727	516
Compensation	530	543	1,636	1,731
Other	691	914	2,188	2,566
Total Expenses	$9,115	$9,360	$28,856	$27,737
Net Income (Loss)	$118,688	$(221,553)	$(139,613)	$(149,003)
Dividends on preferred stock	(3,905)	(3,905)	(11,716)	(11,716)
Net Income (Loss) related to common stockholders	$114,783	$(225,458)	$(151,329)	$(160,719)
Net Income (Loss) per share related to common stockholders (Note 13):				
Basic	$3.13	$(5.18)	$(4.12)	$(3.68)
Diluted	$3.12	$(5.18)	$(4.12)	$(3.68)
Dividends declared per common share	$0.66	$0.98	$2.36	$2.90
Weighted average common shares outstanding:				
Basic	36,703	43,561	36,693	43,709
Diluted	36,746	43,561	36,693	43,709

(1) Interest expense related to our interest rate swap contracts is recorded as realized loss on derivatives on the condensed consolidated statements of operations. For additional information, see Note 9 to the condensed consolidated financial statements.

See notes to condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(in thousands)
(Unaudited)

	For the Quarter Ended		For the Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Net Income (Loss)	$118,688	$(221,553)	$(139,613)	$(149,003)
Other comprehensive income (loss):				
Reclassification adjustment for realized gain on sale of available for sale Agency Securities	(2,421)	(69)	(18,937)	(1,562)
Net unrealized gain (loss) on available for sale Agency Securities	(7,526)	137,312	251,510	5,241
Other comprehensive income (loss)	$(9,947)	$137,243	$232,573	$3,679
Comprehensive Income (Loss)	$108,741	$(84,310)	$92,960	$(145,324)

See notes to the condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
(in thousands, except per share amounts)
(Unaudited)

	Preferred Stock 8.250% Series A			7.875% Series B			Common Stock						
	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Total Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2016	2,181	$2	$53,172	5,650	$6	$136,547	36,682	$37	$2,369,642	$2,559,361	$(1,266,938)	$(67,302)	$1,22
Series A Preferred dividends	—	—	—	—	—	—	—	—	—	—	(3,373)	—	(3,37
Series B Preferred dividends	—	—	—	—	—	—	—	—	—	—	(8,343)	—	(8,34
Common stock dividends	—	—	—	—	—	—	—	—	—	—	(86,753)	—	(86,7
Stock based compensation, net of withholding requirements	—	—	—	—	—	—	31	—	660	660	—	—	660
Net Loss	—	—	—	—	—	—	—	—	—	—	(139,613)	—	(139,
Other comprehensive income	—	—	—	—	—	—	—	—	—	—	—	232,573	232,5
Balance, September 30, 2016	2,181	$2	$53,172	5,650	$6	$136,547	36,713	$37	$2,370,302	$2,560,021	$(1,505,020)	$165,271	$1,22

See notes to condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiaries
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(Unaudited)

	For the Nine Months Ended	
	September 30, 2016	September 30, 2015
Cash Flows From Operating Activities:		
Net Loss	$(139,613)	$(149,003)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Net amortization of premium on Agency Securities	60,127	85,203
Accretion of net discount on Non-Agency Securities	(1,336)	—
Net amortization of Interest-Only Securities	3,682	—
Realized gain on sale of Agency Securities	(18,937)	(1,562)
Gain on Non-Agency Securities	(53,795)	—
Loss on Interest-Only Securities	2,348	—
Stock based compensation	660	717
Bargain purchase price on acquisition of JAVELIN	(6,484)	—
Changes in operating assets and liabilities:		
Decrease in accrued interest receivable	16,597	4,348
(Increase) decrease in prepaid and other assets	1,440	(3,195)
(Increase) decrease in derivatives, at fair value	(16,825)	260,340
Decrease in accrued interest payable- repurchase agreements	(2,612)	(3,082)
Decrease in accounts payable and other accrued expenses	(16,951)	(13,278)
Net cash provided by (used in) operating activities	$(171,699)	$180,488
Cash Flows From Investing Activities:		
Purchases of Agency Securities	(391,277)	(3,485,806)
Purchases of Non-Agency Securities	(760,666)	—
Purchases of Interest-Only Securities	(101,947)	—
Principal repayments of Agency Securities	1,020,179	1,486,497
Principal repayments of Non-Agency Securities	37,698	—
Proceeds from sales of Agency Securities	5,428,174	3,395,902
Increase (decrease) in cash collateral	22,499	(333,103)
Net cash used in the acquisition of JAVELIN	(73,174)	—
Net cash provided by investing activities	$5,181,486	$1,063,490
Cash Flows From Financing Activities:		
Issuance of common stock, net of expenses	—	124
Proceeds from repurchase agreements	108,505,750	64,947,629
Principal repayments on repurchase agreements	(113,305,168)	(66,233,977)
Series A Preferred stock dividends paid	(3,373)	(3,373)
Series B Preferred stock dividends paid	(8,343)	(8,343)
Common stock dividends paid	(86,753)	(127,669)
Common stock repurchased	—	(36,441)
Net cash used in financing activities	$(4,897,887)	$(1,462,050)
Net increase (decrease) in cash	111,900	(218,072)
Cash - beginning of period	289,925	494,561
Cash - end of period	$401,825	$276,489
Supplemental Disclosure:		
Cash paid during the period for interest	$130,758	$184,928
Non-Cash Investing and Financing Activities:		

Net unrealized gain on available for sale Agency Securities	$251,510	$5,241
Amounts payable for common stock repurchased	$—	$(9,530)

See notes to condensed consolidated financial statements

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Note 1 -Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles 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 promulgated by the Securities and Exchange Commission (the “SEC”). 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. Certain prior year amounts have been reclassified to conform to the current year's presentation. All per share amounts, common shares outstanding and stock-based compensation amounts for all periods presented reflect our one-for-eight reverse stock split (the “Reverse Stock Split”), which was effective July 31, 2015. Operating results for the quarter and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2016. These unaudited financial statements should be read in conjunction with the audited financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2015.

The condensed consolidated financial statements include the accounts of ARMOUR Residential REIT, Inc. and its subsidiaries including the results of JAVELIN Mortgage Investment Corp. ("JAVELIN") since its acquisition on April 6, 2016. All intercompany accounts and transactions have been eliminated. The preparation of the condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates affecting the accompanying condensed consolidated financial statements include the valuation of MBS (as defined below), including an assessment of whether other-than-temporary impairment (“OTTI”) exists, and derivative instruments.

Note 2 -Organization and Nature of Business Operations

References to “we,” “us,” “our,” “ARMOUR” or the “Company” are to ARMOUR Residential REIT, Inc. References to “ACM are to ARMOUR Capital Management LP, a Delaware limited partnership.

We are a Maryland corporation incorporated in 2008. ARMOUR and its subsidiaries, including JAVELIN are managed by ACM, an investment advisor registered with the SEC (see Note 10 -Commitments and Contingencies and Note 15 -Related Party Transactions for additional discussion). We invest in residential mortgage backed securities issued or guaranteed by a United States (“U.S.”) Government-sponsored entity (“GSE”), such as the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac), or a government agency such as Government National Mortgage Administration (Ginnie Mae) (collectively, “Agency Securities”). Interest-only Securities are the interest portion of Agency Securities, which is separated and sold individually from the principal portion of the same payment. Other securities backed by residential mortgages in which we invest, for which the payment of principal and interest is not guaranteed by a GSE or government agency may benefit from credit enhancement derived from structural elements such as subordination, over collateralization or insurance (collectively, “Non-Agency Securities”). Agency Securities, Non-Agency Securities and Interest-only Securities are collectively referred to as “MBS”.

At September 30, 2016 and December 31, 2015, investments in Agency Securities accounted for 86.5% and 100.0% of our MBS portfolio, respectively. During the first quarter of 2016, we began to invest in Non-Agency Securities. At

September 30, 2016, investments in Non-Agency Securities accounted for 12.3% of our MBS portfolio. During the second quarter of 2016, we began to invest in Interest-only Securities. At September 30, 2016, investments in Interest-only Securities accounted for 1.2% of our MBS portfolio.

Our charter permits us to invest in Agency Securities, Non-Agency Securities and Interest-only Securities. Our MBS portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our assets may be invested in Agency Securities backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by GSEs, U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a real estate investment trust (“REIT”).

We have elected to be taxed as a REIT under the Internal Revenue Code, as amended (“the Code”). Our qualification as a REIT depends on our ability to meet, on a continuing basis, various complex requirements under the Code relating to, among other things, the sources of our gross income, the composition and values of our assets, our distribution levels and the concentration of ownership of our capital stock. We believe that we are organized in conformity with the requirements for qualification as a REIT under the Code and our manner of operations enables us to meet the requirements for taxation as a REIT for federal income tax purposes.

As a REIT, we will generally not be subject to federal income tax on the REIT taxable income that we currently distribute to our stockholders. If we fail to qualify as a REIT in any taxable year and do not qualify for certain statutory relief provisions, we will be subject to federal income tax at regular corporate rates. Even if we qualify as a REIT for federal income tax purposes, we may still be subject to some federal, state and local taxes on our income.

Note 3 -Summary of Significant Accounting Policies

Cash

Cash includes cash on deposit with financial institutions. We may maintain deposits in federally insured financial institutions in excess of federally insured limits. However, management believes we are not exposed to significant credit risk due to the financial position and creditworthiness of the depository institutions in which those deposits are held.

Cash Collateral Posted To/By Counterparties

Cash collateral posted to/by counterparties represents cash posted by us to counterparties or posted by counterparties to us as collateral. Cash collateral posted to/by counterparties may include collateral for interest rate swap contracts (including swaptions and basis swap contracts), Eurodollar Futures Contracts (“Futures Contracts”) and repurchase agreements on our MBS and our Agency Securities purchased or sold on a to-be-announced basis (“TBA Agency Securities”).

MBS, at Fair Value

We generally intend to hold most of our MBS for extended periods of time. We may, from time to time, sell any of our MBS as part of the overall management of our MBS portfolio. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. Purchases and sales of our MBS are recorded on the trade date.

Agency Securities, Available For Sale - At September 30, 2016 and December 31, 2015, all of our Agency Securities were classified as available for sale securities. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the condensed consolidated statements of comprehensive income (loss).

Non-Agency Securities, Trading - At September 30, 2016, all of our Non-Agency Securities were classified as trading securities. Non-Agency Securities classified as trading are reported at their estimated fair values with unrealized gains and losses included in Other Income (Loss) as a component of the condensed consolidated statements of operations. We estimate future cash flows for each Non-Agency Security and then discount those cash flows based on our estimates of current market yield for each individual security. We then compare our calculated price with our pricing services and/or dealer marks. Our estimates for future cash flows and current market yields incorporate such factors as coupons, prepayment speeds, defaults, delinquencies and severities.

Interest-only Securities, Trading - At September 30, 2016, all of our Interest-only Securities were classified as trading securities. Interest-only Securities represent the right to receive a specified proportion of the contractual interest flows of specific Agency MBS. Interest-only Securities classified as trading are reported at their estimated fair values with unrealized gains and losses included in Other Income (Loss) as a component of the condensed consolidated statements of operations.

Receivables and Payables for Unsettled Sales and Purchases

We account for purchases and sales of securities on the trade date, including purchases and sales for forward settlement. Receivables and payables for unsettled trades represent the agreed trade price multiplied by the outstanding balance of the securities at the balance sheet date.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Accrued Interest Receivable and Payable

Accrued interest receivable includes interest accrued between payment dates on MBS. Accrued interest payable includes interest payable on our repurchase agreements and may, at certain times, contain interest payable on U.S. Treasury Securities sold short.

Repurchase Agreements

We finance the acquisition of our MBS through the use of repurchase agreements. Our repurchase agreements are secured by our MBS and bear interest rates that have historically moved in close relationship to the Federal Funds Rate and the London Interbank Offered Rate (“LIBOR”). Under these repurchase agreements, we sell MBS to a lender and agree to repurchase the same MBS in the future for a price that is higher than the original sales price. The difference between the sales price that we receive and the repurchase price that we pay represents interest paid to the lender. A repurchase agreement operates as a financing arrangement under which we pledge our MBS as collateral to secure a loan which is equal in value to a specified percentage of the estimated fair value of the pledged collateral. We retain beneficial ownership of the pledged collateral. At the maturity of a repurchase agreement, we are required to repay the loan and concurrently receive back our pledged collateral from the lender or, with the consent of the lender, we may renew such agreement at the then prevailing interest rate. The repurchase agreements may require us to pledge additional assets to the lender in the event the estimated fair value of the existing pledged collateral declines.

In addition to the repurchase agreement financing discussed above, at certain times we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities in the future in exchange for a price that is higher than the original purchase price. The difference between the purchase price originally paid and the sale price represents interest received from the borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same master repurchase agreement (“MRA”), settlement through the same brokerage or clearing account and maturing on the same day. We did not have any reverse repurchase agreements outstanding at September 30, 2016 and December 31, 2015.

Obligations to Return Securities Received as Collateral, at Fair Value

At certain times, we also sell to third parties the U.S. Treasury Securities received as collateral for reverse repurchase agreements and recognize the resulting obligation to return said U.S. Treasury Securities as a liability on our condensed consolidated balance sheets. Interest is recorded on the repurchase agreements, reverse repurchase agreements and U.S. Treasury Securities sold short on an accrual basis and presented as interest expense. Both parties to the transaction have the right to make daily margin calls based on changes in the fair value of the collateral received and/or pledged. We did not have any obligations to return securities received as collateral at September 30, 2016 and December 31, 2015.

Derivatives, at Fair Value

We recognize all derivatives as either assets or liabilities at fair value on our condensed consolidated balance sheets. All changes in the fair values of our derivatives are reflected in our condensed consolidated statements of operations. We designate derivatives as hedges for tax purposes and any unrealized derivative gains or losses would not affect our distributable net taxable income. These transactions include interest rate swap contracts, interest rate swaptions and basis swap contracts. We also may utilize forward contracts for the purchase or sale of TBA Agency Securities. We account for TBA Agency Securities as derivative instruments if it is reasonably possible that we will not take or make physical delivery of the Agency Security upon settlement of the contract. We account for TBA dollar roll transactions as a series of derivative transactions.

We may also purchase and sell TBA Agency Securities as a means of investing in and financing Agency Securities (thereby increasing our "at risk" leverage) or as a means of disposing of or reducing our exposure to Agency Securities (thereby reducing our "at risk" leverage). Pursuant to TBA Agency Securities, we agree to purchase or sell, for future delivery, Agency Securities with certain principal and interest terms and certain types of collateral, but the particular Agency Securities to be delivered are not identified until shortly before the TBA settlement date. We may also choose, prior to settlement, to move the settlement of these securities out to a later date by entering into an offsetting short or long position (referred to as a "pair off"), net settling the paired off positions for cash, and simultaneously purchasing or selling a similar TBA Agency Security for a later settlement date. This transaction is commonly referred to as a "dollar roll." When it is reasonably possible that we will pair off a TBA Agency Security, we account for that contract as a derivative.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Revenue Recognition

Agency Securities, Available For Sale - Interest income is earned and recognized on Agency Securities based on their unpaid principal amounts and their contractual terms. Recognition of interest income commences on the settlement date of the purchase transaction and continues through the settlement date of the sale transaction. Premiums and discounts associated with the purchase of Multi-Family MBS, which are generally not subject to prepayment, are amortized or accreted into interest income over the contractual lives of the securities using a level yield method. Premiums and discounts associated with the purchase of other Agency Securities are amortized or accreted into interest income over the actual lives of the securities, reflecting actual prepayments as they occur.

Fair Value of Agency Securities: We invest in Agency Securities representing interests in or obligations backed by pools of fixed rate, hybrid adjustable rate and adjustable rate mortgage loans. GAAP requires us to classify our investments as either trading, available for sale or held to maturity securities. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. We currently classify all of our Agency Securities as available for sale. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the statements of comprehensive income (loss).

Security purchase and sale transactions, including purchase of TBA Agency Securities, are recorded on the trade date to the extent it is probable that we will take or make timely physical delivery of the related securities. Gains or losses realized from the sale of securities are included in income and are determined using the specific identification method.

Impairment of Assets: We evaluate Agency Securities for other than temporary impairment at least on a quarterly basis and more frequently when economic or market concerns warrant such evaluation. We consider an impairment to be other than temporary if we (1) have the intent to sell the Agency Securities, (2) believe it is more likely than not that we will be required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations) or (3) a credit loss exists. Impairment losses recognized establish a new cost basis for the related Agency Securities.

Non-Agency Securities and Interest-only Securities, Trading - Interest income on Non-Agency Securities and Interest-only Securities is recognized using the effective yield method over the life of the securities based on the future cash flows expected to be received. Future cash flow projections and related effective yields are determined for each security and updated quarterly. Other than temporary impairments, which establish a new cost basis in the security for purposes of calculating effective yields, are recognized when the fair value of a security is less than its cost basis and there has been an adverse change in the future cash flows expected to be received. Other changes in future cash flows expected to be received are recognized prospectively over the remaining life of the security.

Comprehensive Income (Loss)

Comprehensive income (loss) refers to changes in equity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period, except those resulting from investments by owners and distributions to owners.

Reclassification

Certain amounts included in other expenses in the first and second quarters of 2016 have been reclassified to Interest Income Agency Securities. All per share amounts, common shares outstanding and stock-based compensation amounts for all periods presented reflect the Reverse Stock Split, which was effective July 31, 2015. No other reclassifications have been made to previously reported amounts.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Note 4 -Recent Accounting Pronouncements

In September 2015, the Financial Accounting Standards Board issued ASU 2015-16, Business Combinations Simplifying the Accounting for Measurement-Period Adjustments (Topic 805). The amendment simplifies the accounting for measurement-period adjustments. An acquirer is required to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendment also requires acquirers to present separately on the face of the income statement or disclose in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustments to the provisional amounts had been recognized as of the acquisition date. The amendment is effective for fiscal years beginning after December 15, 2015 and has not had a significant impact on the consolidated financial statements for the quarter.

In February 2016, the Financial Accounting Standards Board issued ASU 2016-02, Leases (Topic 842). The standard introduces a new lessee model that will require most leases to be recorded on the balance sheet recognizing a right-of-use lease asset and a liability to make lease payments. The standard will be effective for annual periods beginning after December 15, 2018. The Company is assessing the impact of this standard but does not expect it to have a significant impact on the consolidated financial statements.

In July 2016 the Financial Accounting Standards Board issued ASU 2016-13, Financial Instruments–Credit Losses (Topic 326). The standard introduces a new model for recognizing credit losses on financial instruments based on an estimate of current expected credit losses. The standard will apply to (1) loans, accounts receivable, trade receivables, and other financial assets measured at amortized cost, (2) loan commitments and certain other off–balance sheet credit, exposures, (3) debt securities and other financial assets measured at fair value through other comprehensive income, and (4) beneficial interests in securitized financial assets. The standard is effective for fiscal years beginning after December 15, 2019. The Company is assessing the impact of this standard but does not expect it to have significant impact on the consolidated financial statements.

Note 5 -Fair Value of Financial Instruments

Our valuation techniques for financial instruments use observable and unobservable inputs. Observable inputs reflect readily obtainable data from third party sources, while unobservable inputs reflect management's market assumptions. The Accounting Standards Codification Topic No. 820, "Fair Value Measurement," classifies these inputs into the following hierarchy:

Level 1 Inputs - Quoted prices for identical instruments in active markets.

Level 2 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 3 Inputs - Prices determined using significant unobservable inputs. Unobservable inputs may be used in situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period). Unobservable inputs reflect management's assumptions about the factors that market participants would use in pricing an asset or liability, and would be based on the best information available.

The following describes the valuation methodologies used for our assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy. Any transfers between levels are assumed to occur at the beginning of the reporting period.

Cash - Cash includes cash on deposit with financial institutions. The carrying amount of cash is deemed to be its fair value and is classified as Level 1. Cash balances posted by us to counterparties or posted by counterparties to us as collateral are classified as Level 2 because they are integrally related to the Company's repurchase financing and interest rate swap agreements, which are classified as Level 2.

Agency Securities, Available for Sale - Fair value for the Agency Securities in our MBS portfolio is based on obtaining a valuation for each Agency Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Agency Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Agency Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At September 30, 2016 and December 31, 2015, all of our Agency Security fair values are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

Non-Agency Securities Trading - The fair value for the Non-Agency Securities in our MBS portfolio is based on estimates prepared by our Portfolio Management group, which organizationally reports to our Chief Investment Officer. In preparing the estimates, our Portfolio Management group uses commercially available and proprietary models and data as well as market intelligence gained from discussions with, and transactions by, other market participants. We estimate the fair value of our Non-Agency Securities by estimating the future cash flows for each Non-Agency Security and then discounting those cash flows based on our estimates of current market yield for each individual security. Our estimates for future cash flows and current market yields incorporate such factors as collateral type, bond structure and priority of payments, coupons, prepayment speeds, defaults, delinquencies and severities. Quarterly, we compare our estimates of fair value of our Non-Agency Securities with pricing from third party pricing services, dealer marks received and recent purchase and financing transaction history to validate our assumptions of cash flow and market yield and calibrate our models. Fair values calculated in this manner are considered Level 3. At September 30, 2016, all of our Non-Agency Security fair values are calculated in this manner and therefore were classified as Level 3.

Interest-Only Securities Trading - The fair value for the Interest-Only Securities in our MBS portfolio is based on obtaining a valuation for each Interest-Only Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models consistent with those models used to price Agency Securities underlying the Interest-Only Securities that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Interest-Only Security is not available from the third party pricing services or such data appears unreliable, we obtain pricing indications from up to three dealers who make markets in similar Interest-Only Securities. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer pricing indications and comparisons to a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing models used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer pricing indications are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information and classify it as a Level 3 security. At September 30, 2016, all of our Interest-Only Security fair values are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

Receivables and Payables for Unsettled Sales and Purchases - The carrying amount is generally deemed to be fair value because of the relatively short time to settlement. Such receivables and payables are classified as Level 2 because they are effectively secured by the related securities and could potentially be subject to counterparty credit considerations.

Repurchase Agreements - The fair value of repurchase agreements reflects the present value of the contractual cash flows discounted at the estimated LIBOR based market interest rates at the valuation date for repurchase agreements with a term equivalent to the remaining term to interest rate repricing, which may be at maturity, of our repurchase agreements. The fair value of the repurchase agreements approximates their carrying amount due to the short-term nature of these financial instruments. Our repurchase agreements are classified as Level 2.

Obligations to Return Securities Received as Collateral - The fair value of the obligations to return securities received as collateral are based upon the prices of the related U.S. Treasury Securities obtained from a third party pricing service. Such obligations are classified as Level 1.

Derivative Transactions - Our Futures Contracts are traded on the Chicago Mercantile Exchange (“CME”) and are classified as Level 1. The fair values of our interest rate swap contracts, interest rate swaptions and basis swaps are valued using

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

third party pricing services that incorporate common market pricing methods that may include current interest rate curves, forward interest rate curves and market spreads to interest rate curves. We estimate the fair value of TBA Agency Securities based on similar methods used to value our Agency Securities. Management compares pricing used to dealer quotes to ensure that the current market conditions are properly reflected. The fair values of our interest rate swap contracts, interest rate swaptions, basis swap contracts and TBA Agency Securities are classified as Level 2.

The following tables provide a summary of our assets and liabilities that are measured at fair value on a recurring basis at September 30, 2016 and December 31, 2015.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at September 30, 2016
Assets at Fair Value:				
Agency Securities, available for sale	$ —	$7,041,228	$ —	$7,041,228
Non-Agency Securities, trading	$ —	$—	$ 1,001,319	$1,001,319
Interest-Only Securities, trading	$ —	$95,918	$ —	$95,918
Derivatives	$ —	$10,194	$ —	$10,194
Liabilities at Fair Value:				
Derivatives	$ —	$243,223	$ —	$243,223

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the quarter and nine months ended September 30, 2016.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at December 31, 2015
Assets at Fair Value:				
Agency Securities, available for sale	$ —	$12,461,556	$ —	$12,461,556
Derivatives	$ —	$999	$ —	$999
Liabilities at Fair Value:				
Derivatives	$ —	$233,301	$ —	$233,301

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the year ended December 31, 2015.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

The following tables provide a summary of the carrying values and fair values of our financial assets and liabilities not carried at fair value but for which fair value is required to be disclosed at September 30, 2016 and December 31, 2015.

September 30, 2016			Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Cash	$401,825	$401,825	$401,825	$—	$ —
Cash collateral posted to counterparties	$281,397	$281,397	$—	$281,397	$ —
Accrued interest receivable	$19,271	$19,271	$—	$19,271	$ —
Financial Liabilities:					
Repurchase agreements	$7,360,670	$7,360,670	$—	$7,360,670	$ —
Cash collateral posted by counterparties	$15,496	$15,496	$—	$15,496	$ —
Accrued interest payable- repurchase agreements	$6,025	$6,025	$—	$6,025	$ —

December 31, 2015			Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Cash	$289,925	$289,925	$289,925	$—	$ —
Cash collateral posted to counterparties	$263,799	$263,799	$—	$263,799	$ —
Principal payments receivable	$37	$37	$—	$37	$ —
Accrued interest receivable	$34,500	$34,500	$—	$34,500	$ —
Financial Liabilities:					
Repurchase agreements	$11,570,481	$11,570,481	$—	$11,570,481	$ —
Accrued interest payable- repurchase agreements	$7,724	$7,724	$—	$7,724	$ —

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

The following table provides a summary of the changes in Level 3 assets measured at fair value on a recurring basis at September 30, 2016. We did not have Level 3 assets at December 31, 2015.

Non-Agency Securities	For the Quarter Ended September 30, 2016	For the Nine Months Ended September 30, 2016
Balance, beginning of period	$ 916,571	$ —
Non-Agency Securities acquired in the acquisition of JAVELIN, at fair value	—	223,220
Purchases of Non-Agency Securities, at cost	68,186	760,666
Principal repayments of Non-Agency Securities	(23,707)	(37,698)
Gain on Non-Agency Securities	39,522	53,795
Discount accretion	747	1,336
Balance, end of period	$ 1,001,319	$ 1,001,319
Gain on Non-Agency Securities	$ 39,522	$ 53,795

The significant unobservable inputs used in the fair value measurement of our Level 3 Non-Agency Securities include assumptions for underlying loan collateral, cumulative default rates and loss severities in the event of default, as well as discount rates.

The following table presents the range of our estimates of cumulative default and loss severities, together with the discount rates implicit in our Level 3 Non-Agency Security fair values at September 30, 2016. We did not have Level 3 assets at December 31, 2015.

September 30, 2016

Unobservable Level 3 Input	Minimum	Weighted Average	Maximum
Cumulative default	0.00 %	1.74 %	40.90 %
Loss severity (life)	0.00 %	23.00 %	75.73 %
Discount rate	2.38 %	4.08 %	7.84 %
Delinquency (life)	0.00 %	4.14 %	47.09 %
Voluntary prepayments (life)	1.56 %	15.71 %	28.14 %

The table above includes the effects of the structural elements of our Non-Agency Securities, such as subordination and over collateralization or insurance. Significant increases or decreases in any of these inputs in isolation would result in a significantly lower or higher fair value measurement. Generally, a change in the assumption used for the probability of cumulative default is accompanied by a directionally similar change in the assumption used for the delinquency and loss severity and a directionally opposite change in the assumption used for voluntary prepayment rates for the life of the security. However, given the interrelationship between loss estimates and the discount rate, overall Non-Agency Security market conditions would likely have a more significant impact on our Level 3 fair values than changes in any one unobservable input.

Note 6 -Agency Securities, Available for Sale

All of our Agency Securities are classified as available for sale and, as such, are reported at their estimated fair value and changes in fair value reported as part of the statements of comprehensive income (loss). At September 30, 2016 and December 31, 2015, investments in Agency Securities accounted for 86.5% and 100.0% of our MBS portfolio.

We evaluated our Agency Securities with unrealized losses at September 30, 2016, September 30, 2015 and December 31, 2015, to determine whether there was an other than temporary impairment. All of our Agency Securities are issued and guaranteed by GSEs or Ginnie Mae. The GSEs have a long term credit rating of AA+. At those dates, we also considered whether we intended to sell Agency Securities and whether it was more likely than not that we could meet our liquidity requirements and contractual

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

obligations without selling Agency Securities. As a result of this evaluation, no other than temporary impairment was recognized for the quarters and nine months ended September 30, 2016 and September 30, 2015 and for the year ended December 31, 2015, respectively, because we determined that we 1) did not have the intent to sell the Agency Securities in an unrealized loss position, 2) did not believe it more likely than not that we were required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations), and/or (3) determined that a credit loss did not exist.

At September 30, 2016, we had the following Agency Securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities at September 30, 2016 are also presented below. Our Agency Securities had a weighted average coupon of 3.53% at September 30, 2016.

September 30, 2016	Amortized Cost	Gross Unrealized Loss	Gross Unrealized Gain	Fair Value	Percent of Total
Fannie Mae					
ARMs & Hybrids	$39,700	$ (93)	$ 351	$39,958	0.57 %
Multi-Family MBS	1,473,296	—	83,738	1,557,034	22.11
10 Year Fixed	96,512	(376)	866	97,002	1.38
15 Year Fixed	2,728,932	(10)	45,721	2,774,643	39.41
20 Year Fixed	590,738	(6)	5,520	596,252	8.47
25 Year Fixed	11,956	—	113	12,069	0.17
30 Year Fixed	1,120,524	—	20,065	1,140,589	16.20
Total Fannie Mae	$6,061,658	$ (485)	$ 156,374	$6,217,547	88.31 %
Freddie Mac					
10 Year Fixed	50,846	(79)	864	51,631	0.73
15 Year Fixed	372,397	—	7,714	380,111	5.40
20 Year Fixed	218,072	(3)	1,322	219,391	3.12
25 Year Fixed	123,857	—	360	124,217	1.76
Total Freddie Mac	$765,172	$ (82)	$ 10,260	$775,350	11.01 %
Ginnie Mae					
ARMs & Hybrids	48,832	(823)	3	48,012	0.68
15 Year Fixed	295	—	24	319	0.00
Total Ginnie Mae	$49,127	$ (823)	$ 27	$48,331	0.68 %
Total Agency Securities	$6,875,957	$ (1,390)	$ 166,661	$7,041,228	100.00 %

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

At December 31, 2015, we had the following securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities at December 31, 2015 are also presented below. Our Agency Securities had a weighted average coupon of 3.47% at December 31, 2015.

December 31, 2015	Amortized Cost	Gross Unrealized Loss	Gross Unrealized Gain	Fair Value	Percent of Total
Fannie Mae					
ARMs&Hybrids	$46,512	$(210)	$ 486	$46,788	0.38 %
Multi-Family MBS	2,182,156	(30,879)	7,312	2,158,589	17.32
10 Year Fixed	91,752	(362)	605	91,995	0.74
15 Year Fixed	4,302,585	(10,462)	5,498	4,297,621	34.49
20 Year Fixed	2,692,310	(25,429)	5,289	2,672,170	21.44
25 Year Fixed	18,488	(128)	—	18,360	0.15
30 Year Fixed	1,447,835	(6,645)	492	1,441,682	11.56
Total Fannie Mae	$10,781,638	$(74,115)	$ 19,682	$10,727,205	86.08 %
Freddie Mac					
ARMs&Hybrids	12,738	(46)	197	12,889	0.10
10 Year Fixed	37,657	(92)	652	38,217	0.31
15 Year Fixed	192,982	(995)	310	192,297	1.54
20 Year Fixed	1,443,652	(16,380)	4,006	1,431,278	11.49
Total Freddie Mac	$1,687,029	$(17,513)	$ 5,165	$1,674,681	13.44 %
Ginnie Mae					
ARMs&Hybrids	59,877	(610)	69	59,336	0.48
15 Year Fixed	314	—	20	334	0.00
Total Ginnie Mae	$60,191	$(610)	$ 89	$59,670	0.48 %
Total Agency Securities	$12,528,858	$(92,238)	$ 24,936	$12,461,556	100.00%

Recognition of interest income commences on the settlement date of the purchase transaction and continues through the settlement date of the sale transaction.

Actual maturities of Agency Securities are generally shorter than stated contractual maturities because actual maturities of Agency Securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal and prepayments of principal.

The following table summarizes the weighted average lives of our Agency Securities at September 30, 2016 and December 31, 2015.

	September 30, 2016		December 31, 2015	
Weighted Average Life of all Agency Securities	Fair Value	Amortized Cost	Fair Value	Amortized Cost
Less than one year	$8	$9	$19	$19
Greater than or equal to one year and less than three years	60,891	60,792	30,189	30,375
Greater than or equal to three years and less than five years	4,247,064	4,184,635	6,037,851	6,039,218
Greater than or equal to five years	2,733,265	2,630,521	6,393,497	6,459,246
Total Agency Securities	$7,041,228	$6,875,957	$12,461,556	$12,528,858

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

We use a third party model to calculate the weighted average lives of our Agency Securities. Weighted average life is calculated based on expectations for estimated prepayments for the underlying mortgage loans of our Agency Securities. These estimated prepayments are based on assumptions such as interest rates, current and future home prices, housing policy and borrower incentives. The weighted average lives of our Agency Securities at September 30, 2016 and December 31, 2015 in the table above are based upon market factors, assumptions, models and estimates from the third party model and also incorporate management's judgment and experience. The actual weighted average lives of our Agency Securities could be longer or shorter than estimated.

The following table presents the unrealized losses and estimated fair value of our Agency Securities by length of time that such securities have been in a continuous unrealized loss position at September 30, 2016 and December 31, 2015.

	Unrealized Loss Position For:					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2016	$60,563	$(322)	$58,538	$(1,068)	$119,101	$(1,390)
December 31, 2015	$7,105,363	$(58,799)	$1,861,211	$(33,439)	$8,966,574	$(92,238)

During the quarter and nine months ended September 30, 2016, we sold $460,169 and $5,428,174 of Agency Securities, which resulted in realized gains of $2,421 and $18,937, respectively. During the quarter and nine months ended September 30, 2015, we sold $331,196 and $3,148,831 of Agency Securities, which resulted in realized gains of $69 and $1,562, respectively. Sales of Agency Securities are done to reposition our MBS portfolio and to reach our target level of liquidity.

Note 7 -Non-Agency Securities, Trading

All of our Non-Agency Securities are classified as trading securities and reported at their estimated fair value. Fair value changes are reported in the condensed consolidated statements of operations in the period in which they occur. At September 30, 2016, investments in Non-Agency Securities accounted for 12.3% of our MBS portfolio.

The components of the carrying value of our Non-Agency Securities at September 30, 2016 are presented in the table below.

	Non-Agency Securities			
September 30, 2016	Fair Value	Amortized Cost	Principal Amount	Weighted Average Coupon
Credit Risk Transfer	$753,901	$703,932	$716,916	5.08 %
NPL/RPL	134,850	133,443	134,329	3.80 %
Legacy Prime Fixed	20,868	20,029	25,381	6.01 %
Legacy ALTA Fixed	62,114	59,619	78,901	5.85 %
Legacy Prime Hybrid	12,098	11,567	14,198	2.65 %
Legacy ALTA Hybrid	6,118	5,927	7,263	3.02 %
New Issue Prime Fixed Non-Agency	11,370	10,802	11,405	3.66 %
Total Non-Agency Securities	$1,001,319	$945,319	$988,393	4.93 %

The following table summarizes the weighted average lives of our Non-Agency Securities at September 30, 2016

September 30, 2016

Weighted Average Life of all Non-Agency Securities	Fair Value	Amortized Cost
Less than one year	$—	$—
Greater than or equal to one year and less than three years	216,630	210,023
Greater than or equal to three years and less than five years	460,256	433,484
Greater than or equal to five years	324,433	301,812
Total Non-Agency Securities	$1,001,319	$945,319

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

We use a third party model to calculate the weighted average lives of our Non-Agency Securities. Weighted average life is calculated based on expectations for estimated prepayments for the underlying mortgage loans of our Non-Agency Securities. These estimated prepayments are based on assumptions such as interest rates, current and future home prices, housing policy and borrower incentives. The weighted average lives of our Non-Agency Securities at September 30, 2016 in the table above are based upon market factors, assumptions, models and estimates from the third party model and also incorporate management's judgment and experience. The actual weighted average lives of our Non-Agency Securities could be longer or shorter than estimated.

At September 30, 2016, we had no Non-Agency Securities in an unrealized losses position less than or greater than twelve months.

Our Non-Agency Securities are subject to risk of loss with regard to principal and interest payments and at September 30, 2016, have generally either been assigned below investment grade ratings by rating agencies, or have not been rated. We evaluate each investment based on the characteristics of the underlying collateral and securitization structure, rather than relying on the ratings assigned by rating agencies.

Note 8 -Repurchase Agreements

At September 30, 2016, we had MRAs with 42 counterparties and had $7,360,670 in outstanding borrowings with 27 of those counterparties. At December 31, 2015, we had MRAs with 38 counterparties and had $11,570,481 in outstanding borrowings with 26 of those counterparties.

The following table represents the contractual repricing regarding our repurchase agreements to finance our MBS purchases at September 30, 2016 and December 31, 2015. No amounts below are subject to offsetting.

September 30, 2016	Repurchase Agreements	Weighted Average Contractual Rate		Weighted Average Maturity in days	Haircut for Repurchase Agreements (1)	
Agency Securities	$ 6,601,439	0.73	%	19	4.80	%
Non-Agency Securities	735,912	2.21	%	33	23.75	%
U.S. Treasury Securities	23,319	0.46	%	0	0.00	%
Total or Weighted Average	$ 7,360,670	0.88	%	21	6.68	%

(1) The Haircut represents the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount.

December 31, 2015	Repurchase Agreements	Weighted Average Contractual Rate		Weighted Average Maturity in days	Haircut for Repurchase Agreements (1)	
Agency Securities	$11,570,481	0.57	%	38	4.79	%
Total or Weighted Average	$11,570,481	0.57	%	38	4.79	%

(1) The Haircut represents the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount.

Our repurchase agreements require that we maintain adequate pledged collateral. A decline in the value of the MBS pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels. We manage this risk by maintaining an adequate balance of available cash and unpledged securities. An event of default or termination event under the standard MRA would give our counterparty the option to terminate all repurchase transactions existing with us and require any amount due to be payable immediately. In addition, certain of our MRAs contain a restriction that prohibits our leverage from exceeding twelve times our stockholders' equity as well as termination events in the case of significant reductions in equity capital. We also may receive cash or securities as collateral from our derivative counterparties which we may use as additional collateral for repurchase agreements. Certain interest rate swap contracts provide for cross collateralization and cross default with repurchase agreements and other contracts with the same counterparty.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Maturing or Repricing	September 30, 2016 Repurchase Agreements	Weighted Average Contractual Rate		December 31, 2015 Repurchase Agreements	Weighted Average Contractual Rate	
Within 30 days	$5,819,944	0.82	%	$8,089,403	0.55	%
31 days to 60 days	1,360,336	0.96	%	2,487,174	0.57	%
61 days to 90 days	180,390	1.87	%	343,904	0.71	%
Greater than 90 days	—	—	%	650,000	0.67	%
Total or Weighted Average	$7,360,670	0.88	%	$11,570,481	0.57	%

At September 30, 2016, 10 repurchase agreement counterparties individually accounted for between 5% and 10% of our aggregate borrowings. In total, these counterparties accounted for approximately 61.5% of our repurchase agreement borrowings outstanding at September 30, 2016. At December 31, 2015, we had 8 repurchase agreement counterparties that individually accounted for between 5% and 10% of our aggregate borrowings. In total, these counterparties accounted for 53.5% of our repurchase agreement borrowings at December 31, 2015. At September 30, 2016 and December 31, 2015, we did not have any repurchase counterparties that individually account for 5% or greater of our stockholders' equity.

Note 9 -Derivatives

We enter into derivative transactions to manage our interest rate risk exposure. These transactions include entering into interest rate swap contracts and interest rate swaptions as well as purchasing or selling Futures Contracts. These transactions are designed to lock in funding costs for repurchase agreements associated with our assets in such a way to help assure the realization of net interest margins. Such transactions are based on assumptions about prepayments which, if not realized, will cause transaction results to differ from expectations. Basis swap contracts allow us to exchange one floating interest rate basis for another, for example, 3 month LIBOR and Fed Funds Rates, thereby allowing us to diversify our floating rate basis exposures. We also utilize forward contracts for the purchase or sale of TBA Agency Securities.

We have agreements with our derivative counterparties that provide for the posting of collateral based on the fair values of our interest rate swap contracts, swaptions, basis swap contracts and TBA Agency Securities. Through this margin process, either we or our swap counterparty may be required to pledge cash or Agency Securities as collateral. Collateral requirements vary by counterparty and change over time based on the fair value, notional amount and remaining term of the contracts. Certain interest rate swap contracts provide for cross collateralization and cross default with repurchase agreements and other contracts with the same counterparty.

Interest rate swaptions generally provide us the option to enter into an interest rate swap agreement at a certain point of time in the future with a predetermined notional amount, stated term and stated rate of interest in the fixed leg and interest rate index on the floating leg.

Futures Contracts are traded on the CME which requires the use of daily mark-to-market collateral and the CME provides substantial credit support. The collateral requirements of the CME require us to pledge assets under a bi-lateral margin arrangement, including either cash or Agency Securities and these requirements may vary and change over time based on the market value, notional amount and remaining term of the Futures Contracts. In the event we would be unable to meet a margin call under a Futures Contract, the counterparty to such agreement may have the option to terminate or close-out all of the outstanding Futures Contracts with us. In addition, any close-out amount due to the counterparty upon termination of the counterparty's transactions would be immediately payable by us pursuant to the applicable agreement.

TBA Agency Securities are forward contracts for the purchase ("long position") or sale ("short position") of Agency Securities at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date. The specific Agency Securities delivered into the contract upon the settlement date, published each month by the Securities Industry and Financial Markets Association, are not known at the time of the transaction. We may enter into TBA Agency Securities as a means of hedging against short-term changes in interest rates. We may also enter into TBA Agency Securities as a means of acquiring or disposing of Agency Securities and we may from time to time utilize TBA dollar roll transactions to finance Agency Security purchases. We estimate the fair value of TBA Agency Securities based on similar methods used to value our Agency Securities.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

The following tables present information about our derivatives at September 30, 2016 and December 31, 2015.

September 30, 2016

Derivative Type	Remaining / Underlying Term	Weighted Average Remaining Swap / Option Term (Months)	Weighted Average Rate	Notional Amount	Asset Fair Value (1)	Liability Fair Value (1)
Interest rate swap contracts	0-12 Months	9	0.54 %	$150,000	$—	$(46)
Interest rate swap contracts	13-24 Months	16	0.73 %	100,000	—	(446)
Interest rate swap contracts	37-48 Months	38	1.48 %	2,410,000	—	(78,270)
Interest rate swap contracts	61-72 Months	64	2.04 %	275,000	—	(20,999)
Interest rate swap contracts	73-84 Months	77	2.10 %	1,425,000	—	(77,524)
Interest rate swap contracts	109-120 Months	113	2.24 %	550,000	—	(65,938)
TBA Agency Securities	—	—	—	2,650,000	10,194	—
Total or Weighted Average				$7,560,000	$10,194	$(243,223)

(1) See Note 5, "Fair Value of Financial Instruments" for additional discussion.

December 31, 2015

Derivative Type (4)	Remaining / Underlying Term	Weighted Average Remaining Swap / Option Term (Months)	Weighted Average Rate	Notional Amount (3)	Asset Fair Value (1)	Liability Fair Value (1)
Interest rate swap contracts	13-24 Months	19	0.63 %	$350,000	$ 265	$(87)
Interest rate swap contracts	25-36 Months	27	1.16 %	700,000	192	(1,633)
Interest rate swap contracts	37-48 Months	47	1.46 %	2,000,000	—	(18,120)
Interest rate swap contracts	49-60 Months	49	1.53 %	350,000	—	(3,085)
Interest rate swap contracts	73-84 Months	75	2.05 %	1,025,000	—	(26,047)
Interest rate swap contracts	85-96 Months	86	2.11 %	1,375,000	—	(23,543)
Interest rate swap contracts	109-120 Months	108	2.66 %	1,000,000	—	(92,927)
Interest rate swap contracts	121-132 Months	123	2.30 %	2,000,000	—	(67,858)
Basis swap contracts (2)	0-60 Months	22	0.22 %	2,000,000	542	(1)
Total or Weighted Average				$10,800,000	$ 999	$(233,301)

(1) See Note 5, "Fair Value of Financial Instruments" for additional discussion.
(2) Weighted average rate is the spread over the pay index.

(3) Notional amount includes $3,775,000 of forward starting interest rate swap contracts which become effective within 6 months.
(4) We did not have any TBA Agency Securities outstanding at December 31, 2015.

We have netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association. We are also required to post or hold cash collateral based upon the net underlying market value of our open positions with the counterparty.

The following tables present information about interest rate swap contracts and basis swap contracts and the potential effects of netting if we were to offset the assets and liabilities of these financial instruments on the accompanying condensed consolidated balance sheets. Currently, we present these financial instruments at their gross amounts and they are included in derivatives, at fair value on the accompanying condensed consolidated balance sheet at September 30, 2016.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

September 30, 2016		Gross Amounts Not Offset in the Condensed Consolidated Balance Sheet		
Assets	Gross and Net Amounts of Assets Presented in the Condensed Consolidated Balance Sheet	Financial Instruments	Cash Collateral	Net Amount
Interest rate swap contracts	$ —	$(243,223)	$276,927	$33,704
Agency Securities TBA	10,194	—	(3,627)	6,567
Totals	$ 10,194	$(243,223)	$273,300	$40,271

September 30, 2016		Gross Amounts Not Offset in the Condensed Consolidated Balance Sheet		
Liabilities	Gross and Net Amounts of Liabilities Presented in the Condensed Consolidated Balance Sheet	Financial Instruments	Cash Collateral	Net Amount
Interest rate swap contracts	$ (243,223)	$ 243,223	$ —	$ —
Totals	$ (243,223)	$ 243,223	$ —	$ —

The following tables present information about interest rate swap contracts and Futures Contracts and the potential effects of netting if we were to offset the assets and liabilities of these financial instruments on the accompanying condensed consolidated balance sheets. Currently, we present these financial instruments at their gross amounts and they are included in derivatives, at fair value on the accompanying condensed consolidated balance sheet at December 31, 2015.

December 31, 2015		Gross Amounts Not Offset in the Condensed Consolidated Balance Sheet		
Assets	Gross and Net Amounts	Financial Instruments	Cash Collateral	Net Amount

	of Assets Presented in the Condensed Consolidated Balance Sheet			
Interest rate swap contracts	$ 457	$(233,301)	$241,604	$ 8,760
Basis swap contracts	542	—	—	542
Totals	$ 999	$(233,301)	$241,604	$ 9,302

23

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

December 31, 2015		Gross Amounts Not Offset in the Condensed Consolidated Balance Sheet		
Liabilities	Gross and Net Amounts of Liabilities Presented in the Condensed Consolidated Balance Sheet	Financial Instruments	Cash Collateral	Net Amount
Interest rate swap contracts	$ (233,301)	$ 233,301	$ —	$ —
Totals	$ (233,301)	$ 233,301	$ —	$ —

The following table represents the location and information regarding our derivatives which are included in Other Income (Loss) in the accompanying condensed consolidated statements of operations for the quarters and nine months ended September 30, 2016 and September 30, 2015.

		Income (Loss) Recognized			
		For the Quarter Ended		For the Nine Months Ended	
Derivatives	Location on condensed consolidated statements of operations	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Interest rate swap contracts:					
Realized gain (loss)	Realized gain (loss) on derivatives	$(419)	$ —	$(326,411)	$ 28,346
Interest income	Realized gain (loss) on derivatives	6,836	2,837	18,741	10,262
Interest expense	Realized gain (loss) on derivatives	(22,670)	(24,864)	(70,826)	(101,825)
Changes in fair value	Unrealized gain (loss) on derivatives	45,154	(294,394)	(6,626)	(305,732)
		$28,901	$ (316,421)	$(385,122)	$ (368,949)
Futures Contracts:					
Realized loss	Realized gain (loss) on derivatives	—	—	—	(184)
Changes in fair value	Unrealized gain (loss) on derivatives	—	—	—	180
		$—	$ —	$—	$ (4)
Basis swap contracts:					
Realized gain	Realized gain (loss) on derivatives	—	—	1,468	—
Interest income	Realized gain (loss) on derivatives	—	—	2,617	—
Interest expense	Realized gain (loss) on derivatives	—	—	(3,116)	—
Changes in fair value	Unrealized gain (loss) on derivatives	—	241	(661)	(817)
		$—	$ 241	$308	$ (817)
TBA Agency Securities:					
Realized gain	Realized gain (loss) on derivatives	36,069	4,627	38,723	(5,879)
Changes in fair value	Unrealized gain (loss) on derivatives	(19,330)	28,079	10,194	18,464

	$16,739	$ 32,706	$48,917	$ 12,585
Totals	$45,640	$ (283,474)	$(335,897)	$ (357,185)

24

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Note 10 -Commitments and Contingencies

Management Agreements with ACM

ARMOUR and its subsidiaries, including JAVELIN are managed by ACM, pursuant to management agreements see also Note 15, "Related Party Transactions". The management agreements entitle ACM to receive management fees payable monthly in arrears. Currently, the monthly ARMOUR management fee is 1/12th of the sum of (a) 1.5% of gross equity raised up to $1.0 billion plus (b) 0.75% of gross equity raised in excess of $1.0 billion. The cost of repurchased stock and any dividend representing a return of capital for tax purposes will reduce the amount of gross equity raised used to calculate the monthly management fee. In connection with the acquisition of JAVELIN, we included in accounts payable and other accrued expenses in our condensed consolidated statements of operations a liability which was recognized as the fair value of JAVELIN's management agreement with ACM, see Note 16 -Acquisition of JAVELIN Mortgage Investment Corp. At September 30, 2016 and September 30, 2015, the effective ARMOUR management fee was 1.05%, and 1.04% based on gross equity raised of $2,469,368 and $2,620,950, respectively. The ACM monthly management fees are not calculated based on the performance of our assets. Accordingly, the payment of our monthly management fees may not decline in the event of a decline in our earnings and may cause us to incur losses. We are also responsible for any costs and expenses that ACM incurred solely on behalf of ARMOUR or JAVELIN other than the various overhead expenses specified in the terms of the management agreements. ACM is further entitled to receive termination fees from ARMOUR and JAVELIN under certain circumstances.

Indemnifications and Litigation

We enter into certain contracts that contain a variety of indemnifications, principally with ACM and underwriters, against third party claims for errors and omissions in connection with their services to us. We have not incurred any costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements, as well as the maximum amount attributable to past events, is not material. Accordingly, we have no liabilities recorded for these agreements at September 30, 2016 and December 31, 2015.

Nine putative class action lawsuits have been filed in connection with the tender offer (the "Tender Offer") and merger (the "Merger") for JAVELIN (see Note 16 -Acquisition of JAVELIN Mortgage Investment Corp. for more information about the Tender Offer and Merger). The Tender Offer and Merger are collectively defined herein as the "Transactions." All nine suits name ARMOUR, the previous members of JAVELIN's board of directors prior to the Merger (of which eight are current members of ARMOUR's board of directors) (the "Individual Defendants") and JMI Acquisition Corporation ("Acquisition") as defendants. Certain cases also name ACM and JAVELIN as additional defendants. The lawsuits were brought by purported holders of JAVELIN's common stock, both individually and on behalf of a putative class of JAVELIN's stockholders, alleging that the Individual Defendants breached their fiduciary duties owed to the plaintiffs and the putative class of JAVELIN stockholders, including claims that the Individual Defendants failed to properly value JAVELIN; failed to take steps to maximize the value of JAVELIN to its stockholders; ignored or failed to protect against conflicts of interest; failed to disclose material information about the Transactions; took steps to avoid competitive bidding and to give ARMOUR an unfair advantage by failing to adequately solicit other potential acquirors or alternative transactions; and erected unreasonable barriers to other third-party bidders. The suits also allege that ARMOUR, JAVELIN, ACM and Acquisition aided and abetted the alleged breaches of fiduciary duties by the Individual Defendants. The lawsuits seek equitable relief, including, among other relief, to enjoin consummation of the Transactions, or rescind or unwind the Transactions if already consummated, and award costs and disbursements, including reasonable attorneys' fees and expenses. On April 25, 2016, the court issued an order consolidating the eight Maryland cases into one action, captioned In re JAVELIN Mortgage Investment Corp. Shareholder Litigation (Case No. 24-C-16-001542), and designated counsel for one of the Maryland cases as interim lead co-counsel. On May 26, 2016, interim lead counsel filed the Consolidated Amended Class Action Complaint for Breach of Fiduciary Duty asserting consolidated claims of breach of fiduciary duty, aiding and abetting the breaches of fiduciary duty, and waste. On June 27, 2016, defendants filed a Motion to Dismiss the Consolidated Amended Class Action Complaint for failing to state a claim upon which relief can be granted. The Motion to Dismiss is fully briefed and ripe for ruling from the Court.

Each of ARMOUR, JAVELIN, ACM and the Individual Defendants intends to defend the claims made in these lawsuits vigorously; however, there can be no assurance that any of ARMOUR, JAVELIN, ACM or the Individual Defendants will prevail in its defense of any of these lawsuits to which it is a party. An unfavorable resolution of any such litigation surrounding the Transactions may result in monetary damages being awarded to the plaintiffs and the putative class of former stockholders of JAVELIN and the cost of defending the litigation, even if resolved favorably, could be substantial. Due to the preliminary nature all of these suits, ARMOUR is not able at this time to estimate their outcome.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Note 11 -Stock Based Compensation

We adopted the 2009 Stock Incentive Plan as amended (the “Plan”) to attract, retain and reward directors and other persons who provide services to us in the course of operations. The Plan authorizes the Board to grant awards including common stock, restricted shares of common stock (“RSUs”), stock options, performance shares, performance units, stock appreciation rights and other equity and cash-based awards (collectively, “Awards”), subject to terms as provided in the Plan.

On May 8, 2014, our stockholders approved an amendment to the Plan to increase the number of shares issuable thereunder from 2,000 to 15,000 shares and the Plan was amended accordingly. In connection with the Reverse Stock Split, the number of shares of common stock issuable under the Plan was properly adjusted to 1,875 shares to reflect the Reverse Stock Split.

Transactions related to awards for the nine months ended September 30, 2016 are summarized below:

	September 30, 2016	
	Number of Awards	Weighted Average Grant Date Fair Value per Award
Unvested RSU Awards Outstanding beginning of period	78	$ 48.85
Vested	(35)	$ 56.20
Unvested RSU Awards Outstanding end of period	43	$ 43.86

At September 30, 2016, there was approximately $980 of unvested stock based compensation related to the Awards (based on the September 30, 2016 stock price of $22.54 per share), that we expect to recognize as an expense over the remaining average service period of 0.4 years. We also pay our non-executive Board quarterly fees of $33, which is payable in cash, common stock, or a combination of common stock and cash at the option of the director.

Note 12 -Stockholders' Equity

Preferred Stock

At September 30, 2016 and December 31, 2015, we were authorized to issue up to 50,000 shares of preferred stock, par value $0.001 per share, with such designations, voting and other rights and preferences as may be determined from time to time by our Board of Directors (“Board”) or a committee thereof. We have designated 9,610 shares as 8.250% Series A Preferred Stock and 6,210 shares as 7.875% Series B Preferred Stock. At September 30, 2016, a total of 34,180 shares of our authorized preferred stock remain available for designation as future series.

Series A Cumulative Preferred Shares (“Series A Preferred Stock”)

At September 30, 2016 and December 31, 2015, we had 2,181 shares of Series A Preferred Stock issued and outstanding with a par value of $0.001 per share and a liquidation preference of $25.00 per share, or $54,514 in the aggregate. Shares designated as Series A Preferred Stock but unissued totaled 7,429 at September 30, 2016. At September 30, 2016 and December 31, 2015, there were no accrued or unpaid dividends on the Series A Preferred Stock. The Series A Preferred Stock is entitled to a dividend at a rate of 8.250% per year based on the $25.00 per share liquidation preference before the common stock is entitled to receive any dividends. The Series A Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends exclusively at our option commencing on June 7, 2017 (subject to our right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve our qualification as a REIT). The Series A Preferred Stock is senior to our common stock and therefore in the event of liquidation, dissolution or winding up, the Series A Preferred Stock will receive a liquidation preference of $25.00 per share plus accumulated and unpaid dividends before distributions are paid to holders of our common stock, with no right or claim to any of our remaining assets thereafter. The Series A Preferred Stock generally does not have voting rights, except if we fail to pay dividends on the Series A Preferred Stock for eighteen months, whether or not consecutive. Under such circumstances, the Series A Preferred Stock will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set aside for payment. The Series A Preferred Stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and will remain outstanding indefinitely unless repurchased or redeemed by us or converted into our common stock in connection with a change of control by the holders of Series A Preferred Stock.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Series B Cumulative Preferred Shares (“Series B Preferred Stock”)

At September 30, 2016 and December 31, 2015, we had 5,650 shares of Series B Preferred Stock issued and outstanding with a par value of $0.001 per share and a liquidation preference of $25.00 per share, or $141,250 in the aggregate. Shares designated as Series B Preferred Stock but unissued totaled 560 at September 30, 2016. At September 30, 2016 and December 31, 2015, there were no accrued or unpaid dividends on the Series B Preferred Stock. The Series B Preferred Stock is entitled to a dividend at a rate of 7.875% per year based on the $25.00 per share liquidation preference before the common stock is entitled to receive any dividends. The Series B Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends exclusively at our option commencing on February 12, 2018 (subject to our right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve our qualification as a REIT). The Series B Preferred Stock is senior to our common stock and rank on parity with the Series A Preferred Stock. In the event of liquidation, dissolution or winding up, the Series B Preferred Stock will receive a liquidation preference of $25.00 per share plus accumulated and unpaid dividends before distributions are paid to holders of our common stock, with no right or claim to any of our remaining assets thereafter. The Series B Preferred Stock generally does not have voting rights, except if we fail to pay dividends on the Series B Preferred Stock for eighteen months, whether or not consecutive. Under such circumstances, the Series B Preferred Stock will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set aside for payment. The Series B Preferred Stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and will remain outstanding indefinitely unless repurchased or redeemed by us or converted into our common stock in connection with a change of control by the holders of Series B Preferred Stock.

Common Stock

Common Stock

On June 18, 2015, we announced that our Board of Directors had approved a Reverse Stock Split. The Reverse Stock Split took effect at approximately 5:00 p.m. Eastern Time on July 31, 2015 (the “Effective Time”). At the Effective Time, every eight issued and outstanding shares of common stock was converted into one share of common stock, and as a result, the number of outstanding shares of common stock was reduced from approximately 350,000 to approximately 43,750. At the Effective Time, the number of authorized shares of common stock was also reduced, on a one-for-eight basis, from 1,000,000 to 125,000. The par value of each share of common stock remained unchanged. No fractional shares were issued in connection with the Reverse Stock Split.

At September 30, 2016 and December 31, 2015, we were authorized to issue up to 125,000 shares of common stock, par value $0.001 per share, with such designations, voting and other rights and preferences as may be determined from time to time by our Board. We had 36,713 shares of common stock issued and outstanding at September 30, 2016 and 36,682 shares of common stock issued and outstanding at December 31, 2015.

Common Stock Repurchased

On March 5, 2014, our Board increased the authorization under our common stock repurchase program (the “Repurchase Program”) to 50,000 shares of our common stock outstanding (on a pre-reverse stock split basis). On July 28, 2015, our Board of Directors increased the number of shares of common stock authorized for repurchase under our Repurchase Program to an aggregate of 9,000 shares on a post-reverse stock split basis, effective August 3, 2015.

Under the Repurchase Program, shares may be purchased in the open market, including block trades, through privately negotiated transactions, or pursuant to a trading plan separately adopted in the future. The timing, manner, price and amount of any repurchases will be at our discretion, subject to the requirements of the Securities Exchange Act of 1934, as amended, and related rules. We are not required to repurchase any shares under the Repurchase Program and it may be modified, suspended or terminated at any time for any reason. We do not intend to purchase shares from our Board or other affiliates. Under Maryland law, such repurchased shares are treated as authorized but unissued. At September 30, 2016, there were 1,874 authorized shares remaining under the Repurchase Program. During the nine months ended September 30, 2016, we did not repurchase any common shares under the Repurchase Program.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Dividends

The following tables present our common stock dividend transactions for the nine months ended September 30, 2016.

Record Date	Payment Date	Rate per common share	Aggregate amount paid to holders of record
January 15, 2016	January 27, 2016	$ 0.33	$ 12,131
February 15, 2016	February 26, 2016	$ 0.33	12,131
March 15, 2016	March 28, 2016	$ 0.33	12,131
April 15, 2016	April 27, 2016	$ 0.27	9,925
May 16, 2016	May 27, 2016	$ 0.22	8,087
June 15, 2016	June 29, 2016	$ 0.22	8,087
July 15, 2016	July 27, 2016	$ 0.22	8,087
August 15, 2016	August 29, 2016	$ 0.22	8,087
September 15, 2016	September 27, 2016	$ 0.22	8,087
Total dividends paid			$ 86,753

The following tables present our Series A Preferred Stock dividend transactions for the nine months ended September 30, 2016.

Record Date	Payment Date	Rate per Series A Preferred Share	Aggregate amount paid to holders of record
January 15, 2016	January 27, 2016	$ 0.17	$ 374.8
February 15, 2016	February 26, 2016	$ 0.17	374.8
March 15, 2016	March 28, 2016	$ 0.17	374.8
April 15, 2016	April 27, 2016	$ 0.17	374.8
May 15, 2016	May 27, 2016	$ 0.17	374.8
June 15, 2016	June 27, 2016	$ 0.17	374.8
July 15, 2016	July 27, 2016	$ 0.17	374.8
August 15, 2016	August 29, 2016	$ 0.17	374.8
September 15, 2016	September 27, 2016	$ 0.17	374.8
Total dividends paid			$ 3,373

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

The following tables present our Series B Preferred Stock dividend transactions for the nine months ended September 30, 2016.

Record Date	Payment Date	Rate per Series B Preferred Share	Aggregate amount paid to holders of record
January 15, 2016	January 27, 2016	$ 0.16	$ 927
February 15, 2016	February 26, 2016	$ 0.16	927
March 15, 2016	March 28, 2016	$ 0.16	927
April 15, 2016	April 27, 2016	$ 0.16	927
May 15, 2016	May 27, 2016	$ 0.16	927
June 15, 2016	June 27, 2016	$ 0.16	927
July 15, 2016	July 27, 2016	$ 0.16	927
August 15, 2016	August 29, 2016	$ 0.16	927
September 15, 2016	September 27, 2016	$ 0.16	927
Total dividends paid			$ 8,343

Note 13 -Net Income (Loss) per Common Share

The following table presents a reconciliation of net income (loss) and the shares used in calculating weighted average basic and diluted earnings per common share for the quarters and nine months ended September 30, 2016, and September 30, 2015.

	For the Quarter Ended		For the Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Net Income (Loss)	$118,688	$(221,553)	$(139,613)	$(149,003)
Less: Preferred dividends	(3,905)	(3,905)	(11,716)	(11,716)
Net income (loss) related to common stockholders	$114,783	$(225,458)	$(151,329)	$(160,719)
Weighted average common shares outstanding – basic	36,703	43,561	36,693	43,709
Add: Effect of dilutive non-vested awards, assumed vested	43	—	—	—
Weighted average common shares outstanding – diluted	36,746	43,561	36,693	43,709

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

Note 14 -Income Taxes

The following table reconciles our GAAP net income (loss) to estimated REIT taxable income for the quarters and nine months ended September 30, 2016 and September 30, 2015.

	For the Quarter Ended		For the Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
GAAP net income (loss)	$118,688	$(221,553)	$(139,613)	$(149,003)
Book to tax differences:				
Non-Agency Securities	(40,249)	—	(54,767)	—
Interest-Only Securities	438	—	1,681	—
Changes in interest rate contracts	(61,473)	261,447	283,314	265,438
Gains on Security Sales	(2,421)	(69)	(18,937)	(1,562)
Amortization of deferred hedging costs	(13,226)	(1,836)	(34,583)	(4,929)
Bargain purchase price on acquisition of JAVELIN	—	—	(6,484)	—
Other	2	3	14	11
Estimated REIT taxable income	$1,759	$37,992	$30,625	$109,955

Interest rate contracts are treated as hedging transactions for tax purposes. Unrealized gains and losses on open interest rate contracts are not included in the determination of taxable income. Realized gains and losses on interest rate contracts terminated before their maturity are deferred and amortized over the remainder of the original term of the contract.

Net capital losses realized in 2013, 2014 and 2015 totaling $(579,322), $(341,850) and $(5,175) will be available to offset future capital gains realized through 2018, 2019 and 2020, respectively.

The aggregate tax basis of our assets and liabilities was greater than our total Stockholders' Equity at September 30, 2016 by approximately $174,376, or approximately $4.75 per common share (based on the 36,713 common shares then outstanding).

We are required and intend to timely distribute substantially all of our REIT taxable income in order to maintain our REIT status under the Code. Total dividend payments to stockholders were $98,469 and $139,385 for the nine months ended September 30, 2016 and September 30, 2015, respectively. Our estimated REIT taxable income available to pay dividends was $30,625 and $109,955 for the nine months ended September 30, 2016 and September 30, 2015, respectively. Our taxable REIT income and dividend requirements to maintain our REIT status are determined on an annual basis. Dividends paid in excess of taxable REIT income for the year (including amounts carried forward from prior years) will generally not be taxable to common stockholders.

Our management is responsible for determining whether tax positions taken by us are more likely than not to be sustained on their merits. We have no material unrecognized tax benefits or material uncertain tax positions.

Note 15 -Related Party Transactions

ARMOUR and its subsidiaries, including JAVELIN are managed by ACM, pursuant to management agreements with ARMOUR and JAVELIN. All of our executive officers are also employees of ACM. ACM manages our day-to-day operations, subject to the direction and oversight of the Board. The ARMOUR management agreement runs through June 18, 2022 and is thereafter automatically renewed for successive five-year terms unless terminated under certain circumstances. The JAVELIN Management Agreement runs through October 5, 2017 and is thereafter automatically renewed for successive one-year terms unless terminated under certain circumstances. Either party must provide 180 days prior written notice of any such termination.

Under the terms of the management agreements, ACM is responsible for costs incident to the performance of its duties, such as compensation of its employees and various overhead expenses. ACM is responsible for the following primary roles:

- Advising us with respect to, arranging for and managing the acquisition, financing, management and disposition of, elements of our investment portfolio;

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

- Evaluating the duration risk and prepayment risk within the investment portfolio and arranging borrowing and hedging strategies;
- Coordinating capital raising activities;
- Advising us on the formulation and implementation of operating strategies and policies, arranging for the acquisition of assets, monitoring the performance of those assets and providing administrative and managerial services in connection with our day-to-day operations; and
- Providing executive and administrative personnel, office space and other appropriate services required in rendering management services to us.

In accordance with management agreements, we incurred $6,521 and $19,549 in management fees for the quarter and nine months ended September 30, 2016. For the quarter and nine months ended September 30, 2015, we incurred $6,851 and $20,595 in management fees. In accordance with the JAVELIN management agreement, we paid management fees of $565 and $1,092, for the quarter and nine months ended September 30, 2016, reducing the liability recorded upon acquisition.

We are required to take actions as may be reasonably required to permit and enable ACM to carry out its duties and obligations. We are also responsible for any costs and expenses that ACM incurred solely on our behalf other than the various overhead expenses specified in the terms of the management agreements. For the quarter and nine months ended September 30, 2016, we reimbursed ACM $362 and $1,245, respectively, for other expenses incurred on our behalf. For the quarter and nine months ended September 30, 2015, we reimbursed ACM $480 and $1,352, respectively, for other expenses incurred on our behalf. In consideration of our 2012 results, in 2013, we also elected to make a restricted stock award to our executive officers and other ACM employees through ACM. No new awards have been granted since 2013. The award vests through 2017 and resulted in our recognizing stock based compensation expense of $123 and $351 for the quarter and nine months ended September 30, 2016 and $140 and $477 for the quarter and nine months ended September 30, 2015.

Note 16 -Acquisition of JAVELIN Mortgage Investment Corp.

On March 1, 2016, we entered into an agreement to purchase all of the outstanding common stock of JAVELIN and commenced a Tender Offer for cash at a price of $7.18, without interest and less any applicable withholding taxes. On April 1, 2016, the Tender Offer expired as the minimum condition was successfully met as greater than 50% of the total outstanding shares of common shares were validly tendered and not withdrawn. On April 6, 2016, we completed our acquisition of all of the outstanding common stock of JAVELIN upon the merger of Acquisition with and into JAVELIN, for cash consideration of $85,200. Subsequently, JAVELIN became a wholly-owned subsidiary of ARMOUR and continues to be managed by ACM pursuant to the pre-existing management agreement between JAVELIN and ACM. The acquisition expanded and diversified our investment portfolio. JAVELIN's complementary assets provided us with investment opportunities in Non-Agency MBS.

We recognized JAVELIN’s assets and liabilities (including JAVELIN’s liability under JAVELIN’s management agreement with ACM) at their fair values on the date of the Merger. None of the bargain purchase price reflected in the table below was included in income for income tax purposes.

ARMOUR Residential REIT, Inc. and Subsidiaries
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands, except per share amounts)
(UNAUDITED)

The following table summarizes the consideration paid for JAVELIN and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date, as well as the fair value at the acquisition date (amounts in millions):

Consideration:	
Cash	$85.2
Fair value of consideration transferred	$85.2
Acquisition related costs (included in professional fees and other expenses)	$2.5
Recognized amounts of identifiable assets acquired and liabilities assumed:	
Cash	$12.0
Cash collateral	24.6
Agency Securities	440.7
Non-Agency Securities	223.2
Accrued interest receivable	1.4
Prepaid and other assets	5.4
Repurchase agreements	(589.6)
Derivatives	(17.5)
Accrued interest payable	(0.9)
Accounts payable and other accrued expenses	(7.6)
Total identifiable net assets	$91.7
Goodwill/(Bargain purchase price)	(6.5)
Total	$85.2

Included in accounts payable and other accrued expenses was a liability of $3,375 which was recognized as the fair value of JAVELIN’s management agreement with ACM as of April 6, 2016.

From the date of the acquisition, total interest income of $4,882 and $10,013 and net income of $6,931 and $10,150 are included in the condensed consolidated statements of operations from the operations of JAVELIN for the quarter and nine months ended September 30, 2016, respectively. Total identifiable net assets of $102,846 are included in the condensed consolidated balance sheet for the period ended September 30, 2016.

We recognized a gain of $6,484 which is included in Other Income (Loss) in our condensed consolidated statements of operations for the nine months ended September 30, 2016 as the amount of the identifiable net assets acquired above exceeded the value of the consideration transferred.

Note 17 -Interest Rate Risk

Our primary market risk is interest rate risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned and the interest expense incurred in connection with the liabilities, by affecting the spread between the interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of MBS and our ability to realize gains from the sale of these assets. A decline in the value of the MBS pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels.

Note 18 -Subsequent Events

Dividends

On October 27, 2016, a cash dividend of $0.17 per outstanding share of Series A Preferred Stock, or $375 in the aggregate, and $0.16 per outstanding share of Series B Preferred Stock, or $927 in the aggregate, was paid to holders of record on October 15, 2016. We have also declared cash dividends of $0.17 and $0.16 per outstanding share of Series A Preferred Stock and Series B Preferred Stock, respectively, payable November 28, 2016 to holders of record on November 15, 2016 and payable December 27, 2016 to holders of record on December 15, 2016.

On October 27, 2016, a cash dividend of $0.22 per outstanding common share, or $8,087 in the aggregate, was paid to holders of record on October 14, 2016. We have also declared cash dividends of $0.22 per outstanding common share payable November 15, 2016 to holders of record on November 29, 2016.

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

The following discussion of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and related notes included elsewhere in this report.

References to "we," "us," "our," "ARMOUR" or the "Company" are to ARMOUR Residential REIT, Inc. References to "ACM are to ARMOUR Capital Management LP, a Delaware limited partnership. Refer to the Glossary of Terms for definitions of capitalized terms and abbreviations used in this report. All per share amounts, common shares outstanding and stock-based compensation amounts for all periods presented reflect our Reverse Stock Split, which was effective July 31, 2015.

U.S. dollar amounts are presented in thousands, except per share amounts or as otherwise noted.

Overview

ARMOUR and its subsidiaries, including JAVELIN, are managed by ACM, an investment advisor registered with the SEC. See Note 10 and Note 15 to the condensed consolidated financial statements for further details. We are a Maryland corporation formed to invest in and manage a leveraged portfolio of MBS and mortgage loans. We invest in residential mortgage backed securities issued or guaranteed by a U.S. GSE, such as Fannie Mae or Freddie Mac, or a government agency such as Ginnie Mae (collectively, Agency Securities). Interest-Only Securities are the interest portion of Agency Securities, which is separated and sold individually from the principal portion of the same payment. Other securities backed by residential mortgages in which we invest, for which the payment of principal and interest is not guaranteed by a GSE or government agency (collectively, Non-Agency Securities and together with Agency Securities, MBS), may benefit from credit enhancement derived from structural elements such as subordination, over collateralization or insurance.

At September 30, 2016 and December 31, 2015, investments in Agency Securities accounted for 86.5% and 100% of our MBS portfolio, respectively. During the first quarter of 2016, we began to invest in Non-Agency Securities. At September 30, 2016, investments in Non-Agency Securities accounted for 12.3% of our MBS portfolio. During the second quarter of 2016, we began to invest in Interest-Only Securities. At September 30, 2016, investments in Interest-Only Securities accounted for 1.2% of our MBS portfolio. Our MBS portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our assets may be invested in Agency Securities backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by GSEs, U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a REIT. Our charter permits us to invest in Agency Securities, Non-Agency Securities and Interest-Only Securities.

We seek attractive long-term investment returns by investing our equity capital and borrowed funds in our targeted asset class of MBS. We earn returns on the spread between the yield on our assets and our costs, including the interest cost of the funds we borrow, after giving effect to our hedges. We identify and acquire MBS, finance our acquisitions with borrowings under a series of short-term repurchase agreements at the most competitive interest rates available to us and then cost-effectively hedge our interest rate and other risks based on our entire portfolio of assets, liabilities and derivatives and our management's view of the market. Successful implementation of this approach requires us to address interest rate risk, maintain adequate liquidity and effectively hedge interest rate risks. We execute our business plan in a manner consistent with our intention of qualifying as a REIT under the Code and avoiding regulation as an investment company under the 1940 Act.

We have elected to be taxed as a REIT under the Code. We will generally not be subject to federal income tax to the extent that we distribute our taxable income to our stockholders and as long as we satisfy the ongoing REIT requirements under the Code including meeting certain asset, income and stock ownership tests.

Acquisition of JAVELIN

On April 6, 2016, we completed the acquisition of JAVELIN for an aggregate of approximately $85,200 in cash. From the date of the acquisition, total interest income of $4,882 and $10,013 and net income of $6,931 and $10,150, were included in the condensed consolidated statements of operations from the operations of JAVELIN for the quarter and nine months ended September 30, 2016, respectively. Total identifiable net assets of $102,846 are included in the condensed consolidated balance sheet for the period ended September 30, 2016 as well as a non-taxable gain of $6,484 as a result of the acquisition for the nine months ended September 30, 2016. See Note 16 to the condensed consolidated financial statements for further details.

Factors that Affect our Results of Operations and Financial Condition

Our results of operations and financial condition are affected by various factors, many of which are beyond our control, including, among other things, our net interest income, the market value of our assets and the supply of and demand for such assets. We invest in financial assets and markets. Recent events, such as those discussed below, can affect our business in ways that are difficult to predict and may produce results outside of typical operating variances. Our net interest income varies primarily as a result of changes in interest rates, borrowing costs and prepayment speeds, the behavior of which involves various risks and uncertainties. We look to invest across the spectrum of mortgage investments, from Agency Securities, for which the principal and interest payments are guaranteed by a GSE, to Non-Agency Securities, non-prime mortgage loans and unrated equity tranches of CMBS. As such, we expect our investments to be subject to risks arising from delinquencies and foreclosures, thereby exposing our investment portfolio to potential losses. We are exposed to changing credit spreads, which could result in declines in the fair value of our investments. We believe ACM’s in-depth investment expertise across multiple sectors of the mortgage market, prudent asset selection and our hedging strategy enable us to minimize our credit losses, our market value losses and financing costs. Prepayment rates, as reflected by the rate of principal pay downs and interest rates vary according to the type of investment, conditions in financial markets, government actions, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment rates on our assets that are purchased at a premium increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. Because changes in interest rates may significantly affect our activities, our operating results depend, in large part, upon our ability to manage interest rate risks and prepayment risks effectively while maintaining our status as a REIT.

For any period during which changes in the interest rates earned on our assets do not coincide with interest rate changes on our borrowings, such assets will tend to reprice more slowly than the corresponding liabilities. Consequently, changes in interest rates, particularly short-term interest rates, may significantly influence our net interest income. With the maturities of our assets generally of a longer term than those of our liabilities, interest rate increases will tend to decrease our net interest income and the market value of our assets (and therefore our book value). Such rate increases could possibly result in operating losses or adversely affect our ability to make distributions to our stockholders.

Prepayments on MBS and the underlying mortgage loans may be influenced by changes in market interest rates and a variety of economic and geographic factors, policy decisions by regulators, as well as other factors beyond our control. To the extent we hold MBS acquired at a premium or discount to par, or face value, changes in prepayment rates may impact our anticipated yield. In periods of declining interest rates, prepayments on our MBS will likely increase. If we are unable to reinvest the proceeds of such prepayments at comparable yields, our net interest income may decline. The climate of government intervention in the mortgage markets significantly increases the risk associated with prepayments.

While we use strategies to economically hedge some of our interest rate risk, we do not hedge all of our exposure to changes in interest rates and prepayment rates, as there are practical limitations on our ability to insulate our MBS portfolio from all potential negative consequences associated with changes in short-term interest rates in a manner that will allow us to seek attractive net spreads on our MBS portfolio. Also, since we have not elected to use cash flow hedge accounting, earnings reported in accordance with GAAP will fluctuate even in situations where our derivatives are operating as intended. As a result of this mark-to-market accounting treatment, our results of operations are likely to fluctuate far more than if we were to designate our derivative activities as cash flow hedges. Comparisons with companies that use cash flow hedge accounting for all or part of their derivative activities may not be meaningful. For these and other reasons more fully described under the section captioned “Derivative Instruments” below, no assurance can be given that our derivatives will have the desired beneficial impact on our results of operations or financial condition.

In addition to the use of derivatives to hedge interest rate risk, a variety of other factors relating to our business may also impact our financial condition and operating performance; these factors include

- our degree of leverage;
- our access to funding and borrowing capacity;

- the REIT requirements under the Code; and
- the requirements to qualify for an exclusion under the 1940 Act and other regulatory and accounting policies related