CAPSTEAD MORTGAGE CORP
Form 10-Q
November 02, 2012
Table of Contents

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, 2012

OR

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

For the transition period from to

Commission File Number: 001-08896

CAPSTEAD MORTGAGE CORPORATION

(Exact name of Registrant as specified in its Charter)

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

(214) 874-2323

(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 ¨

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 ¨

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	¨
Non-accelerated filer	¨	Smaller reporting company	¨

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock ($0.01 par value)	98,956,174 as of November 2, 2012

Table of Contents

CAPSTEAD MORTGAGE CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2012

INDEX

	Page
PART I. FINANCIAL INFORMATION	
ITEM 1. Financial Statements (unaudited)	
Consolidated Balance Sheets September 30, 2012 and December 31, 2011	3
Consolidated Statements of Income Quarter and Nine Months Ended September 30, 2012 and 2011	4
Consolidated Statements of Comprehensive Income Quarter and Nine Months Ended September 30, 2012 and 2011	5
Consolidated Statements of Cash Flows Nine Months Ended September 30, 2012 and 2011	6
Notes to Consolidated Financial Statements	7
ITEM 2. Management s Discussion and Analysis of Financial Condition and Results of Operations	20
ITEM 3. Quantitative and Qualitative Disclosure of Market Risk	45
ITEM 4. Controls and Procedures	45
PART II. OTHER INFORMATION	
ITEM 6. Exhibits	45
SIGNATURES	47

Computation of Ratio of Income from Continuing Operations
Certification Pursuant to Section 302(a)
Certification Pursuant to Section 302(a)
Certification Pursuant to Section 906

Table of Contents

ITEM 1. FINANCIAL STATEMENTS

PART I. FINANCIAL INFORMATION

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	September 30, 2012 (unaudited)	*December 31, 2011*
Assets:		
Residential mortgage investments($13.93 and $11.93 billion pledged under repurchase arrangements at September 30, 2012 and December 31, 2011, respectively)	$ 14,313,208	$ 12,264,906
Cash collateral receivable from interest rate swap counterparties	57,737	48,505
Interest rate swap agreements at fair value	24	617
Cash and cash equivalents	500,741	426,717
Receivables and other assets	140,727	100,760
Investments in unconsolidated affiliates	3,117	3,117
	$ 15,015,554	$ 12,844,622
Liabilities:		
Repurchase arrangements and similar borrowings	$ 13,250,488	$ 11,352,444
Interest rate swap agreements at fair value	41,199	31,348
Unsecured borrowings	103,095	103,095
Common stock dividend payable	36,173	38,184
Accounts payable and accrued expenses	20,772	26,844
	13,451,727	11,551,915
Stockholders equity:		
Preferred stock $0.10 par value; 100,000 shares authorized:		
$1.60 Cumulative Preferred Stock, Series A, 186 shares issued and outstanding ($3,054 and $3,056 aggregate liquidation preference) at September 30, 2012 and December 31, 2011, respectively	2,604	2,605
$1.26 Cumulative Convertible Preferred Stock, Series B, 16,493 and 16,184 shares issued and outstanding ($187,692 and $184,175 aggregate liquidation preference) at September 30, 2012 and December 31, 2011, respectively	186,388	181,909
Common stock $0.01 par value; 250,000 shares authorized:		
98,956 and 88,287 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	990	883
Paid-in capital	1,400,514	1,257,653
Accumulated deficit	(354,883)	(354,883)
Accumulated other comprehensive income	328,214	204,540
	1,563,827	1,292,707
	$ 15,015,554	$ 12,844,622

See accompanying notes to consolidated financial statements.

-3-

Table of Contents

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	Quarter Ended September 30		*Nine Months Ended September 30*	
	2012	*2011*	*2012*	*2011*
Interest income:				
Residential mortgage investments	$ 63,463	$ 62,890	$ 194,983	$ 179,167
Other	154	59	480	230
	63,617	62,949	195,463	179,397
Interest expense:				
Repurchase arrangements and similar borrowings	(17,875)	(15,744)	(48,429)	(41,772)
Unsecured borrowings	(2,186)	(2,186)	(6,560)	(6,560)
Other				(5)
	(20,061)	(17,930)	(54,989)	(48,337)
	43,556	45,019	140,474	131,060
Other revenue (expense):				
Miscellaneous other revenue (expense)	9	(109)	(147)	(926)
Incentive compensation	(781)	(1,429)	(3,614)	(4,149)
Salaries and benefits	(1,696)	(1,631)	(5,205)	(5,004)
Other general and administrative expense	(1,115)	(911)	(3,160)	(2,939)
	(3,583)	(4,080)	(12,126)	(13,018)
Income before equity in earnings of unconsolidated affiliates	39,973	40,939	128,348	118,042
Equity in earnings of unconsolidated affiliates	64	64	194	194
Net income	$ 40,037	$ 41,003	$ 128,542	$ 118,236
Net income available to common stockholders:				
Net income	$ 40,037	$ 41,003	$ 128,542	$ 118,236
Less cash dividends paid on preferred shares	(5,270)	(5,105)	(15,751)	(15,223)
	$ 34,767	$ 35,898	$ 112,791	$ 103,013
Net income per common share:				
Basic	$ 0.35	$ 0.43	$ 1.20	$ 1.33
Diluted	0.35	0.43	1.20	1.32
Cash dividends declared per share:				
Common	$ 0.360	$ 0.440	$ 1.190	$ 1.330
Series A Preferred	0.400	0.400	1.200	1.200
Series B Preferred	0.315	0.315	0.945	0.945

See accompanying notes to consolidated financial statements.

Table of Contents

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, unaudited)

	Quarter Ended September 30		*Nine Months Ended September 30*	
	2012	*2011*	*2012*	*2011*
Net income	$ 40,037	$ 41,003	$ 128,542	$ 118,236
Other comprehensive income:				
Amounts related to available-for-sale securities:				
Change in net unrealized gains	66,910	26,118	134,583	56,565
Amounts related to cash flow hedges:				
Change in net unrealized losses	(8,454)	(33,129)	(25,539)	(50,690)
Reclassification adjustment for amounts included in net income	4,835	8,060	14,630	21,639
	63,291	1,049	123,674	27,514
Comprehensive income	$ 103,328	$ 42,052	$ 252,216	$ 145,750

See accompanying notes to consolidated financial statements.

Table of Contents

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Nine Months Ended September 30 2012	Nine Months Ended September 30 2011
Operating activities:		
Net income	$ 128,542	$ 118,236
Noncash items:		
Amortization of investment premiums	67,346	48,023
Depreciation and other amortization	142	159
Equity-based compensation costs	1,661	1,352
Change in measureable hedge ineffectiveness related to interest rate swap agreements	(464)	575
Impairment charge related to real estate held for sale		470
Gain on sales of real estate held for sale	(273)	(50)
Net change in receivables, other assets, accounts payable and accrued expenses	(3,350)	(753)
Net cash provided by operating activities	193,604	168,012
Investing activities:		
Purchases of residential mortgage investments	(3,936,151)	(5,263,254)
Purchased interest receivable related to purchases of residential mortgage investments	(6,390)	(10,999)
Proceeds from sales of real estate held for sale	2,010	1,029
Principal collections on residential mortgage investments	1,918,542	1,517,116
Net cash used in investing activities	(2,021,989)	(3,756,108)
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	100,706,383	66,614,532
Principal payments on repurchase arrangements and similar borrowings	(98,808,335)	(63,319,411)
Increase in cash collateral receivable from interest rate swap counterparties	(9,232)	(21,839)
Decrease in cash collateral payable to interest rate swap counterparties		(9,024)
Capital stock transactions	145,930	197,653
Dividends paid	(132,337)	(112,238)
Net cash provided by financing activities	1,902,409	3,349,673
Net change in cash and cash equivalents	74,024	(238,423)
Cash and cash equivalents at beginning of period	426,717	359,590
Cash and cash equivalents at end of period	$ 500,741	$ 121,167

See accompanying notes to consolidated financial statements.

Table of Contents

CAPSTEAD MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2012

(unaudited)

NOTE 1 BUSINESS

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a REIT) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as Capstead or the Company. Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (ARM) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac (together, the GSEs), or by an agency of the federal government, Ginnie Mae. Agency-guaranteed residential mortgage pass-through securities (Agency Securities) are considered to have limited, if any, credit risk.

NOTE 2 BASIS OF PRESENTATION

Interim Financial Reporting and Reclassifications

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter and nine months ended September 30, 2012 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2012. For further information refer to the audited consolidated financial statements and footnotes thereto included in the Company s annual report on Form 10-K for the year ended December 31, 2011. Certain prior year amounts have been reclassified to conform to the current year presentation.

NOTE 3 NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income, after deducting preferred share dividends and adjusting for the impact of unvested stock awards deemed to be participating securities, by the weighted average number of common shares outstanding, calculated excluding unvested stock awards. Diluted net income per common share is computed by dividing net income, after deducting dividends on convertible preferred shares when such shares are antidilutive and similar adjustments for participating securities, by the weighted average number of common shares and common share equivalents outstanding calculated excluding unvested stock awards, giving effect to equity awards and convertible preferred shares when such awards and shares are dilutive. For calculation purposes the Series A and B preferred shares are considered dilutive whenever basic net income per common share exceeds each Series dividend divided by the conversion rate applicable for that period. Unvested stock awards that are deemed participating securities are included in the calculation of diluted net income per common share, if dilutive, under either the two class method or the treasury stock method, depending upon which method produces the more dilutive result.

Table of Contents

Components of the computation of basic and diluted net income per common share were as follows (dollars in thousands, except per share amounts):

	Quarter Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Basic net income per common share				
Numerator for basic net income per common share:				
Net income	$ 40,037	$ 41,003	$ 128,542	$ 118,236
Series A and B preferred share dividends	(5,270)	(5,105)	(15,751)	(15,223)
Unvested stock award participation in earnings	(91)	(148)	(296)	(434)
	$ 34,676	$ 35,750	$ 112,495	$ 102,579
Denominator for basic net income per common share:				
Weighted average common shares outstanding	98,581	84,147	94,324	77,852
Average unvested stock awards outstanding	(510)	(465)	(516)	(461)
	98,071	83,682	93,808	77,391
	$ 0.35	$ 0.43	$ 1.20	$ 1.33
Diluted net income per common share				
Numerator for diluted net income per common share:				
Net income	$ 40,037	$ 41,003	$ 128,542	$ 118,236
Dividends on antidilutive convertible preferred shares	(5,195)	(5,031)	(15,528)	(14,999)
Unvested stock award participation in earnings	(91)	(148)	(296)	(434)
	$ 34,751	$ 35,824	$ 112,718	$ 102,803
Denominator for diluted net income per common share:				
Weighted average common shares outstanding	98,581	84,147	94,324	77,852
Average unvested stock awards outstanding	(510)	(465)	(516)	(461)
Net effect of dilutive stock and option awards	132	77	119	74
Net effect of dilutive convertible preferred shares	309	309	309	309
	98,512	84,068	94,236	77,774
	$ 0.35	$ 0.43	$ 1.20	$ 1.32

Potentially dilutive securities excluded from the computation of net income per common share because the effect of inclusion was antidilutive during the indicated periods were as follows (in thousands):

	Quarter Ended September 30		Nine Months Ended September 30	
	2012	2011	2012	2011
Antidilutive convertible preferred shares	16,493	16,024	16,493	16,024
Antidilutive equity awards excludable under the treasury stock method:				
Shares issuable under option awards	10	10	10	10
Unvested stock awards	2		2	

Table of Contents

NOTE 4 RESIDENTIAL MORTGAGE INVESTMENTS

Residential mortgage investments classified by collateral type and interest rate characteristics were as follows (dollars in thousands):

	Unpaid Principal Balance	*Investment Premiums*	*Amortized Cost Basis*	*Carrying Amount (a)*	*Net WAC (b)*	*Average Yield (b)*
September 30, 2012						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$ 3,417	$ 10	$ 3,427	$ 3,433	6.70%	6.48%
ARMs	11,887,228	363,586	12,250,814	12,586,241	2.74	1.82
Ginnie Mae ARMs	1,628,246	50,332	1,678,578	1,712,427	2.78	2.10
	13,518,891	413,928	13,932,819	14,302,101	2.74	1.86
Residential mortgage loans:						
Fixed-rate	3,066	5	3,071	3,071	6.96	6.15
ARMs	5,139	20	5,159	5,159	3.51	3.83
	8,205	25	8,230	8,230	4.80	4.69
Collateral for structured financings	2,829	48	2,877	2,877	8.12	7.39
	$ 13,529,925	$ 414,001	$ 13,943,926	$ 14,313,208	2.75	1.86
December 31, 2011						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$ 4,015	$ 12	$ 4,027	$ 4,035	6.73%	6.55%
ARMs	10,378,503	285,963	10,664,466	10,880,200	2.85	2.08
Ginnie Mae ARMs	1,312,049	37,191	1,349,240	1,368,197	3.02	2.31
	11,694,567	323,166	12,017,733	12,252,432	2.87	2.11
Residential mortgage loans:						
Fixed-rate	3,234	5	3,239	3,239	6.96	6.58
ARMs	5,887	22	5,909	5,909	3.48	3.66
	9,121	27	9,148	9,148	4.71	4.69
Collateral for structured financings	3,272	54	3,326	3,326	8.04	7.60
	$ 11,706,960	$ 323,247	$ 12,030,207	$ 12,264,906	2.87	2.11

(a) *Includes unrealized gains and losses for residential mortgage investments classified as available-for-sale (see NOTE 8).*

(b) *Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments net of servicing and other fees as of the indicated balance sheet date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments. Average yield is presented for the quarter then ended, and is based on the cash component of interest income expressed as a percentage calculated on an annualized basis on average amortized cost basis (the cash yield) less the effects of amortizing investment premiums. Investment premium amortization is determined using the interest method and incorporates actual and anticipated future mortgage prepayments.*

Agency Securities are considered to have limited, if any, credit risk, particularly in light of the conservatorship of the GSEs by the federal government in 2008. Residential mortgage loans held by the Company were originated prior to 1995 when Capstead operated a mortgage conduit and the related credit risk is borne by the Company. Collateral for structured financings consists of private residential mortgage securities obtained through the above-mentioned mortgage conduit that are pledged to secure repayment of related structured financings. The credit risk for these securities is borne by the related bondholders. The maturity of *Residential mortgage investments* that are mortgage securities is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, actual maturities will be significantly shorter than the portfolio s weighted average contractual maturity of 295 months.

Table of Contents

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

Capstead classifies its ARM securities based on each security s average number of months until coupon reset (months to roll). Months to roll is an indicator of asset duration which is a measure of market price sensitivity to interest rate movements. Current-reset ARM securities have months to roll of less than 18 months while longer-to-reset ARM securities have months to roll of 18 months or greater. As of September 30, 2012, the average months to roll for the Company s $8.07 billion (basis) in current-reset ARM securities was 5.4 months while the average months-to-roll for the Company s $5.87 billion (basis) in longer-to-reset ARM securities was 44.1 months.

Under variable interest entity accounting rules, the Company began consolidating two townhome developments in the Dallas, Texas area that were collateral for subordinated loans made by the Company during 2009. The Company completed foreclosure proceedings in 2011, assuming ownership of the underlying collateral. By September 30, 2012 all of the remaining townhome units, which had a basis of $1.8 million at December 31, 2011, were sold. Included in *Miscellaneous other revenue (expense)* is $41,000 and $48,000 of gains on unit sales, net of operating costs, recorded during the quarter and nine months ended September 30, 2012, respectively. During the quarter and nine months ended September 30, 2011, net operating costs totaled $74,000 and $747,000, respectively, including a $470,000 impairment charge. In addition, the Company is a subordinated participant in the lending group to the Four Seasons resort in Nevis, West Indies which was foreclosed on in May 2010. The Company wrote off its related $39.2 million investment in December 2009. A recovery on this investment, if any, would come from the eventual disposition of the resort by the lending group.

NOTE 5 INVESTMENTS IN UNCONSOLIDATED AFFILIATES

To facilitate the issuance of *Unsecured borrowings*, Capstead formed and capitalized three Delaware statutory trusts through the issuance to the Company of the trusts common securities totaling $3.1 million (see NOTE 7). The Company s equity in the earnings of the trusts consists solely of the common trust securities pro rata share in interest accruing on *Unsecured borrowings* issued to the trusts. Under variable interest accounting rules, the trusts are not considered variable interests at risk and as such are not consolidated.

NOTE 6 REPURCHASE ARRANGEMENTS AND SIMILAR

BORROWINGS, INCLUDING RELATED HEDGING ACTIVITY

Capstead generally pledges its *Residential mortgage investments* as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties, when each borrowing is initiated or renewed. Repurchase arrangements entered into by the Company

Table of Contents

involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date, typically with terms of 30 to 90 days, and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of the repurchase arrangement and receives the related principal and interest payments. The amount borrowed is generally equal to the fair value of the assets pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a haircut. Interest rates on these borrowings are fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase arrangement at which time the Company may enter into a new repurchase arrangement at prevailing market rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. None of the Company s counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. In response to declines in fair value of pledged securities due to changes in market conditions or the publishing of monthly security pay down factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. The maturity of structured financings is directly affected by prepayments on the related mortgage pass-through securities pledged as collateral and these financings are subject to redemption by the residual bondholders.

Repurchase arrangements and similar borrowings (and related pledged collateral, including accrued interest receivable), classified by collateral type and remaining maturities, and related weighted average borrowing rates as of the indicated quarter-end were as follows (dollars in thousands):

Collateral Type	*Collateral Carrying Amount*	*Accrued Interest Receivable*	*Borrowings Outstanding*	*Average Borrowing Rates*
As of September 30, 2012:				
Borrowings with maturities of 30 days or less:				
Agency Securities	$ 12,903,773	$ 28,526	$ 12,279,241	0.40%
Borrowings with maturities greater than 30 days:				
Agency Securities (31 to 90 days)	1,021,416	2,117	968,370	0.41
Similar borrowings:				
Collateral for structured financings	2,877		2,877	8.12
	$ 13,928,066	$ 30,643	$ 13,250,488	0.41
Quarter-end borrowing rates adjusted for effects of related derivatives held as cash flow hedges				0.56
As of December 31, 2011:				
Borrowings with maturities of 30 days or less:				
Agency Securities	$ 11,306,478	$ 25,630	$ 10,754,835	0.37%
Borrowings with maturities greater than 30 days:				
Agency Securities (31 to 90 days)	619,710	1,551	594,283	0.32
Similar borrowings:				
Collateral for structured financings	3,326		3,326	8.04
	$ 11,929,514	$ 27,181	$ 11,352,444	0.37
Quarter-end borrowing rates adjusted for effects of related derivatives held as cash flow hedges				0.58

Table of Contents

Average borrowings outstanding during the indicated quarters were lower than borrowings outstanding at indicated balance sheet dates primarily due to portfolio growth and differences in the timing of portfolio acquisitions relative to portfolio runoff as illustrated below (dollars in thousands):

	Quarter Ended			
	September 30, 2012		*December 31, 2011*	
	Average Borrowings	*Average Rate*	*Average Borrowings*	*Average Rate*
Average borrowings and rates for the indicated quarters, adjusted for the effects of related derivatives held as cash flow hedges	$ 12,833,675	0.56%	$ 11,278,675	0.54%

To help mitigate exposure to higher short-term interest rates, Capstead uses currently-paying and forward-starting, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that typically require interest payments for two-year terms. These derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate of current and forecasted 30- to 90-day repurchase arrangements. This hedge relationship establishes a relatively stable fixed rate on related borrowings because the variable-rate payments received on the swap agreements largely offset interest accruing on the related borrowings, leaving the fixed-rate payments to be paid on the swap agreements as the Company s effective borrowing rate, subject to certain adjustments including the effects of measured hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and actual borrowing rates. Capstead entered into new forward-starting swap agreements hedging short-term interest rates totaling $1.10 billion during the third quarter of 2012 with average fixed rate payment requirements of 0.45%. At September 30, 2012, the Company was a party to swap agreements hedging short-term interest rates with an average expiration of 18 months and the following characteristics (dollars in thousands):

Period of Contract Expiration	*Notional Amount*	*Average Fixed Rate Payment Requirement*
Currently-paying two-year contracts:		
First quarter 2013	$ 1,100,000	0.81%
Second quarter 2013	700,000	0.96
Third quarter 2013	300,000	0.87
Fourth quarter 2013	800,000	0.78
First quarter 2014	200,000	0.60
Second quarter 2014	400,000	0.51
Third quarter 2014	200,000	0.51
	3,700,000	0.78
Forward-starting two-year contracts:		
Fourth quarter 2014	500,000	0.58
First quarter 2015	1,100,000	0.50
Second quarter 2015	200,000	0.43
Third quarter 2015	400,000	0.47
Fourth quarter 2015	100,000	0.41
	$ 6,000,000	

In addition to swap agreements hedging short-term interest rates, in 2010 the Company entered into three forward-starting three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements with notional amounts totaling $100 million, average fixed rates of 4.09% that begin in 2015 and 2016 and 20-year terms coinciding with the floating-rate terms of the Company s *Unsecured borrowings*. These derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate associated with the floating-rate terms of these long-term borrowings (see NOTE 7).

Table of Contents

Interest rate swap agreements are measured at fair value on a recurring basis primarily using Level Two Inputs in accordance with Fair Value Measurements and Disclosures (ASC 820). In determining fair value estimates for these derivatives, the Company utilizes the standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts based on expected future interest rates derived from observable market interest rate curves. The Company also incorporates both its own nonperformance risk and its counterparties nonperformance risk in determining the fair value of its interest rate swap derivatives. In considering the effect of nonperformance risk, the Company considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and has concluded that counterparty risk is not significant to the overall valuation of these agreements. Included in the *Accumulated other comprehensive income* component of *Stockholders equity* are unrealized losses on derivatives held as cash flow hedges of $41.1 million and $30.2 million as of September 30, 2012 and December 31, 2011, respectively. The following tables include fair value and other related disclosures regarding all derivatives held as of and for the indicated periods (in thousands):

	Location in Balance Sheet	*September 30, 2012*	*December 31, 2011*
Balance sheet-related			
Interest rate swap agreements in a gain position (an asset) related to:			
Repurchase arrangements and similar borrowings	*(a)*	$ 24	$ 617
Interest rate swap agreements in a loss position (a liability) related to:			
Repurchase arrangements and similar borrowings	*(a)*	(23,937)	(15,691)
Unsecured borrowings	*(a)*	(17,262)	(15,657)
Related net interest payable	*(b)*	(7,497)	(10,023)
		$ (48,672)	$ (40,754)

(a) The fair value of derivatives with realized and unrealized gains are aggregated and recorded as an asset on the face of the balance sheet separately from the fair value of derivatives with realized and unrealized losses that are recorded as a liability. The amount of unrealized losses that will be recognized in the statement of income over the next twelve months in the form of fixed- and variable-rate swap payments in excess of current market rates totaled $18.4 million at September 30, 2012.

(b) Included in Accounts payable and accrued expenses on the face of the balance sheet.

	Location of Gain or (Loss) Recognized in Net Income	*Quarter Ended September 30 2012*	*Quarter Ended September 30 2011*	*Nine Months Ended September 30 2012*	*Nine Months Ended September 30 2011*
Income statement-related					
Components of effect on interest expense:					
Amount of loss reclassified from AOCI related to the effective portion of active positions		$ (4,835)	$ (8,060)	$ (14,630)	$ (21,639)
Amount of gain (loss) recognized (ineffective portion)		211	(830)	(96)	(879)
Increase in interest expense and decrease in *Net income* as a result of the use of derivatives	*(a)*	$ (4,624)	$ (8,890)	$ (14,726)	$ (22,518)
Other comprehensive income-related					
Amount of loss recognized in other comprehensive income (loss) (effective portion)		$ (8,454)	$ (33,129)	$ (25,539)	$ (50,690)

(a) Included in Interest expense: Repurchase arrangements and similar borrowings on the face of the statement of income.

NOTE 7 UNSECURED BORROWINGS

Unsecured borrowings consist of 30-year junior subordinated notes issued in 2006 and 2005 to three special-purpose statutory trusts. These unconsolidated affiliates were formed to issue $3.1 million of the trusts common securities to Capstead and to privately place $100 million of preferred securities with unrelated third party investors. Included in *Receivables and other assets* are $2.3 million in remaining issue costs associated with these transactions at September 30, 2012 and December 31, 2011. Note balances and related weighted average interest rates as of September 30, 2012 and December 31, 2011 (calculated including issue cost amortization) were as follows (dollars in thousands):

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

* *After considering cash flow hedges that coincide with the floating rate terms of these borrowings that begin in 2015 and 2016, the effective borrowing rate during the final 20 years of these borrowings will average 7.56%, subject to certain adjustments for the effects of measured hedge ineffectiveness, if any.*

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

NOTE 8 DISCLOSURES REGARDING FAIR VALUES OF FINANCIAL INSTRUMENTS

The following tables and related discussion provide fair value disclosures as of the indicated balance sheet dates, all of which are determined using Level 2 Inputs in accordance with ASC 820, for Capstead s financial assets and liabilities, most of which are influenced by changes in, and market expectations for changes in, interest rates and market liquidity conditions, as well as other factors beyond the control of management.

Residential mortgage investments, nearly all of which are mortgage securities classified as available-for-sale, are measured at fair value on a recurring basis. In determining fair value estimates for mortgage securities the Company considers recent trading activity for similar investments and pricing levels indicated by lenders in connection with designating collateral for repurchase arrangements, provided such pricing levels are considered indicative of actual market clearing transactions. Included in the *Accumulated other comprehensive income* component of *Stockholders equity* are unrealized gains on available-for-sale mortgage securities totaling $369.3 million and $234.7 million as of September 30, 2012 and December 31, 2011, respectively. In determining fair value estimates for longer-term borrowings under repurchase arrangements, the Company considers pricing levels indicated by lenders

Table of Contents

for entering into new transactions using similar pledged collateral with terms equal to the remaining terms of the longer-term borrowings. In determining fair value estimates for unsecured borrowings, the Company considers current pricing for financial instruments with similar characteristics. Excluded from these disclosures are financial instruments for which the Company s cost basis is deemed to approximate fair value due primarily to the short duration of these instruments, which are valued using primarily Level 1 measurements, including *Cash and cash equivalents*, *Cash collateral receivable from interest rate swap counterparties*, receivables, payables and borrowings under repurchase arrangements with initial terms of 120 days or less. See NOTE 6 for information relative to the valuation of interest rate swap agreements.

Fair value disclosures for financial instruments other than debt securities were as follows (in thousands):

	September 30, 2012		*December 31, 2011*	
	Carrying Amount	*Fair Value*	*Carrying Amount*	*Fair Value*
Financial assets:				
Residential mortgage loans	$ 8,230	$ 8,400	$ 9,148	$ 9,300
Interest rate swap agreements	24	24	617	617
Financial liabilities:				
Repurchase arrangements with initial terms of greater than 120 days			47,419	47,400
Unsecured borrowings	103,095	104,900	103,095	104,200
Interest rate swap agreements	41,199	41,199	31,348	31,348

Fair value and related disclosures for debt securities were as follows (in thousands):

	Amortized Cost Basis	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Fair Value*
As of September 30, 2012				
Agency Securities classified as available-for-sale	$ 13,929,478	$ 369,449	$ 167	$ 14,298,760
Residential mortgage securities classified as held-to-maturity	6,218	325		6,543
As of December 31, 2011				
Agency Securities classified as available-for-sale	12,013,804	236,000	1,301	12,248,503
Residential mortgage securities classified as held-to-maturity	7,255	349		7,604

	September 30, 2012		*December 31, 2011*	
	Fair Value	*Unrealized Loss*	*Fair Value*	*Unrealized Loss*
Securities in an unrealized loss position:				
One year or greater	$ 30,966	$ 74	$ 4,933	$ 26
Less than one year	199,206	93	369,226	1,275
	$ 230,172	$ 167	$ 374,159	$ 1,301

Managing a leveraged portfolio of primarily ARM Agency Securities is the core focus of Capstead s investment strategy and management expects these securities will be held until payoff absent a major shift in the Company s investment focus. Declines in fair value caused by increases in interest rates are typically modest for investments in relatively short-duration ARM Agency Securities compared to investments in longer-duration, fixed-rate assets. These declines are generally recoverable in a relatively short period of time as the coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment allowing for the potential recovery of financing spreads diminished during periods of rising interest rates.

Table of Contents

From a credit risk perspective, the real or implied federal government guarantee associated with Agency Securities, particularly in light of the conservatorship of the GSEs by the federal government, helps ensure that fluctuations in value due to credit risk associated with these securities will be limited. Given that (a) any existing unrealized losses on mortgage securities held by the Company are not attributable to credit risk, (b) the Company typically holds its investments to maturity, and (c) it is more likely than not that the Company will not be required to sell any of its investments, none of these investments are considered other-than-temporarily impaired at September 30, 2012.

NOTE 9 COMPENSATION PROGRAMS

The compensation committee of Capstead s board of directors (the Committee) administers all compensation programs for employees including salaries and related programs, annual incentive compensation and long-term equity-based awards, as well as other benefit programs.

Performance-based Cash Compensation Program to Augment Base Salaries

In 2008 the Committee began implementing a performance-based cash compensation program designed to introduce a variable component to the base compensation for executive officers. This program provides for payments equal to the per share dividend declared on the Company s common stock multiplied by a notional amount of non-vesting or phantom common shares (Dividend Equivalent Rights). Dividend Equivalent Rights are not attached to any stock or option awards and only have the right to receive the same cash distributions that the Company s common stockholders are entitled to receive during the term of the grants, subject to certain conditions, including continuous service. In July 2012, the Committee granted an additional 72,000 Dividend Equivalent Rights that expire on July 1, 2015. In addition, the Committee extended the expiration of previous grants by one year such that all grants expire on July 1, 2015. Dividend Equivalent Rights issued and outstanding and the related compensation costs for the quarter and nine months ended September 30, 2012 were as follows:

Month of Grant	*Total Grant*	*Quarter Ended September 30, 2012*	*Nine Months Ended September 30, 2012*
July 2008	225,000	$ 81,000	$ 268,000
July 2009	225,000	81,000	268,000
July 2010	60,000	21,000	71,000
August 2011	72,000	26,000	85,000
July 2012	72,000	26,000	26,000
		$ 235,000	$ 718,000

Annual Incentive Compensation

To provide employees with an appropriate performance-based annual incentive compensation opportunity, each year the Committee approves an incentive formula designed to create an incentive pool to serve as a guideline for the award of annual incentive compensation that is directly linked with the performance of the Company. The formula adopted accomplishes this by establishing an incentive pool equal to a percentage participation in the Company s earnings in excess of a pre-established performance threshold subject to a maximum amount, or cap, available to be paid in any one year. Notwithstanding the calculated amount of the incentive pool, the Committee retains complete discretion to determine (i) the amount actually awarded, (ii) its allocation between executive officers and other employees, and (iii) the form of payment (e.g., cash or equity awards).

The current formula for the incentive pool is based on a 10.0% participation in annual earnings, in excess of a benchmark amount established by multiplying average long-term investment capital by the greater of 10.0%, or the average 10-year U.S. Treasury rate plus 200 basis points, subject to a cap of 50 basis points multiplied by average long-term investment capital. Annual earnings for formula purposes is defined as

Table of Contents

Net income excluding (i) *Incentive compensation*, (ii) any gains or losses from asset sales or writedowns, including impairment charges, and (iii) interest on *Unsecured borrowings*, net of equity in the earnings of related statutory trusts reflected in the balance sheet as *Investments in unconsolidated affiliates*. Average long-term investment capital for formula purposes is defined as average *Unsecured borrowings*, net of related investments in statutory trusts, and average *Stockholders equity*, excluding (i) *Accumulated other comprehensive income*, (ii) incentive compensation accruals, (iii) certain gains or losses from asset sales or writedowns, and (iv) interest accruals on *Unsecured borrowings*. Included in *Accounts payable and accrued expenses* are annual incentive compensation accruals totaling $3.6 million and $5.7 million at September 30, 2012 and December 31, 2011, respectively.

Long-term Equity-based Awards

The Company sponsors equity-based award plans to provide for the issuance of stock awards, option awards and other long-term equity-based awards to directors and employees (collectively, the Plans). At September 30, 2012, the Plans had 829,668 common shares remaining available for future issuance.

In 2008 the Company implemented a performance-based stock award program in lieu of its previous practice of issuing service-based awards to employees. As this program is currently configured, the first 50% of awards granted each year vest provided certain performance criteria pertaining to a three-year measurement period that starts at the beginning of the following calendar year are met. The remaining 50% vests provided performance criteria pertaining to a three-year measurement period beginning one year later are met. If the performance criteria are not met at the end of a three-year measurement period, vesting will be deferred and a new three-year measurement period will be established to include the subsequent year, up to and including the seventh calendar year after the year of grant. Any remaining unvested awards will expire if the performance criteria for the final three-year measurement period are not met. The performance criteria establishes an annualized threshold return on the Company s long-term investment capital, subject to certain adjustments, that must be exceeded for the awards to vest equal to the greater of 8.0% or the average 10-year U.S. Treasury rate plus 200 basis points. The following table includes performance-based stock awards issued to employees with related measurement period information at September 30, 2012:

Year of Grant	*Grant Date Fair Value Per Share*	*Total Original Grants*	*Final Measurement Period Ends December 31*	*Remaining Shares with Initial Measurement Periods Ending December 31* 2012	*2013*	*2014*	*2015*
2008	$ 10.18	140,658*	2015	67,595			
2009	14.33	110,917	2016	55,043	55,035		
2010	12.44	128,766	2017		64,087	64,077	
2011	12.72	132,490	2018			66,247	66,243

* *The performance criteria for the first three-year measurement period ending December 31, 2011 was met resulting in the vesting of 67,599 shares associated with the first 50% of this grant.*

The following table includes service-based stock awards issued to directors and employees with related vesting and forfeiture information (subject to certain restrictions, principally continuous service), at September 30, 2012:

Year of Grant	*Grant Date Fair Value Per Share*	*Total Original Grants*	*As of December 31, 2011 Vested*	*Forfeited*	*Remaining Shares Scheduled to Vest During:* 2012	*2013*	*2014*
2007	$ 12.93	156,000	76,009	12,499	22,498*	22,497	22,497
2008	12.87	6,000	6,000				
2009	11.39	6,000	6,000				
2010	11.64	12,000	12,000				
2011	13.23	24,000			24,000*		
2012	13.59	29,000				29,000	

* *The 2007 grant shares vested in January 2012 and the 2011 grant shares vested in April 2012.*

Table of Contents

Performance- and service-based stock award activity for the nine months ended September 30, 2012 is summarized below:

	Number of Shares	*Weighted Average Grant Date Fair Value*
Unvested stock awards outstanding at December 31, 2011	597,418	$ 12.41
Grants	29,000	13.59
Vestings	(114,097)	11.39
Unvested stock awards outstanding at September 30, 2012	512,321	12.71

During the quarter and nine months ended September 30, 2012, the Company recognized in *Salaries and benefits* $469,000 and $1,406,000, respectively, related to amortization of the grant date fair value of employee performance- and service-based stock awards. The amounts amortized for these periods assumed that performance criteria, if applicable, would continue to be met for related initial measurement periods. In addition, the Company recognized in *Other general and administrative expense* $94,000 and $255,000 related to amortization of the grant date fair value of service-based director stock awards during the quarter and nine months ended September 30, 2012, respectively. All service-based stock awards, as well as performance-based stock awards granted in 2008 and 2009, are entitled to receive dividends on a current basis without risk of forfeiture if the related awards do not vest. Performance-based awards granted subsequent to 2009 defer the payment of dividends accruing during the vesting period until vesting and if the related awards do not vest these accrued dividends will be forfeited. At September 30, 2012 dividends accrued pertaining to these awards totaled $643,000 and are included in *Common stock dividend payable*. Unrecognized compensation expense for unvested stock awards totaled $3.5 million as of September 30, 2012, to be expensed over a weighted average period of 1.5 years, assuming performance criteria, if applicable, are met for related initial measurement periods.

Option awards currently outstanding have contractual terms and vesting requirements at the grant date of ten years and were issued with strike prices equal to the quoted market prices of the Company s common shares on the date of grant. The fair value of each option award was estimated on the date of grant using a Black-Scholes option pricing model. The Company estimated option exercises, expected holding periods and forfeitures based on past experience and expectations for option performance and employee or director attrition. Risk-free rates were based on market rates for the expected life of the options. Expected dividends were based on historical experience and expectations for future performance. Expected volatility factors were based on historical experience. No option awards were granted during the nine months ended September 30, 2012. Option award activity for the nine months ended September 30, 2012 is summarized below:

	Number of Shares	*Weighted Average Exercise Price*
Option awards outstanding at December 31, 2011	256,250	$ 10.71
Exercises	(158,750)	10.14
Option awards outstanding at September 30, 2012	97,500	11.63

Exercisable option awards outstanding as of September 30, 2012 totaled 97,500 shares with a weighted average remaining contractual term of 5.0 years, an average exercise price of $11.63 and an aggregate intrinsic value of $190,000. The total intrinsic value of option awards exercised during the quarter and nine months ended September 30, 2012 was $495,000 and $620,000, respectively.

Table of Contents

Other Benefit Programs

Capstead sponsors a qualified defined contribution retirement plan for all employees and a nonqualified deferred compensation plan for certain of its officers. In general the Company matches up to 50% of a participant s voluntary contribution up to a maximum of 6% of a participant s compensation and makes discretionary contributions of up to another 3% of compensation regardless of participation in the plans. Company contributions are subject to certain vesting requirements. During the quarter and nine months ended September 30, 2012, the Company recognized in *Salaries and benefits* $86,000 and $336,000 related to contributions to these plans, respectively.

NOTE 10 NET INTEREST INCOME ANALYSIS

The following table summarizes interest income, interest expense and weighted average interest rates as well as related changes due to changes in interest rates versus changes in volume (dollars in thousands):

	Quarter Ended September 30						
	2012		*2011*		*Related Changes in*		
	Amount	*Average Rate*	*Amount*	*Average Rate*	*Rate**	*Volume**	*Total**
Interest income:							
Residential mortgage investments	$ 63,463	1.86%	$ 62,890	2.17%	$ (9,707)	$ 10,280	$ 573
Other	154	0.15	59	0.09	54	41	95
	63,617	1.81	62,949	2.12	(9,653)	10,321	668
Interest expense:							
Repurchase arrangements and similar borrowings	(17,875)	0.56	(15,744)	0.57	(274)	2,405	2,131
Unsecured borrowings	(2,186)	8.49	(2,186)	8.49			
Other				0.08			
	(20,061)	0.62	(17,930)	0.65	(274)	2,405	2,131
	$ 43,556	1.19	$ 45,019	1.47	$ (9,379)	$ 7,916	$ (1,463)

	Nine Months Ended September 30						
	2012		*2011*		*Related Changes in*		
	Amount	*Average Rate*	*Amount*	*Average Rate*	*Rate**	*Volume**	*Total**
Interest income:							
Residential mortgage investments	$ 194,983	2.01%	$ 179,167	2.29%	$ (23,646)	$ 39,462	$ 15,816
Other	480	0.16	230	0.13	63	187	250
	195,463	1.95	179,397	2.25	(23,583)	39,649	16,066
Interest expense:							
Repurchase arrangements and similar borrowings	(48,429)	0.53	(41,772)	0.57	(3,055)	9,712	6,657
Unsecured borrowings	(6,560)	8.49	(6,560)	8.49			
Other		0.07	(5)	0.14	(2)	(3)	(5)
	(54,989)	0.60	(48,337)	0.65	(3,057)	9,709	6,652
	$ 140,474	1.35	$ 131,060	1.60	$ (20,526)	$ 29,940	$ 9,414

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

Table of Contents

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

FINANCIAL CONDITION

Overview

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a REIT) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as Capstead or the Company. Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (ARM) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae or Freddie Mac (together, the GSEs), or by an agency of the federal government, Ginnie Mae. Agency-guaranteed mortgage securities (Agency Securities) are considered to have limited, if any, credit risk.

Capstead s investment strategy involves managing a conservatively leveraged portfolio of ARM Agency Securities that can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. This strategy differentiates the Company from its peers because ARM Agency Securities reset to more current interest rates within a relatively short period of time allowing for (a) the recovery of financing spreads diminished during periods of rising interest rates and (b) smaller fluctuations in portfolio values from changes in interest rates compared to portfolios that contain a significant amount of fixed-rate Agency Securities. From a credit-risk perspective, the credit quality of Agency Securities helps ensure that fluctuations in value due to credit risk should be limited and financing at reasonable rates and terms is more likely to remain available under stressed market conditions.

Capstead finances its investments with borrowings under repurchase arrangements with commercial banks and other financial institutions supported by its long-term investment capital, which as of September 30, 2012 totaled $1.66 billion and consisted of $1.37 billion of common and $189 million of perpetual preferred stockholders equity (recorded amounts) and $100 million of long-term unsecured borrowings (net of related investments in statutory trusts). Long-term investment capital increased by $271 million or 19% during the nine months ended September 30, 2012 primarily as a result of raising $142 million in common equity capital and higher portfolio pricing levels. Holdings of ARM Agency Securities increased by $2.05 billion or 17% in 2012, to $14.31 billion at September 30, 2012, while repurchase arrangements and similar borrowings increased $1.90 billion or 17% in 2012 to $13.25 billion. Portfolio leverage (repurchase arrangements and similar borrowings divided by long-term investment capital) decreased modestly to 7.96 to one by September 30, 2012 from 8.15 to one at December 31, 2011. Management believes borrowing at current levels represents an appropriate and prudent use of leverage for a portfolio of Agency Securities under current market conditions, particularly a portfolio consisting almost entirely of short-duration ARM Agency Securities (duration is a common measure of market price sensitivity to interest rate movements). Provided capital can continue to be deployed at attractive levels and financing conditions remain favorable, management anticipates maintaining portfolio leverage near September 30, 2012 levels.

Capstead reported net income of $40 million and $129 million or $0.35 and $1.20 per diluted common share for the quarter and nine months ended September 30, 2012, respectively, compared to $41 million and $118 million or $0.43 and $1.32 per diluted common share for the same periods in 2011. Financing spreads on residential mortgage investments averaged 130 and 148 basis points for the quarter and nine months ended September 30, 2012, respectively, compared to 160 and 172 basis points during the same periods in 2011. Financing spreads on residential mortgage investments is a non-GAAP financial measure based solely on yields on the Company s residential mortgage investments, net of borrowing rates on repurchase arrangements and similar borrowings, adjusted for currently-paying interest rate swap agreements held for hedging purposes. This measure differs from total financing spreads, an all-inclusive GAAP measure, that is based on all interest-bearing assets and all interest-paying liabilities see page 26 of this filing for a reconciliation of these measures. Lower financing spreads during 2012 reflect (a) lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates underlying the portfolio resetting lower to more current rates and lower coupon interest rates on acquisitions, and (b) higher investment premium amortization primarily because of higher portfolio runoff as well as higher prices paid for portfolio acquisitions in recent years. The effect on financing spreads of lower portfolio yields was only partially offset by lower borrowing rates as the benefits of replacing higher cost interest rate swap agreements as these contracts expired with additional two-year term swap agreements at more favorable rates have been largely offset by increases in unhedged borrowing rates in recent quarters due to a variety of market factors.

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

Risk Factors and Critical Accounting Policies

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

Equity Capital Issuances and Recently Announced Common Stock Repurchase Program

During the third quarter of 2012 Capstead raised $21 million in new common equity capital, after underwriting discounts and offering expenses, by issuing 1.5 million common shares at an average price of $13.93 per share, after expenses, through the Company s at-the-market, continuous offering program. No shares were issued under this program subsequent to quarter-end. Year-to-date the Company has raised $142 million by issuing 10.5 million common shares at an average price of $13.52 per share under this program. Additionally, during the first and second quarters of 2012 the Company raised $4 million by issuing 309,000 Series B preferred shares at an average price of $14.50 per share under this program. As of quarter-end, 6.4 million common shares and 1.3 million Series B preferred shares are available for issuance under this program pursuant to supplements filed with the applicable registration statement on file with the Securities and Exchange Commission (the SEC).

The Company suspended its continuous offering program in connection with its October 30, 2012 announcement of a $100 million common stock repurchase program. Purchases made pursuant to the stock repurchase program will be made in the open market or through privately negotiated transactions from time to time as permitted by securities laws and other legal requirements. The timing, manner, price and amount of any repurchases will be determined by the Company in its discretion and will be subject to economic and market conditions, stock price, applicable legal requirements and other factors. The authorization does not obligate the Company to acquire any particular amount of common shares and the program may be suspended or discontinued at the Company s discretion without prior notice.

Book Value per Common Share

Nearly all of Capstead s residential mortgage investments and all of its interest rate swap agreements are reflected at fair value on the Company s balance sheet and included in the calculation of book value per common share (total stockholders equity, less perpetual preferred share liquidation preferences, divided by common shares outstanding). The fair value of these investments is impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels. The Company s investment strategy attempts to mitigate these risks by focusing on investments in

Table of Contents

Agency Securities, which are considered to have little, if any, credit risk and are collateralized by ARM loans with interest rates that reset periodically to more current levels. Because of these characteristics, the fair value of Capstead s portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to portfolios containing a significant amount of non-agency and/or fixed-rate mortgage securities. The following table illustrates the progression of book value per common share for the quarter and nine months ended September 30, 2012:

	Quarter Ended September 30, 2012	*Nine Months Ended September 30, 2012*
Book value per common share, beginning of period	$ 13.23	$ 12.52
Capital transactions:		
Accretion from capital raises	0.01	0.11
Increase related to stock awards		0.01
Dividend distributions in excess of earnings	(0.01)	(0.02)
Increase in fair value of mortgage securities classified as available-for-sale	0.68	1.36
Increase (decrease) in fair value of interest rate swap agreements designated as cash flow hedges of:		
Repurchase arrangements and similar borrowings	(0.05)	(0.09)
Unsecured borrowings	0.02	(0.01)
Book value per common share, end of period	$ 13.88	$ 13.88
Increase in book value per common share during the indicated periods	$ 0.65	$ 1.36

Residential Mortgage Investments

Capstead s investment strategy focuses on managing a large portfolio of residential mortgage investments consisting almost exclusively of ARM Agency Securities. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by the GSEs, which are federally chartered corporations, or an agency of the federal government, Ginnie Mae. The 2008 conservatorship of the GSEs by their federal regulator, and related capital commitments to the GSEs made by the U.S. Treasury, have largely alleviated market concerns regarding the ability of the GSEs to fulfill their guarantee obligations. By focusing on investing in relatively short-duration ARM Agency Securities, declines in fair value caused by increases in interest rates are typically relatively modest compared to investments in longer-duration, fixed-rate assets. These declines can be recovered in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then current interest rate environment allowing for the potential recovery of financing spreads diminished during periods of rising interest rates. The following table illustrates the progression of Capstead s portfolio of residential mortgage investments for the quarter and nine months ended September 30, 2012 (in thousands):

	Quarter Ended September 30, 2012	*Nine Months Ended September 30, 2012*
Residential mortgage investments, beginning of period	$ 13,799,487	$ 12,264,906
Increase in unrealized gains on mortgage securities classified as available-for-sale	66,910	134,583
Portfolio acquisitions (principal amount) at average lifetime purchased yields of 2.01% and 2.20%	1,197,496	3,778,048
Investment premiums on acquisitions	53,866	158,103
Portfolio runoff (principal amount)	(777,400)	(1,955,086)
Investment premium amortization	(27,151)	(67,346)
Residential mortgage investments, end of period	$ 14,313,208	$ 14,313,208

Average carrying amount of residential mortgage investments outstanding during the indicated periods *	$ 13,989,176	$ 13,250,676

* *Includes unrealized gains and losses for residential mortgage investments classified as available-for-sale.*

Table of Contents

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

As of September 30, 2012, nearly all of Capstead s residential mortgage investments consisted of ARM Agency Securities and a small amount of adjustable-rate residential mortgage loans, featuring the following characteristics (dollars in thousands):

ARM Type [(a)]	*Amortized Cost Basis* [(b)]	*Net WAC* [(c)]	*Fully Indexed WAC* [(c)]	*Average Net Margins* [(c)]	*Average Periodic Caps* [(c)]	*Average Lifetime Caps* [(c)]	*Months To Roll* [(a)]
Current-reset ARMs:							
Fannie Mae Agency Securities	$ 5,369,945	2.48%	2.38%	1.70%	3.19%	10.18%	5.0
Freddie Mac Agency Securities	1,945,619	2.83	2.52	1.84	2.08	10.66	6.2
Ginnie Mae Agency Securities	745,926	2.46	1.70	1.51	1.02	9.32	6.6
Residential mortgage loans	5,159	3.51	2.44	2.04	1.49	10.97	4.5
	8,066,649	2.56	2.35	1.71	2.73	10.21	5.4
Longer-to-reset ARMs:							
Fannie Mae Agency Securities	3,034,453	3.00	2.74	1.77	4.80	8.06	44.2
Freddie Mac Agency Securities	1,900,797	2.97	2.80	1.84	4.91	8.00	49.8
Ginnie Mae Agency Securities	932,652	3.04	1.69	1.51	1.02	8.07	32.6
	5,867,902	3.00	2.59	1.75	4.24	8.04	44.1
	$ 13,934,551	2.74	2.45	1.73	3.36	9.30	21.6
Gross WAC (rate paid by borrowers) [(d)]		3.37					

(a) *Capstead classifies its ARM securities based on the average length of time until the loans underlying each security reset to more current rates (months-to-roll) (less than 18 months for current-reset ARM securities, and 18 months or greater for longer-to-reset ARM securities). Once an ARM loan reaches its initial reset date, it will reset at least once a year to a margin over a corresponding interest rate index, subject to periodic and lifetime limits or caps.*

(b) *Amortized cost basis represents the Company s investment (unpaid principal balance plus unamortized investment premiums) before unrealized gains and losses. As of September 30, 2012, the ratio of amortized cost basis to related unpaid principal balance for the Company s ARM securities was 103.06. This table excludes $3 million in fixed-rate Agency Securities, $3 million in fixed-rate residential mortgage loans and $3 million in private residential mortgage pass-through securities held as collateral for structured financings.*

(c) *Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments, net of servicing and other fees as of the indicated date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments. Fully indexed WAC represents the weighted average coupon upon one or more resets using interest rate indexes and net margins as of the indicated date. Average net margins represent the weighted average levels over the underlying indexes that the portfolio can adjust to upon reset, usually subject to initial, periodic and/or lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. ARM securities issued by the GSEs with initial fixed-rate periods of five years or longer typically have 500 basis point initial caps with 200 basis point periodic caps. Additionally, certain ARM securities held by the Company are subject only to lifetime caps or were not subject to a cap. For presentation purposes, average periodic caps in the table above reflect initial caps until after an ARM security has reached its initial reset date and lifetime caps, less the current net WAC, for ARM securities subject only to lifetime* *caps. At quarter-end, 80% of current-reset ARMs were subject to periodic caps averaging 1.85%; 4% were subject to initial caps averaging 2.42%; 15% were subject to lifetime caps, less the current net WAC, averaging 7.56%; and 1% were not subject to a cap. All longer-to-reset ARM securities at September 30, 2012 were subject to initial caps.*

(d) Gross WAC is the weighted average interest rate of the mortgage loans underlying the indicated investments, including servicing and other fees paid by borrowers, as of the indicated balance sheet date.

After consideration of any applicable initial fixed-rate periods, at September 30, 2012 approximately 80%, 12% and 8% of the Company s ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly. Approximately 96% of the Company s current-reset ARM securities have reached an initial coupon reset date, while none of its longer-to-reset ARM securities have reached an

Table of Contents

initial coupon reset date. Additionally, at September 30, 2012 approximately 18% of the Company s ARM securities were backed by interest-only loans that have not reached an initial coupon reset date. All percentages are approximate and based on averages of the characteristics of mortgage loans underlying each security and calculated using unpaid principal balances as of the indicated balance sheet date.

ARM Agency Securities typically are acquired at a premium to the securities unpaid principal balances and high levels of mortgage prepayments can put downward pressure on yields and financing spreads because the level of mortgage prepayments impacts how quickly investment premiums are written off against earnings as portfolio yield adjustments. Portfolio runoff during the quarter and nine months ended September 30, 2012 averaged 21.1% and 18.8% on an annualized basis, respectively (a constant prepayment rate, or CPR, of 18.7% and 16.4%, respectively). Higher portfolio runoff in the third quarter reflects seasonal prepayment patterns as well as lower prevailing mortgage interest rates available to consumers. While the current low interest rate environment can be expected to persist for some time, certain characteristics of the Company s portfolio are expected to lessen the risk of experiencing sharply higher prepayment levels. A key differentiating factor of Capstead s investment strategy relative to the strategies implemented by peers in the mortgage REIT sector is the Company s focus on investing solely in ARM securities. At September 30, 2012 the portfolio was backed by mortgages requiring borrowers to make payments predicated on rates averaging a relatively low 3.37%, of which 56% were originated prior to 2009. Mortgage prepayments on securities backed by more seasoned loans have been partially suppressed by low housing prices and credit problems being experienced by many of these borrowers, even as prepayments on newer originations have increased. As a result, many borrowers with mortgage loans underlying securities in the portfolio lack the ability to meaningfully lower their mortgage payments even if they can overcome all of these impediments to refinancing. For these reasons, management anticipates mortgage prepayments to remain at manageable levels.

Capstead generally pledges its residential mortgage investments as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties, when each borrowing is initiated or renewed. None of the Company s counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date, typically with terms of 30 to 90 days, and are accounted for as financings by the Company. The Company maintains the beneficial interest in the specific securities pledged during the term of the repurchase arrangement and receives the related principal and interest payments. The amount borrowed is generally equal to the fair value of the assets pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a haircut. Since early in 2009, haircut requirements for pledged Agency Securities have remained relatively stable and as of September 30, 2012, haircuts on outstanding borrowings averaged 4.5 percent and typically ranged from 3.0 to 5.0 percent of the fair value of the pledged securities. After considering related interest receivable, as well as interest payable on these borrowings, the Company had $706 million of capital at risk with its lending counterparties as of September 30, 2012.

Interest rates charged on repurchase arrangements and similar borrowings are fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase arrangement at which time the Company may enter into a new repurchase arrangement at prevailing market rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. When the fair value of pledged securities declines due to changes in market conditions or the publishing of monthly security pay down factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. Conversely, if collateral fair values increase, lenders are required to release collateral back to the Company pursuant to Company-issued margin calls. The Company s borrowings under repurchase arrangements and similar borrowings at September 30, 2012 consisted of $13.25 billion of primarily 30-day borrowings with 24 counterparties at average rates of 0.41%, before the effects of interest rate swap agreements held as cash flow hedges on a designated portion of 30- to 90-day borrowings (see below) and 0.56% including the effects of these derivative financial instruments.

To help mitigate exposure to higher short-term interest rates, Capstead typically uses currently-paying and forward-starting, one-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that require interest payments for two-year terms. Variable payments received by the Company under these swap agreements largely offset interest accruing on a like amount of the Company s 30- to 90-day borrowings, leaving the fixed-rate payments to be paid on the swap agreements as the Company s effective borrowing rate, subject to certain adjustments. These adjustments include the effects of measured hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and related actual borrowing rates. Under the terms of currently-paying interest rate swap agreements held at September 30, 2012, the Company is required to pay fixed rates of interest averaging 0.78% on notional amounts totaling $3.70 billion with average remaining interest payment terms of ten months. Additionally, as of quarter-end the Company had entered into forward-starting swap agreements with notional amounts totaling $2.30 billion that will begin requiring interest payments at fixed rates averaging 0.50% for two-year periods that commence on various dates between October 2012 and October 2013, with an average expiration of 29 months.

After consideration of all swap positions entered into as of quarter-end to hedge short-term borrowing rates, the Company s residential mortgage investments and related borrowings under repurchase arrangements had estimated durations at September 30, 2012 of 10 $^{1}/_{2}$ months and 8 months, respectively, for a net duration gap of 2 $^{1}/_{2}$ months. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated repurchase arrangements if available at attractive terms.

The following table illustrates the components of financing spreads on residential mortgage investments over the past seven quarters:

	2012			***2011***			
	Q3	***Q2***	***Q1***	***Q4***	***Q3***	***Q2***	***Q1***
Yields on re							