

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2010

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 001-34385

**INVESCO MORTGAGE CAPITAL INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Maryland**

(State or Other Jurisdiction of  
Incorporation or Organization)

**26-2749336**

(I.R.S. Employer  
Identification No.)

**1555 Peachtree Street, N.E., Suite 1800**

**Atlanta, Georgia**

(Address of Principal Executive Offices)

**30309**

(Zip Code)

**(404) 892-0896**

(Registrant's Telephone Number, Including Area Code)

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

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

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

Large Accelerated filer

Accelerated filer

Non-Accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of November 9, 2010, there were 39,849,185 outstanding shares of common stock of Invesco Mortgage Capital Inc.

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**INVESCO MORTGAGE CAPITAL INC.**  
**TABLE OF CONTENTS**

	<u>Page</u>
<b>PART I FINANCIAL INFORMATION</b> .....	1
Item 1. Consolidated Financial Statements .....	1
Consolidated Balance Sheets as of September 30, 2010 (unaudited) and December 31, 2009 .....	1
Unaudited Consolidated Statements of Operations for the three and nine months ended September 30, 2010 and 2009 .....	2
Unaudited Consolidated Statement of Shareholders' Equity and Comprehensive Income for the nine months ended September 30, 2010 .....	3
Unaudited Consolidated Statements of Cash Flows for the nine months ended September 30, 2010 and 2009 ...	4
Notes to Consolidated Financial Statements .....	5
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.....	23
Item 3. Quantitative and Qualitative Disclosures About Market Risk .....	37
Item 4. Controls and Procedures .....	39
<b>PART II OTHER INFORMATION</b> .....	40
Item 1. Legal Proceedings .....	40
Item 1A. Risk Factors.....	40
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds .....	40
Item 3. Defaults Upon Senior Securities .....	40
Item 4. Reserved.....	40
Item 5. Other Information.....	40
Item 6. Exhibits .....	42

**PART I**

**ITEM 1. FINANCIAL STATEMENTS**

**INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS**

**\$ in thousands, except per share amounts**

	<b>As of</b>	
<b>ASSETS</b>	<b>September 30, 2010</b>	<b>December 31, 2009</b>
	(Unaudited)	
Mortgage-backed securities, at fair value	2,457,871	802,592
Cash	20,394	24,041
Restricted cash	40,235	14,432
Principal paydown receivable	1,138	2,737
Investments in unconsolidated limited partnerships, at fair value	61,290	4,128
Accrued interest receivable	10,950	3,518
Prepaid insurance	685	681
Deferred offering costs	237	288
Other assets	591	983
Total assets	2,593,391	853,400
<b>LIABILITIES AND EQUITY</b>		
<b>Liabilities:</b>		
Repurchase agreements	1,748,969	545,975
TALF financing	151,757	80,377
Derivative liability, at fair value	46,265	3,782
Dividends and distributions payable	27,473	10,828
Payable for investment securities purchased	57,016	—
Accrued interest payable	1,601	598
Accounts payable and accrued expenses	931	665
Due to affiliate	2,301	865
Total liabilities	2,036,313	643,090
<b>Equity:</b>		
Preferred Stock: par value \$0.01 per share; 50,000,000 shares authorized, 0 shares issued and outstanding	—	—
Common Stock: par value \$0.01 per share; 450,000,000 shares authorized, 26,047,682 and 8,887,212 shares issued and outstanding, at September 30, 2010 and December 31, 2009, respectively	260	89
Additional paid in capital	514,423	172,385
Accumulated other comprehensive income	10,511	7,721
Retained earnings	771	320
Total shareholders' equity	525,965	180,515
Non-controlling interest	31,113	29,795
Total equity	557,078	210,310
Total liabilities and equity	2,593,391	853,400

The accompanying notes are an integral part of these consolidated financial statements.

**INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)

<b>\$ in thousands, except per share data</b>	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
<b>Revenues</b>				
Interest income	36,067	10,983	83,284	10,983
Interest expense	8,873	2,070	18,904	2,070
<b>Net interest income</b>	<b>27,194</b>	<b>8,913</b>	<b>64,380</b>	<b>8,913</b>
<b>Other income (loss)</b>				
Gain (loss) on sale of investments, net	(311)	—	1,064	—
Equity in earnings and fair value change in unconsolidated limited partnerships	3,793	—	5,888	—
Loss on other-than-temporarily impaired securities	(124)	—	(510)	—
Unrealized loss on interest rate swaps	(9)	(13)	(44)	(13)
<b>Total other income (loss)</b>	<b>3,349</b>	<b>(13)</b>	<b>6,398</b>	<b>(13)</b>
<b>Expenses</b>				
Management fee – related party	2,039	753	5,094	753
General and administrative	263	245	729	349
Insurance	236	354	929	369
Professional fees	386	375	1,181	388
<b>Total expenses</b>	<b>2,924</b>	<b>1,727</b>	<b>7,933</b>	<b>1,859</b>
Net income	<b>27,619</b>	<b>7,173</b>	<b>62,845</b>	<b>7,041</b>
Net income attributable to non-controlling interest	1,433	970	3,860	970
Net income attributable to common shareholders	<b>26,186</b>	<b>6,203</b>	<b>58,985</b>	<b>6,071</b>
Earnings per share:				
Net income attributable to common shareholders (basic/diluted)	<b>1.01</b>	<b>0.70</b>	<b>2.74</b>	<b>NM</b>
Dividends declared per common share	<b>1.00</b>	<b>—</b>	<b>2.52</b>	<b>—</b>
Weighted average number of shares of common stock:				
Basic	<b>26,047</b>	<b>8,886</b>	<b>21,552</b>	<b>NM</b>
Diluted	<b>27,478</b>	<b>10,311</b>	<b>22,981</b>	<b>NM</b>

NM = not meaningful

The accompanying notes are an integral part of these consolidated financial statements.

**INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY AND COMPREHENSIVE INCOME**  
**For the nine months ended September 30, 2010**  
(Unaudited)

\$ in thousands, except per share amounts	Attributable to Common Shareholders								Comprehensive Income (Loss)
	Common Stock Shares	Common Stock Amount	Additional Paid in Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Shareholders' Equity	Non-Controlling Interest	Total Equity	
<b>Balance at January 1, 2010</b> .....	8,887,212	89	172,385	7,721	320	180,515	29,795	210,310	26,470
Net income .....	—	—	—	—	58,985	58,985	3,860	62,845	62,845
Comprehensive income									
Change in net unrealized gains and losses on available for sale securities .....	—	—	—	42,570	—	42,570	3,702	46,272	46,272
Change in net unrealized gains and losses on derivatives .....	—	—	—	(39,780)	—	(39,780)	(2,658)	(42,438)	(42,438)
Total comprehensive income .....									93,149
Net proceeds from issuance of common stock, net of offering costs .....	17,157,800	171	341,958	—	—	342,129	—	342,129	
Stock awards to directors .....	2,670	—	—	—	—	—	—	—	
Common stock dividends .....	—	—	—	—	(58,534)	(58,534)	—	(58,534)	
Common unit dividends .....	—	—	—	—	—	—	(3,591)	(3,591)	
Amortization of equity-based compensation .....	—	—	80	—	—	80	5	85	
<b>Balance at September 30, 2010</b> .....	26,047,682	260	514,423	10,511	771	525,965	31,113	557,078	

The accompanying notes are an integral part of this consolidated financial statement.

**INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

<b>\$ in thousands</b>	<b>Nine Months Ended September 30,</b>	
	<b>2010</b>	<b>2009</b>
<b>Cash Flows from Operating Activities</b>		
Net income	62,845	7,041
Adjustments to reconcile net income to net cash provided by operating activities		
Amortization of premiums and discounts, net – mortgage-backed securities	(9,827)	(609)
Unrealized loss on derivatives	44	13
Gain on sale of mortgage-backed securities	(1,064)	—
Loss on other-than-temporarily impaired securities	510	—
Equity in earnings and fair value change in unconsolidated limited partnerships	(5,888)	—
Amortization of equity-based compensation	85	19
Changes in operating assets and liabilities		
Increase in accrued interest	(7,432)	(3,893)
Increase in prepaid insurance	(5)	(1,034)
Increase in deferred offering costs	(58)	—
(Increase) decrease in other assets	393	(254)
Increase in accrued interest payable	1,003	541
Increase in due to affiliate	1,385	761
Increase in accounts payable and accrued expenses	570	496
Net cash provided by operating activities	42,561	3,081
<b>Cash Flows from Investing Activities</b>		
Purchase of mortgage-backed securities	(2,022,403)	(897,925)
Investment in PPIP	(50,890)	—
Principal payments of mortgage-backed securities	265,904	26,982
Proceeds from sale of mortgage-backed securities	216,104	—
Net cash used in investing activities	(1,591,285)	(870,943)
<b>Cash Flows from Financing Activities</b>		
Proceeds from issuance of common stock	341,986	174,441
Increase in restricted cash	(25,802)	(9,158)
Proceeds from private placement of OP Units	—	28,500
Proceeds from repurchase agreements	11,092,883	1,981,153
Principal repayments of repurchase agreements	(9,889,889)	(1,366,191)
Proceeds from TALF financing	71,525	64,837
Principal payments of TALF financing	(146)	(30)
Payments of dividends and distributions	(45,480)	—
Net cash provided by financing activities	1,545,077	873,552
Net change in cash	(3,647)	5,690
Cash, beginning of period	24,041	1
Cash, end of period	20,394	5,691
<b>Supplement disclosure of cash flow information</b>		
Interest paid	17,831	1,529
<b>Non-cash investing and financing activities information</b>		
Net change in unrealized gain on available-for-sale securities and derivatives	3,834	7,390
Net change in investment in PPIP	384	—
Purchase of mortgage-backed securities, unsettled	57,016	2,503
Obligation to brokers incurred for purchase of mortgage-backed securities	(57,016)	(2,503)
Dividends and distributions declared not paid	27,473	—

The accompanying notes are an integral part of these consolidated financial statements.

**INVESCO MORTGAGE CAPITAL INC. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**Note 1 – Organization and Business Operations**

Invesco Mortgage Capital Inc. (the “Company”) is a Maryland corporation focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. The Company invests in residential mortgage-backed securities (“RMBS”) for which a U.S. Government Agency such as the Government National Mortgage Association (“Ginnie Mae”), the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”) guarantees payments of principal and interest on the securities (collectively “Agency RMBS”). The Company’s Agency RMBS investments include mortgage pass-through securities and collateralized mortgage obligations (“CMOs”). The Company also invests in residential mortgage-backed securities that are not issued or guaranteed by a U.S. government Agency (“Non-Agency RMBS”), commercial mortgage-backed securities (“CMBS”), and residential and commercial mortgage loans. The Company is externally managed and advised by Invesco Advisers, Inc. (the “Manager”), a registered investment adviser and an indirect, wholly-owned subsidiary of Invesco Ltd. (“Invesco”), a global investment management company.

The Company conducts its business through IAS Operating Partnership LP (the “Operating Partnership”) as its sole general partner. As of September 30, 2010, the Company owned 94.8% of the Operating Partnership and Invesco Investments (Bermuda) Ltd., a direct, wholly-owned subsidiary of Invesco, owned the remaining 5.2%.

The Company finances its Agency RMBS and Non-Agency RMBS investments through short-term borrowings structured as repurchase agreements. The Manager has secured commitments for the Company with a number of repurchase agreement counterparties. In addition, the Company has financed its CMBS portfolio with financings under the U.S. government’s Term Asset-Backed Securities Loan Facility (“TALF”). The Company has also financed, and may do so again in the future, investments in CMBS through short-term borrowings structured as repurchase agreements. The Company also finances its investments in certain Non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing capital to a partnership that invests in public-private investment funds (“PPIF”) managed by the Company’s Manager. In addition, the Company may use other sources of financing including committed borrowing facilities and other private financing.

The Company elected to be taxed as a real estate investment trust (“REIT”) for U.S. federal income tax purposes under the provisions of the Internal Revenue Code of 1986, as amended (“Code”), commencing with the Company’s taxable year ended December 31, 2009. To maintain the Company’s REIT qualification, the Company is generally required to distribute at least 90% of its taxable income (excluding net capital gains) to its shareholders annually.

**Note 2 – Summary of Significant Accounting Policies**

**Basis of Quarterly Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial position and the results of operations of the Company for the interim periods presented have been included. The interim consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and related notes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2009 which was filed with the Securities and Exchange Commission (the “SEC”) on March 24, 2010 and amended on April 29, 2010. The results of operations for the period ended September 30, 2010 are not necessarily indicative of the results to be expected for the full year or any other future period.

## **Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany balances and transactions have been eliminated.

## **Use of Estimates**

The accounting and reporting policies of the Company conform to U.S. GAAP. The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Examples of estimates include, but are not limited to, estimates of the fair values of financial instruments, interest income on mortgage-backed securities (“MBS”) and other-than-temporary impairment charges. Actual results may differ from those estimates.

## **Cash and Cash Equivalents**

The Company considers all highly liquid investments that have original or remaining maturity dates of three months or less when purchased to be cash equivalents. At September 30, 2010, the Company had cash and cash equivalents, including amounts restricted, in excess of the Federal Deposit Insurance Corporation, or FDIC, deposit insurance limit of \$250,000 per institution. The Company mitigates its risk of loss by placing cash and cash equivalents with numerous major financial institutions.

## **Deferred Offering Costs**

The Company records costs associated with stock offerings as a reduction in additional paid in capital. At December 31, 2009, deferred offering costs consisted of legal and other costs of approximately \$288,000 related to the follow-on public offering which was completed on January 15, 2010 (the “January Offering”). In addition, the Company recorded deferred offering costs of approximately \$237,000 at September 30, 2010 related to a follow-on public offering completed on October 13, 2010 (the “October Offering”).

## **Underwriting Commissions and Costs**

Underwriting commissions and direct costs incurred in connection with the Company’s initial public offering (“IPO”) and the subsequent follow-on offerings are reflected as a reduction of additional paid-in-capital.

## **Repurchase Agreements**

The Company finances its Agency RMBS, Non-Agency RMBS and a portion of its CMBS investment portfolio through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

In instances where the Company acquires Agency RMBS, Non-Agency RMBS or CMBS through repurchase agreements with the same counterparty from whom the Agency RMBS, Non-Agency RMBS or CMBS were purchased, the Company accounts for the purchase commitment and repurchase agreement on a net basis and records a forward commitment to purchase Agency RMBS, Non-Agency RMBS or CMBS as a derivative instrument if the transaction does not comply with the criteria for gross presentation. All of the following criteria must be met for gross presentation in the circumstance where the repurchase assets are financed with the same counterparty:

- the initial transfer of and repurchase financing cannot be contractually contingent;
- the repurchase financing entered into between the parties provides full recourse to the transferee and the repurchase price is fixed;

- the financial asset has an active market and the transfer is executed at market rates; and
- the repurchase agreement and financial asset do not mature simultaneously.

If the transaction complies with the criteria for gross presentation, the Company records the assets and the related financing on a gross basis on its balance sheet, and the corresponding interest income and interest expense in its statements of operations. Such forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. Additionally, the Company records the cash portion of its investment in Agency RMBS and Non-Agency RMBS as a mortgage related receivable from the counterparty on its balance sheet.

For assets representing available-for-sale investment securities any change in fair value is reported through consolidated other comprehensive income (loss) with the exception of impairment losses, which are recorded in the consolidated statement of operations.

### **Fair Value Measurements**

In January 2010, the FASB updated guidance entitled, “Improving Disclosures about Fair Value Measurements.” The guidance required a number of additional disclosures regarding fair value measurements. Specifically, entities should disclose: (1) the amount of significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for these transfers; (2) the reasons for any transfers in or out of Level 3; and (3) information in the reconciliation of recurring Level 3 measurements about purchases, sales, issuances and settlements on a gross basis. Except for the requirement to disclose information about purchases, sales, issuances, and settlements in the reconciliation of recurring Level 3 measurements on a gross basis, all the amendments are effective for interim and annual reporting periods beginning after December 15, 2009. The Company adopted these provisions in preparing the Consolidated Financial Statements for the period ended March 31, 2010. The adoption of these provisions only affected the disclosure requirements for fair value measurements and as a result had no impact on the Company’s consolidated statements of operations and consolidated balance sheets.

The Company discloses the fair value of its financial instruments according to a fair value hierarchy (levels 1, 2, and 3, as defined). In accordance with U.S. GAAP, the Company is required to provide enhanced disclosures regarding instruments in the level 3 category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities.

Additionally, U.S. GAAP permits entities to choose to measure many financial instruments and certain other items at fair value (the “fair value option”). Unrealized gains and losses on items for which the fair value option has been elected are irrevocably recognized in earnings at each subsequent reporting date.

During 2009, the Company elected the fair value option for its investments in unconsolidated limited partnerships. The Company has the one-time option to elect fair value for these financial assets on the election date. The changes in the fair value of these instruments are recorded in equity in earnings and fair value change in unconsolidated limited partnerships in the consolidated statements of operations.

### **Securities**

The Company designates securities as held-to-maturity, available-for-sale, or trading depending on its ability and intent to hold such securities to maturity. Trading and securities available-for-sale are reported at fair value, while securities held-to-maturity are reported at amortized cost. Although the Company generally intends to hold most of its RMBS and CMBS until maturity, the Company may, from time to time, sell any of its RMBS or CMBS as part of its overall management of its investment portfolio and as such will classify its RMBS and CMBS as available-for-sale securities.

All securities classified as available-for-sale are reported at fair value, based on market prices from third-party sources, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders’ equity. When applicable, included with available-for-sale securities are forward purchase commitments on to be announced securities (“TBA”). The Company records TBA purchases on the trade date and

the corresponding payable is recorded as an outstanding liability as a payable for investments purchased until the settlement date of the transaction.

The Company evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. The determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. Consideration is given to (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near-term prospects of recovery, in fair value of the security, and (iii) the Company's intent and ability to retain its investment in the security for a period of time sufficient to allow for any anticipated recovery in fair value. For debt securities, the amount of the other-than-temporary impairment related to a credit loss or impairments on securities that the Company has the intent or for which it is more likely than not that the Company will need to sell before recovery are recognized in earnings and reflected as a reduction in the cost basis of the security. The amount of the other-than-temporary impairment on debt securities related to other factors is recorded consistent with changes in the fair value of all other available-for-sale securities as a component of consolidated shareholders' equity in other comprehensive income or loss with no change to the cost basis of the security.

### **Interest Income Recognition**

Interest income on available-for-sale MBS, which includes accretion of discounts and amortization of premiums on such MBS, is recognized over the life of the investment using the effective interest method. Management estimates, at the time of purchase, the future expected cash flows and determines the effective interest rate based on these estimated cash flows and the Company's purchase price. As needed, these estimated cash flows are updated and a revised yield is computed based on the current amortized cost of the investment. In estimating these cash flows, there are a number of assumptions subject to uncertainties and contingencies, including the rate and timing of principal payments (prepayments, repurchases, defaults and liquidations), the pass through or coupon rate and interest rate fluctuations. In addition, management must use its judgment to estimate interest payment shortfalls due to delinquencies on the underlying mortgage loans. These uncertainties and contingencies are difficult to predict and are subject to future events that may impact management's estimates and its interest income. Security transactions are recorded on the trade date. Realized gains and losses from security transactions are determined based upon the specific identification method and recorded as gain (loss) on sale of available-for-sale securities in the consolidated statement of operations.

### **Investments in Unconsolidated Limited Partnerships**

The Company has investments in unconsolidated limited partnerships. In circumstances where the Company has a non-controlling interest but is deemed to be able to exert influence over the affairs of the enterprise the Company utilizes the equity method of accounting. Under the equity method of accounting, the initial investment is increased each period for additional capital contributions and a proportionate share of the entity's earnings and decreased for cash distributions and a proportionate share of the entity's losses.

The Company elected the fair value option for its investments in unconsolidated limited partnerships. The election for investments in unconsolidated limited partnerships was made upon their initial recognition in the financial statements. The Company has elected the fair value option for the investments in unconsolidated limited partnerships for the purpose of enhancing the transparency of its financial condition.

The Company measures the fair value of the investments in unconsolidated limited partnerships on the basis of the net asset value per share of the investments as permitted in guidance effective for the interim and annual periods ended after December 15, 2009.

### **Dividends and Distributions Payable**

Dividends and distributions payable represent dividends declared at the balance sheet date which are payable to common shareholders and distributions declared at the balance sheet date which are payable to non-controlling interest common unit holders of the Operating Partnership, respectively.

## **Earnings per Share**

The Company calculates basic earnings per share by dividing net income for the period by weighted-average shares of the Company's common stock outstanding for that period. Diluted income per share takes into account the effect of dilutive instruments, such as units of limited partnership interest in the Operating Partnership ("OP Units"), stock options and unvested restricted stock, but uses the average share price for the period in determining the number of incremental shares that are to be added to the weighted-average number of shares outstanding. For the nine months ended September 30, 2009, earnings per share is not presented because it is not a meaningful measure of the Company's performance.

## **Comprehensive Income**

Comprehensive income is comprised of net income, as presented in the consolidated statements of operations, adjusted for changes in unrealized gains or losses on available for sale securities and changes in the fair value of derivatives accounted for as cash flow hedges.

## **Accounting for Derivative Financial Instruments**

U.S. GAAP provides disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (i) how and why an entity uses derivative instruments; (ii) how derivative instruments and related hedged items are accounted for; and (iii) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. U.S. GAAP requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting under U.S. GAAP.

## **Income Taxes**

The Company elected to be taxed as a REIT, commencing with the Company's taxable year ended December 31, 2009. Accordingly, the Company will generally not be subject to U.S. federal and applicable state and local corporate income tax to the extent that the Company makes qualifying distributions to its shareholders, and provided the Company satisfies on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If the Company fails to qualify as a REIT, and does not qualify for certain statutory relief provisions, it will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which the Company lost its REIT qualification. Accordingly, the Company's failure to qualify as a REIT could have a material adverse impact on its results of operations and amounts available for distribution to its shareholders.

A REIT's dividend paid deduction for qualifying dividends to the Company's shareholders is computed using its taxable income as opposed to net income reported on the consolidated financial statements. Taxable income, generally, will differ from net income reported on the consolidated financial statements because the determination of taxable income is based on tax regulations and not financial accounting principles.

The Company may elect to treat certain of its future subsidiaries as taxable REIT subsidiaries ("TRS"). In general, a TRS may hold assets and engage in activities that the Company cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes.

While a TRS will generate net income, a TRS can declare dividends to the Company which will be included in its taxable income and necessitate a distribution to its shareholders. Conversely, if the Company retains earnings at a TRS level, no distribution is required and the Company can increase book equity of the consolidated entity. The Company has no adjustments regarding its tax accounting treatment of any uncertainties. The Company expects to recognize interest and penalties related to uncertain tax positions, if any, as income tax expense, which will be included in general and administrative expense.

### Share-Based Compensation

Share-based compensation arrangements include share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. Compensation costs relating to share-based payment transactions are recognized in the consolidated financial statements, based on the fair value of the equity or liability instruments issued on the date of grant, for awards to the Company's independent directors. Compensation related to stock awards to officers and employees of the Manager are recorded at the estimated fair value of the award during the vesting period. The Company makes an upward or downward adjustment to compensation expense for the difference in the fair value at the date of grant and the date the award was earned.

On July 1, 2009, the Company adopted an equity incentive plan under which its independent directors, as part of their compensation for serving as directors, are eligible to receive quarterly restricted stock awards. In addition, the Company may compensate its officers and employees of the Manager under this plan pursuant to the management agreement.

### Note 3 – Mortgage-Backed Securities

All of the Company's MBS are classified as available-for-sale and, as such, are reported at fair value, determined by obtaining valuations from an independent source. If the fair value of a security is not available from a dealer or third-party pricing service, or such data appears unreliable, the Company may estimate the fair value of the security using a variety of methods including other pricing services, repurchase agreement pricing, discounted cash flow analysis, matrix pricing, option adjusted spread models and other fundamental analysis of observable market factors. At September 30, 2010, all of the Company's MBS values were based on third-party values. The following tables present certain information about the Company's investment portfolio at September 30, 2010 and December 31, 2009.

#### September 30, 2010

\$ in thousands	Principal Balance	Unamortized Premium (Discount)	Amortized Cost	Unrealized Gain/ (Loss)	Fair Value	Net Weighted Average Coupon <sup>(1)</sup>	Average Yield <sup>(2)</sup>
Agency RMBS:							
15 year fixed-rate	656,387	33,487	689,874	7,648	697,522	4.88%	3.24%
30 year fixed-rate	652,555	44,993	697,548	9,568	707,116	5.82%	3.87%
ARM	8,247	180	8,427	(245)	8,182	3.04%	2.23%
Hybrid ARM	33,112	1,081	34,193	630	34,823	4.08%	3.14%
Total Agency	<u>1,350,301</u>	<u>79,741</u>	<u>1,430,042</u>	<u>17,601</u>	<u>1,447,643</u>	5.30%	3.54%
MBS-CMO	22,085	889	22,974	540	23,514	5.89%	4.52%
Non-Agency MBS	1,078,638	(341,410)	737,228	21,984	759,212	4.68%	6.68%
CMBS	211,512	(2,899)	208,613	18,889	227,502	5.17%	5.45%
Total	<u>2,662,536</u>	<u>(263,679)</u>	<u>2,398,857</u>	<u>59,014</u>	<u>2,457,871</u>	5.05%	4.68%

(1) Net weighted average coupon ("WAC") is presented net of servicing and other fees.

(2) Average yield incorporates future prepayment and loss assumptions.

**December 31, 2009**

<b>\$ in thousands</b>	<b>Principal Balance</b>	<b>Unamortized Premium (Discount)</b>	<b>Amortized Cost</b>	<b>Unrealized Gain/ (Loss)</b>	<b>Fair Value</b>	<b>Net Weighted Average Coupon <sup>(1)</sup></b>	<b>Average Yield <sup>(2)</sup></b>
Agency RMBS:							
15 year fixed-rate	251,752	9,041	260,793	1,023	261,816	4.82%	3.80%
30 year fixed-rate	149,911	10,164	160,075	990	161,065	6.45%	5.02%
ARM	10,034	223	10,257	(281)	9,976	2.52%	1.99%
Hybrid ARM	117,163	5,767	122,930	597	123,527	5.14%	3.55%
Total Agency	528,860	25,195	554,055	2,329	556,384	5.31%	4.07%
MBS-CMO	27,819	978	28,797	936	29,733	6.34%	4.83%
Non-Agency MBS	186,682	(79,341)	107,341	7,992	115,333	4.11%	17.10%
CMBS	104,512	(4,854)	99,658	1,484	101,142	4.93%	5.97%
Total	847,873	(58,022)	789,851	12,741	802,592	5.03%	6.10%

(1) Net weighted average coupon ("WAC") is presented net of servicing and other fees.

(2) Average yield incorporates future prepayment and loss assumptions.

The components of the carrying value of the Company's investment portfolio at September 30, 2010 and December 31, 2009 are presented below.

<b>\$ in thousands</b>	<b>September 30, 2010</b>	<b>December 31, 2009</b>
Principal balance	2,662,536	847,873
Unamortized premium	82,433	26,174
Unamortized discount	(346,112)	(84,196)
Gross unrealized gains	71,150	14,595
Gross unrealized losses	(12,136)	(1,854)
Fair value	2,457,871	802,592

The following table summarizes certain characteristics of the Company's investment portfolio, at fair value, according to estimated weighted average life classifications as of September 30, 2010 and December 31, 2009:

<b>\$ in thousands</b>	<b>September 30, 2010</b>	<b>December 31, 2009</b>
Less than one year	42,502	—
Greater than one year and less than five years	1,881,136	483,540
Greater than or equal to five years	534,233	319,052
Total	2,457,871	802,592

The following tables present the gross unrealized losses and estimated fair value of the Company's MBS by length of time that such securities have been in a continuous unrealized loss position at September 30, 2010 and December 31, 2009, respectively:

<b>September 30, 2010</b>	<b>Less than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>
<b>\$ in thousands</b>						
Agency RMBS:						
15 year fixed-rate	135,021	(674)	—	—	135,021	(674)
30 year fixed-rate	79,653	(180)	—	—	79,653	(180)
ARM	—	—	—	—	—	—
Hybrid ARM	—	—	8,183	(244)	8,183	(244)
Total Agency	214,674	(854)	8,183	(244)	222,857	(1,098)
MBS – CMO	—	—	—	—	—	—
Non-Agency MBS	265,731	(10,932)	—	—	265,731	(10,932)
CMBS	11,147	(106)	—	—	11,147	(106)
Total	491,552	(11,892)	8,183	(244)	499,735	(12,136)

December 31, 2009	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized	Fair Value	Unrealized	Fair Value	Unrealized
		Losses		Losses		Losses
<b>\$ in thousands</b>						
Agency RMBS:						
15 year fixed-rate	42,446	(82)	—	—	42,446	(82)
30 year fixed-rate	22,195	(70)	—	—	22,195	(70)
ARM	9,976	(281)	—	—	9,976	(281)
Hybrid ARM	—	—	—	—	—	—
Total Agency	74,617	(433)	—	—	74,617	(433)
MBS – CMO	—	—	—	—	—	—
Non-Agency MBS	13,499	(1,044)	—	—	13,499	(1,044)
CMBS	18,281	(377)	—	—	18,281	(377)
Total	106,397	(1,854)	—	—	106,397	(1,854)

The following table presents the impact of the Company's MBS on its accumulated other comprehensive income for the three and nine months ended September 30, 2010. The Company does not consider comparisons of the three and nine months ended September 30, 2009 to be meaningful.

<u>\$ in thousands</u>	<u>Three Months ended September 30, 2010</u>	<u>Nine Months ended September 30, 2010</u>
Accumulated other comprehensive income from investment securities:		
Unrealized gain on MBS at beginning of period	33,921	12,741
Unrealized gain on MBS, net	25,093	46,273
Balance at the end of period	59,014	59,014

The Company assesses its investment securities for other-than-temporary impairment on at least a quarterly basis. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either "temporary" or "other-than-temporary." In deciding on whether or not a security is other than temporarily impaired, the Company considers several factors, including the nature of the investment, communications from the trustees of securitizations regarding the credit quality of the security, the severity and duration of the impairment, the cause of the impairment, and the Company's intent that it is more likely than not that the Company can hold the security until recovery of its cost basis.

The following table presents the other than temporary impairments for the three and nine months ended September 30, 2010. We do not consider comparisons of the three and six months ended September 30, 2009 to be meaningful:

<u>\$ in thousands</u>	<u>Three Months ended September 30, 2010</u>	<u>Nine Months ended September 30, 2010</u>
Credit related other-than-temporary impairments included in earnings	124	510
Non-credit related other-than-temporary impairments recognized in other comprehensive income	—	—
Total other-than-temporary impairment losses	124	510

The following table presents a roll-forward of the credit loss component of other-than-temporary impairments for the three and nine months ended September 30, 2010. We do not consider the comparisons of the three and nine month months ended September 30, 2009 to be meaningful:

<u>\$ in thousands</u>	<u>Three Months ended September 30, 2010</u>	<u>Nine Months ended September 30, 2010</u>
Credit loss amount at the beginning of the period	386	—
Additions for credit losses for which other-than-temporary impairment had not been previously recognized	124	510
Credit loss amount at end of period	510	510

The following table presents components of interest income on the Company's Agency and Non-Agency portfolio for the three and nine months ended September 30, 2010. We do not consider comparisons of the three and nine months ended September 30, 2009 to be meaningful:

**For the three months ended September 30, 2010**

<b><u>\$ in thousands</u></b>	<b>Coupon Interest</b>	<b>Net (Premium Amortization)/Discount Accretion</b>	<b>Interest Income</b>
Agency	17,330	(4,304)	13,026
Non-Agency	11,868	8,637	20,505
CMBS	2,458	69	2,527
Other	9	—	9
Total	<u>31,665</u>	<u>4,402</u>	<u>36,067</u>

**For the nine months ended September 30, 2010**

<b><u>\$ in thousands</u></b>	<b>Coupon Interest</b>	<b>Net (Premium Amortization)/Discount Accretion</b>	<b>Interest Income</b>
Agency	41,328	(12,518)	28,810
Non-Agency	25,050	22,105	47,155
CMBS	7,059	239	7,298
Other	21	—	21
Total	<u>73,458</u>	<u>9,826</u>	<u>83,284</u>

**Note 4 – Investments in Unconsolidated Limited Partnerships**

**Invesco Mortgage Recovery Feeder Fund, L.P. and Invesco Mortgage Recovery Loans AIV, L.P.**

The Company invested in certain Non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing equity capital to a legacy securities PPIF established and managed by the Manager or one of its affiliates, Invesco Mortgage Recovery Feeder Fund, L.P. (the "Fund") that receives financing under the U.S. government's Public-Private Investment Program ("PPIP"). In addition the Manager identified a whole loan transaction for the Company, which resulted in the Company's admission into an alternative investment vehicle, the Invesco Mortgage Recovery Loans AIV, L.P. ("AIV"). The Company's initial commitment in the Fund and AIV was \$25.0 million. The Fund and AIV limited partnership agreements provided for additional subscriptions of limited partners within six months of the initial closing. During 2009 and 2010 the Fund and AIV accepted additional subscriptions and the Company increased its overall commitment to \$100.0 million which effectively increased the Company's initial ownership interest in the Fund and AIV. As of March 31, 2010, the Fund stopped accepting investment subscriptions and was deemed closed. The Company began contributions to the Fund in October 2009. In connection with the increase of the Company's interest in the Fund and AIV, the Company is committed to fund approximately \$45 million of additional capital at September 30, 2010. The Company realized approximately \$2.0 million and \$3.8 million of equity in earnings and \$1.8 million and \$2.1 million of unrealized appreciation from these investments for the three and nine months ended September 30, 2010.

The Company's non-controlling, unconsolidated ownership interests in these entities are accounted for under the equity method. Capital contributions, distributions, profits and losses of the Fund and AIV are allocated in accordance with the terms of the entities' limited partnership agreements. Such allocations may differ from the stated percentage interests, if any, as a result of preferred returns and allocation formulas as described in such agreements. The Company has made the fair value election for its investment in both unconsolidated limited partnerships. The fair value measurement for the investment in unconsolidated limited partnerships is based on the net asset value per share of the investment, or its equivalent.

## Note 5 – Borrowings

### Repurchase Agreements

The Company has entered into repurchase agreements to finance a portion of its portfolio of investments. The repurchase agreements bear interest at a contractually agreed rate. The repurchase obligations mature and typically reinvest every thirty to ninety days and have a weighted average aggregate interest rate of 0.67% and 0.26% at September 30, 2010 and December 31, 2009, respectively. During the second quarter of 2010, the Company entered into a repurchase agreement with a one year maturity. The facility expires in April 2011. These repurchase agreements are being accounted for as secured borrowings since the Company maintains effective control of the financed assets. The following table summarizes certain characteristics of the Company's repurchase agreements at September 30, 2010 and December 31, 2009:

<u>\$ in thousands</u>	<u>September 30, 2010</u>		<u>December 31, 2009</u>	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Agency RMBS	1,296,368	0.30%	545,975	0.26%
Non-Agency RBS	434,262	1.75%	—	—
CMBS	18,339	1.29%	—	—
Total	<u>1,748,969</u>	<u>0.67%</u>	<u>545,975</u>	<u>0.26%</u>

Under the repurchase agreements, the respective lender retains the right to mark the underlying collateral to fair value. A reduction in the value of pledged assets would require the Company to provide additional collateral or fund margin calls. In addition, the repurchase agreements are subject to certain financial covenants. The Company is in compliance with these covenants.

The following tables summarize certain characteristics of the Company's repurchase agreements at September 30, 2010 and December 31, 2009:

<u>September 30, 2010</u> <u>\$ in thousands</u>	<u>Amount</u> <u>Outstanding</u>	<u>Percent of Total</u> <u>Amount</u> <u>Outstanding</u>	<u>Company MBS Held</u> <u>as Collateral</u>
<u>Repurchase Agreement Counterparties</u>			
Credit Suisse Securities (USA) LLC	382,232	22%	454,772
Barclays Capital Inc.	107,057	6%	136,463
RBS Securities Inc.	134,124	8%	161,202
Deutsche Bank Securities Inc.	140,161	8%	149,946
Goldman, Sachs & Co.	230,439	13%	244,852
BNP Paribas Securities Corp.	99,808	6%	104,818
Wells Fargo Securities, LLC	255,755	15%	316,573
Morgan Stanley & Co. Incorporated	108,898	6%	121,696
JP Morgan Securities Inc.	163,484	9%	176,228
Mitsubishi UFJ Securities (USA), Inc.	127,011	7%	130,816
Total	<u>1,748,969</u>	<u>100%</u>	<u>1,997,366</u>

<u>December 31, 2009</u> <u>\$ in thousands</u>	<u>Amount</u> <u>Outstanding</u>	<u>Percent of Total</u> <u>Amount</u> <u>Outstanding</u>	<u>Company MBS Held</u> <u>as Collateral</u>
<u>Repurchase Agreement Counterparties</u>			
Credit Suisse Securities (USA) LLC	109,697	20%	110,501
Barclays Capital Inc.	62,279	12%	64,228
RBS Securities Inc.	83,093	15%	86,503
Deutsche Bank Securities Inc.	115,764	21%	113,804
Goldman, Sachs & Co.	175,142	32%	182,731
Total	<u>545,975</u>	<u>100%</u>	<u>557,767</u>

Cash collateral held by the counterparties at September 30, 2010 and December 31, 2009 was \$30.0 million and \$14.0 million, respectively.

## TALF Financing

Under the TALF, the Federal Reserve made non-recourse loans to borrowers to fund purchases of asset-backed securities (“ABS”). The TALF facility ceased making loans collateralized by newly issued and legacy ABS on March 31, 2010. The Company has secured borrowings of \$151.8 million and \$80.4 million under the TALF at a weighted average interest rate of 3.56% and 3.82% at September 30, 2010 and December 31, 2009, respectively. The TALF loans are non-recourse. However, they are secured by \$206.0 million of CMBS and mature in February 2013, July 2014, August 2014, December 2014 and January 2015.

At September 30, 2010, the TALF financing agreements had the following remaining maturities:

<u>\$ in thousands</u>	<u>September 30, 2010</u>
2011	—
2012	—
2013	33,764
2014	64,739
2015	53,254
Thereafter	—
Total	<u>151,757</u>

## Note 6 – Derivatives and Hedging Activities

### Risk Management Objective of Using Derivatives

The Company is exposed to certain risks arising from both its business operations and general economic conditions. The Company principally manages its exposure to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by managing the amount, source, and duration of its investments, debt funding, and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future unknown and uncertain cash amounts, the value of which are determined by interest rates. The Company’s derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company’s known or expected cash receipts and its known or expected cash payments principally related to the Company’s investments and borrowings.

### Cash Flow Hedges of Interest Rate Risk

The Company finances its investment activities primarily through repurchase agreements, which are generally settled on a short-term basis, usually from one to three months. At each settlement date, the Company refinances each repurchase agreement at the market interest rate at that time. Since the interest rate on its repurchase agreements change on a monthly basis, the Company is exposed to changing interest rates. The Company’s objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

The effective portion of changes in the fair value of derivatives designated and qualifying as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. During the three and nine months ended September 30, 2010, the Company recorded \$9,000 and \$44,000, respectively, of unrealized swap losses in earnings as hedge ineffectiveness attributable primarily to differences in the reset dates on the Company’s swaps versus the refinancing dates of certain of its repurchase agreements. For the three and nine months ended September 30, 2009, the Company recorded \$13,000 of unrealized swap losses in earnings.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest is accrued and paid on the Company's repurchase agreements. During the next twelve months, the Company estimates that an additional \$19.1 million will be reclassified as an increase to interest expense.

The Company is hedging its exposure to the variability in future cash flows for forecasted transactions over a maximum period of 58 months.

As of September 30, 2010, the Company had the following interest rate derivatives outstanding, that were designated as cash flow hedges of interest rate risk:

<u>Counterparty</u>	<u>Notional Amount \$ in thousands</u>	<u>Maturity Date</u>	<u>Fixed Interest Rate in Contract</u>
The Bank of New York Mellon	175,000	8/5/2012	2.07%
SunTrust Bank	100,000	7/15/2014	2.79%
Credit Suisse International	100,000	2/24/2015	3.26%
Credit Suisse International	100,000	3/24/2015	2.76%
The Bank of New York Mellon	100,000	5/24/2013	1.83%
Wells Fargo Bank, N.A.	100,000	7/15/2015	2.85%
The Bank of New York Mellon	200,000	7/15/2013	1.73%
Wells Fargo Bank, N.A.	50,000	7/15/2015	2.44%
Total/Weighted Average	<u>925,000</u>		2.35%

### Tabular Disclosure of the Effect of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments, as well as their classification on the balance sheet as of September 30, 2010 and December 31, 2009.

<u>\$ in thousands</u>							
<u>Asset Derivatives</u>				<u>Liability Derivatives</u>			
<u>As of September 30, 2010</u>		<u>As of December 31, 2009</u>		<u>As of September 30, 2010</u>		<u>As of December 31, 2009</u>	
<u>Balance Sheet</u>	<u>Fair Value</u>	<u>Balance Sheet</u>	<u>Fair Value</u>	<u>Balance Sheet</u>	<u>Fair Value</u>	<u>Balance Sheet</u>	<u>Fair Value</u>
Interest rate swap asset	—	Interest rate swap asset	—	Interest rate swap liability	46,265	Interest rate swap liability	3,782

### Tabular Disclosure of the Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the statement of operations for the three and nine months ended September 30, 2010.

Three months ended September 30, 2010

<u>\$ in thousands</u>					
<u>Derivative type for cash flow hedge</u>	<u>Amount of loss recognized in OCI on derivative (effective portion)</u>	<u>Location of loss reclassified from accumulated OCI into income (effective portion)</u>	<u>Amount of loss reclassified from accumulated OCI into income (effective portion)</u>	<u>Location of loss recognized in income on derivative (ineffective portion)</u>	<u>Amount of loss recognized in income on derivative (ineffective portion)</u>
Interest Rate Swap	19,663	Interest Expense	4,702	Other Expense	9

Nine months ended September 30, 2010

<u>\$ in thousands</u>					
<u>Derivative type for cash flow hedge</u>	<u>Amount of loss recognized in OCI on derivative (effective portion)</u>	<u>Location of loss reclassified from accumulated OCI into income (effective portion)</u>	<u>Amount of loss reclassified from accumulated OCI into income (effective portion)</u>	<u>Location of loss recognized in income on derivative (ineffective portion)</u>	<u>Amount of loss recognized in income on derivative (ineffective portion)</u>
Interest Rate Swap	52,010	Interest Expense	9,572	Other Expense	44

Three and nine months ended September 30, 2009

**\$ in thousands**

Derivative type for cash flow hedge	Amount of loss recognized in OCI on derivative (effective portion)	Location of loss reclassified from accumulated OCI into income (effective portion)	Amount of loss reclassified from accumulated OCI into income (effective portion)	Location of loss recognized in income on derivative (ineffective portion)	Amount of loss recognized in income on derivative (ineffective portion)
Interest Rate Swap	6,672	Interest Expense	1,172	Other Expense	13

### Credit-risk-related Contingent Features

The Company has agreements with each of its derivative counterparties. Some of these agreements contain a provision where if the Company defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Company could also be declared in default on its derivative obligations.

The Company has an agreement with one of its derivative counterparties that contains a provision where if the Company's net asset value declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations. The Company also has agreements with certain of its derivative counterparties that contain provisions where if the Company's shareholders' equity declines by certain percentages over specified time periods, then the Company could be declared in default on its derivative obligations.

The Company has an agreement with certain of its derivative counterparties that contain provisions where if the Company fails to maintain a minimum shareholders' equity or market value of \$100 million and \$80 million, respectively, then the Company could be declared in default on its derivative obligations.

As of September 30, 2010, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was \$47.0 million. The Company has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of approximately \$10.2 million of cash and \$45.7 million of Agency RMBS. If the Company had breached any of these provisions at September 30, 2010, it could have been required to settle its obligations under the agreements at their termination value. The Company was in compliance with all of its financial provisions through September 30, 2010.

### Note 7 – Financial Instruments

U.S. GAAP defines fair value, provides a consistent framework for measuring fair value under U.S. GAAP and Accounting Standards Codification (ASC) Topic 820 expands fair value financial statement disclosure requirements. ASC Topic 820 does not require any new fair value measurements and only applies to accounting pronouncements that already require or permit fair value measures, except for standards that relate to share-based payments.

Valuation techniques are based on observable and unobservable inputs. Observable inputs reflect readily obtainable data from independent sources, while unobservable inputs reflect the Company's market assumptions. 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* – Instruments with primarily unobservable value drivers.

The fair values at September 30, 2010 and December 31, 2009, on a recurring basis, of the Company's MBS and interest rate hedges based on the level of inputs are summarized below:

<b>\$ in thousands</b>	<b>September 30, 2010</b>			<b>Total at Fair Value</b>
	<b>Fair Value Measurements Using:</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	
<b>Assets</b>				
Mortgage-backed securities (1)	—	2,457,871	—	2,457,871
Investments in unconsolidated limited partnerships	—	—	61,290	61,290
<b>Total</b>	—	2,457,871	61,290	2,519,161
<b>Liabilities</b>				
Derivatives	—	46,265	—	46,265
<b>Total</b>	—	46,265	—	46,265
<b>\$ in thousands</b>	<b>December 31, 2009</b>			<b>Total at Fair Value</b>
	<b>Fair Value Measurements Using:</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	
<b>Assets</b>				
Mortgage-backed securities (1)	—	802,592	—	802,592
Investments in unconsolidated limited partnerships	—	—	4,128	4,128
<b>Total</b>	—	802,592	4,128	806,720
<b>Liabilities</b>				
Derivatives	—	3,782	—	3,782
<b>Total</b>	—	3,782	—	3,782

(1) For more detail about the fair value of our MBS and type of securities, see Note 3 in the unaudited consolidated financial statements.

The following table presents additional information about the Company's investments in unconsolidated limited partnerships which are measured at fair value on a recurring basis for which the Company has utilized level 3 inputs to determine fair value:

<b>\$ in thousands</b>	<b>September 30, 2010</b>	<b>December 31, 2009</b>
Beginning balance	4,128	—
Purchases, sales and settlements, net	51,275	4,057
Total net gains / (losses) included in net income		
Realized gains/(losses), net	3,830	63
Unrealized gains/(losses), net	2,057	8
Unrealized gain/(losses), net included in other comprehensive income	—	—
<b>Ending balance</b>	<b>61,290</b>	<b>4,128</b>

The fair value of the TALF debt and repurchase agreements are based on an expected present value technique. This method discounts future estimated cash flows using rates the Company determined best reflect current market interest rates that would be offered for loans with similar characteristics and credit quality. At September 30, 2010, the TALF debt had a fair value of \$158.4 million and a carrying value of \$151.8 million and the repurchase agreements had a fair value of \$1.75 billion and a carrying value of \$1.75 billion. At December 31, 2009, the TALF debt had a fair value of \$80.0 million and a carrying value of \$80.4 million and the repurchase agreements had a fair value of \$546.1 million and a carrying value of \$546.0 million.

#### **Note 8 – Related Party Transactions**

The Company is externally managed and advised by the Manager. Pursuant to the terms of the management agreement, effective July 1, 2009, the Manager provides the Company with its management team, including its officers, along with appropriate support personnel. Each of the Company's officers is an employee of Invesco or one of Invesco's affiliates. The Company does not have any employees. With the exception of the Company's Chief Financial Officer, the Manager is not obligated to dedicate any of its employees exclusively to the Company, nor is the Manager or its employees obligated to dedicate any specific portion of its or their time to the

Company's business. The Manager is at all times subject to the supervision and oversight of the Company's board of directors and has only such functions and authority as the Company delegates to it.

### **Management Fee**

The Company pays the Manager a management fee equal to 1.50% of the Company's shareholders' equity per annum, which is calculated and payable quarterly in arrears. For purposes of calculating the management fee, shareholders' equity is equal to the sum of the net proceeds from all issuances of equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus retained earnings at the end of the most recently completed calendar quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount paid to repurchase common stock since inception, and excluding any unrealized gains, losses or other items that do not affect realized net income (regardless of whether such items are included in other comprehensive income or loss, or in net income). This amount will be adjusted to exclude one-time events pursuant to changes in U.S. GAAP, and certain non-cash items after discussions between the Manager and the Company's independent directors and approval by a majority of the Company's independent directors.

A termination fee is due to the Manager upon termination of the management agreement by the Company equal to three times the sum of the average annual management fee earned by the Manager during the 24-month period prior to such termination, calculated as of the end of the most recently completed fiscal quarter.

The Manager has agreed to reduce (but not below zero) the management fee payable by the Company under the management agreement with respect to any equity investment the Company may make in the Fund managed by the Manager or any of its affiliates. In addition, the Company may include any stock-based compensation awarded to personnel of the Manager as a component of the Manager's compensation.

For the three and nine months ended September 30, 2010, the Company incurred management fees of approximately \$2.0 million and \$5.1 million, respectively of which approximately \$2.0 million was accrued but had not been paid.

### **Expense Reimbursement**

Pursuant to the management agreement, the Company is required to reimburse the Manager for operating expenses related to the Company incurred by the Manager, including certain salary expenses and other expenses related to legal, accounting, due diligence and other services. The Company's reimbursement obligation is not subject to any dollar limitation.

The Company incurred costs, originally paid by Invesco, of approximately \$0.6 million and \$2.7 million for the three and nine months ended September 30, 2010, respectively, compared to approximately \$0.7 million and \$1 million for the three and nine months ended September 30, 2009, respectively. Approximately \$0.5 million and \$1.8 million was expensed for the three and nine months ended September 30, 2010, respectively, compared to \$0.2 million and \$0.3 million for the three and nine months ended September 30, 2009, respectively. Approximately \$0.1 million and \$0.9 million was charged against equity as a cost of raising capital for the three and nine months ended September 30, 2010, respectively, compared to \$0.4 million and \$0.6 million for the three and nine months ended September 30, 2009, respectively. Approximately \$0.1 million was capitalized to other assets for the three and nine months ended September 30, 2009.

### **Note 9 – Shareholders' Equity**

#### **Securities Convertible into Shares of Common Stock**

As of the completion of the Company's IPO on July 1, 2009, (i) the limited partners who hold units of the Operating Partnership ("OP Units") have the right to cause the Operating Partnership to redeem their OP Units for cash equal to the market value of an equivalent number of shares of common stock, or at the Company's option, the Company may purchase their OP Units by issuing one share of common stock for each OP Unit redeemed, and

(ii) the Company adopted an equity incentive plan which includes the ability for the Company to grant securities convertible into the Company's common stock to the independent directors and the executive officers of the Company and the personnel of the Manager.

### **Registration Rights**

The Company entered into a registration rights agreement with regard to the common stock and OP Units owned by the Manager and Invesco Investments (Bermuda) Ltd., respectively, upon completion of the Company's IPO and any shares of common stock that the Manager may elect to receive under the management agreement or otherwise. Pursuant to the registration rights agreement, the Company has granted to the Manager and Invesco Investments (Bermuda) Ltd., (i) unlimited demand registration rights to have the shares purchased by the Manager or granted to it in the future and the shares that the Company may issue upon redemption of the OP Units purchased by Invesco Investments (Bermuda) Ltd. registered for resale, and (ii) in certain circumstances, the right to "piggy-back" these shares in registration statements the Company might file in connection with any future public offering so long as the Company retains the Manager under the management agreement. The registration rights of the Manager and Invesco Investments (Bermuda) Ltd., with respect to the common stock and OP Units that they purchased simultaneously with the Company's IPO, will apply on and after June 25, 2010.

### **Public Offerings**

On January 15, 2010, the Company completed a follow-on public offering of 7,000,000 shares of common stock and an issuance of an additional 1,050,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$21.25 per share. Net proceeds to the Company were \$162.4 million, net of issuance costs of approximately \$8.6 million.

On May 3, 2010, the Company completed an additional follow-on public offering of 9,000,000 shares of common stock at \$20.75 per share. The net proceeds to the Company were \$177.4 million, net of issuance costs of approximately \$9.2 million.

On June 2, 2010, the underwriters purchased an additional 107,800 shares of common stock at \$20.75 per share pursuant to an over-allotment option. The net proceeds to the Company were \$2.1 million, net of issuance costs of approximately \$106,000.

### **Share-Based Compensation**

The Company established the 2009 Equity Incentive Plan for grants of restricted common stock and other equity based awards to the independent directors and the executive officers of the Company and personnel of the Manager (the "Incentive Plan"). Under the Incentive Plan, a total of 1,000,000 shares of common stock are currently reserved for issuance. Unless terminated earlier, the Incentive Plan will terminate in 2019, but will continue to govern the unexpired awards. The Company recognized compensation expense of approximately \$19,000 and \$71,000 for the three and nine months ended September 30, 2010. During the nine months ended September 30, 2010, the Company issued 2,670 shares of restricted stock pursuant to the Incentive Plan to the Company's non-executive directors. The fair market value of the shares granted was determined by the closing stock market price on the date of the grant.

On March 17, 2010, the Company awarded 5,725 restricted stock units to the executive officers of the Company who are employees of the Manager. The restricted stock units vest equally in four installments on the anniversary date of each award. Compensation related to stock awards to officers and employees of the Manager are recorded at the estimated fair value of the award during the vesting period. The Company makes an upward or downward adjustment to compensation expense for the difference in the fair value at the date of grant and the date the award was earned. The Company recognized compensation expense of approximately \$6,000 and \$14,000 for the three and nine months ended September 30, 2010, respectively, related to awards to officers and employees of the Manager.

## Dividends

On September 20, 2010, the Company declared a dividend of \$1.00 per share of common stock. The dividend was paid on October 27, 2010 to shareholders of record as of the close of business on September 30, 2010.

## Note 10 – Earnings per Share

Earnings per share for the three and nine months ended September 30, 2010 is computed as follows:

\$ in thousands	Three Months Ended September 30,		Nine Months Ended September 30,
	2010	2009	2010
<b>Numerator (Income)</b>			
Basic Earnings			
Net income available to common shareholders	26,186	6,203	58,985
Effect of dilutive securities:			
Income allocated to non-controlling interest	1,433	970	3,860
Dilutive net income available to shareholders	<u>27,619</u>	<u>7,173</u>	<u>62,845</u>
<b>Denominator (Weighted Average Shares)</b>			
Basic Earnings:			
Shares available to common shareholders	26,047	8,886	21,552
Effect of dilutive securities:			
Restricted Stock Awards	6	—	4
OP Units	<u>1,425</u>	<u>1,425</u>	<u>1,425</u>
Dilutive Shares	<u>27,478</u>	<u>10,311</u>	<u>22,981</u>

For the nine months ended September 30, 2009, earnings per share is not presented because it is not a meaningful measure of the Company's performance.

## Note 11 – Non-controlling Interest - Operating Partnership

Non-controlling interest represents the aggregate OP Units in the Operating Partnership held by limited partners (the "Unit Holders"). Income allocated to the non-controlling interest is based on the Unit Holders ownership percentage of the Operating Partnership. The ownership percentage is determined by dividing the number of OP Units held by the Unit Holders by the total number of dilutive shares of common stock. The issuance of common stock ("Share" or "Shares") or OP Units changes the percentage ownership of both the Unit Holders and the holders of common stock. Since an OP unit is generally redeemable for cash or Shares at the option of the Company, it is deemed to be equivalent to a Share. Therefore, such transactions are treated as capital transactions and result in an allocation between shareholders' equity and non-controlling interest in the accompanying consolidated balance sheet to account for the change in the ownership of the underlying equity in the Operating Partnership. As of September 30, 2010, non-controlling interest related to the outstanding 1,425,000 OP units represented a 5.2% interest in the Operating Partnership. Income allocated to the Operating Partnership non-controlling interest for the three and nine months ended September 30, 2010, was approximately \$1.4 million and \$3.9 million, respectively. Distributions paid and payable to the non-controlling interest were approximately \$3.7 million and \$1.4 million, respectively.

## Note 12 – Subsequent Events

On October 13, 2010, the Company completed a public offering of 12,000,000 shares of common stock and an additional 1,800,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$20.75 per share. Net proceeds to the Company were approximately \$274.7 million, net of issuance costs of approximately \$11.7 million.

In November 2010, the Company exercised its right to prepay the TALF loans secured by CMBS. The purpose for the prepayment was to obtain lower borrowing costs from other sources. The Company obtained additional advances under existing repurchase agreement financing arrangements.

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

*In this quarterly report on Form 10-Q, or this "Report," we refer to Invesco Mortgage Capital Inc. and its consolidated subsidiaries as "we," "us," "our Company," or "our," unless we specifically state otherwise or the context indicates otherwise. We refer to our external manager, Invesco Advisers, Inc., as our "Manager," and we refer to the indirect parent company of our Manager, Invesco Ltd., together with its consolidated subsidiaries (other than us), as "Invesco."*

The following discussion should be read in conjunction with our consolidated financial statements and the accompanying notes to our consolidated financial statements, which are included in Item 1 of this report, as well as the information contained in our most recent Form 10-K, as amended, filed with the Securities and Exchange Commission (the "SEC").

### **Forward-Looking Statements**

We make forward-looking statements in this Report and other filings we make with the SEC within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, and such statements are intended to be covered by the safe harbor provided by the same. Forward-looking statements are subject to substantial risks and uncertainties, many of which are difficult to predict and are generally beyond our control. These forward-looking statements include information about possible or assumed future results of our business, financial condition, liquidity, results of operations, plans and objectives. When we use the words "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "may" or similar expressions, we intend to identify forward-looking statements. Factors that could cause actual results to differ from those expressed in the Company's forward-looking statements include, but are not limited to:

- the impact of any deficiencies in foreclosure practices of third parties and related delays in the foreclosure process;
- actions and initiatives of the U.S. government and changes to U.S. government policies, including the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and our ability to respond to and comply with such actions, initiatives and changes;
- our ability to obtain additional financing arrangements and the terms of such arrangements;
- financing and advance rates for our target assets;
- changes to our expected leverage;
- general volatility of the securities markets in which we invest;
- interest rate mismatches between our target assets and our borrowings used to fund such investments;
- changes in interest rates and the market value of our target assets;
- changes in prepayment rates on our target assets;
- effects of hedging instruments on our target assets;
- rates of default or decreased recovery rates on our target assets;
- modifications to whole loans or loans underlying securities;

- the degree to which our hedging strategies may or may not protect us from interest rate volatility;
- changes in governmental regulations, tax law and rates, and similar matters and our ability to respond to such changes;
- our ability to qualify as a REIT for U.S. federal income tax purposes;
- our ability to maintain our exclusion from the definition of “investment company” under the 1940 Act;
- availability of investment opportunities in mortgage-related, real estate-related and other securities;
- availability of U.S. government Agency guarantees with regard to payments of principal and interest on securities;
- availability of qualified personnel;
- our understanding of our competition;
- changes to accounting principles generally accepted in the United States of America (“US GAAP”); and
- market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy.

These forward-looking statements are based upon information presently available to our management and are inherently subjective, uncertain and subject to change. There can be no assurance that actual results will not differ materially from our expectations. We caution investors not to rely unduly on any forward-looking statements and urge you to carefully consider the risks identified under the captions “Risk Factors,” “Forward-Looking Statements” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this Report and the most recent Form 10-K, as amended, which is available on the SEC’s website at [www.sec.gov](http://www.sec.gov).

All written or oral forward-looking statements that we make, or that are attributable to us, are expressly qualified by this cautionary notice. We expressly disclaim any obligation to update the information in any public disclosure if any forward-looking statement later turns out to be inaccurate, except as may otherwise be required by law.

## **Overview**

We are a Maryland corporation focused on investing in, financing and managing residential and commercial mortgage-backed securities and mortgage loans. We are externally managed and advised by Invesco Advisers, Inc. (our “Manager”), which is an indirect, wholly-owned subsidiary of Invesco Ltd. (NYSE:IVZ) (“Invesco”). We elected to qualify to be taxed as a REIT commencing with our taxable year ended December 31, 2009. Accordingly, we generally will not be subject to U.S. federal income taxes on our taxable income that we distribute currently to our shareholders as long as we maintain our qualification as a REIT. We operate our business in a manner that will permit us to maintain our exclusion from the definition of “investment company” under the Investment Company Act of 1940, as amended (the “1940 Act”).

Our objective is to provide attractive risk-adjusted returns to our shareholders, primarily through dividends and secondarily through capital appreciation. To achieve this objective, we invest in the following securities:

- Agency RMBS, which are residential mortgage-backed securities, for which a U.S. government Agency such as the Government National Mortgage Association (“Ginnie Mae”) or a federally

chartered corporation such as the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”) guarantees payments of principal and interest on the securities;

- Non-Agency RMBS, which are RMBS that are not issued or guaranteed by a U.S. government Agency or a federally chartered corporation;
- CMBS, which are commercial mortgage-backed securities; and
- Residential and commercial mortgage loans.

We finance our investments in Agency RMBS and Non-Agency RMBS through short-term borrowings structured as repurchase agreements. In addition, we have financed our investments in CMBS with borrowings under the U.S. government’s Term Asset-Backed Securities Loan Facility (“TALF”). We have also financed, and may do so again in the future, our investments in CMBS through short-term borrowings structured as repurchase agreements. We have also financed our investments in certain Non-Agency RMBS, CMBS and residential and commercial mortgage loans by contributing capital to one or more of the legacy securities public-private investment funds (“PPIFs”) that receive financing under the U.S. government’s Public-Private Investment Program (“PIPP”), established and managed by our Manager or one of its affiliates (the “Invesco PPIP Fund”), which, in turn, invests in our target assets.

### **Recent Developments**

Recent announcements of deficiencies in foreclosure documentation by, among others, several large mortgage servicers have raised various concerns relating to foreclosure practices. A number of mortgage servicers have temporarily suspended foreclosure proceedings in some or all states in which they do business while they review and correct their foreclosure practices. In addition, a group consisting of state attorneys general and state bank and mortgage regulators in all 50 states and the District of Columbia has announced it is reviewing foreclosure practices in their various jurisdictions. The extension of foreclosure timelines increases the inventory backlog of distressed homes on the market and creates greater uncertainty about housing prices. Prior to making investments in non-agency RMBS, we carefully consider many factors, including housing prices and foreclosure timelines, and estimate loss assumptions. The concerns about deficiencies in foreclosure practices of servicers and related delays in the foreclosure process may impact our loss assumptions and affect the values of, and our returns on, our investments in non-agency RMBS. Our management is actively reviewing and monitoring the deficiencies and delays in the foreclosure process and assessing its potential impact on our business, financial condition, and results of operations.

### **Factors Impacting Our Operating Results**

Our operating results can be affected by a number of factors and primarily depend on, among other things, the level of our net interest income, the market value of our assets and the supply of, and demand for, the target assets in which we invest. Our net interest income, which includes the amortization of purchase premiums and accretion of purchase discounts, varies primarily as a result of changes in market interest rates and prepayment speeds, as measured by the constant prepayment rate (“CPR”) on our target assets. Interest rates and prepayment speeds vary according to the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty.

### **Market Conditions**

Beginning in the summer of 2007, significant adverse changes in financial market conditions resulted in a deleveraging of the entire global financial system. As part of this process, residential and commercial mortgage markets in the United States experienced a variety of difficulties, including loan defaults, credit losses and reduced liquidity. As a result, many lenders tightened their lending standards, reduced lending capacity, liquidated significant portfolios or exited the market altogether, and therefore, financing with attractive terms was generally unavailable. In response to these unprecedented events, the U.S. government has taken a number of actions to

stabilize the financial markets and encourage lending. Significant measures include the enactment of the Emergency Economic Stabilization Act of 2008 to, among other things, establish the Troubled Asset Relief Program, or TARP, the enactment of the Housing and Economic Recovery Act of 2008, which established a new regulator for Fannie Mae and Freddie Mac and the establishment of the TALF and the PPIP. Some of these programs are beginning to expire and the impact of the wind-down of these programs on the financial sector and on the economic recovery is unknown.

The Federal Reserve initiated a program to purchase Agency securities issued or guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae on January 5, 2009, and completed the purchase program in March 2010. The termination of the purchase program may cause a decrease in demand for Agency securities, which could reduce their market price.

We have elected to participate in programs established by the U.S. government, including the TALF and the PPIP, in order to increase our ability to acquire our target assets and to provide a source of financing for such acquisitions. The TALF was intended to make credit available to consumers and businesses on more favorable terms by facilitating the issuance of asset-backed securities and improving the market conditions for asset-backed securities generally. The Federal Reserve Bank of New York, or FRBNY, made up to \$200 billion of loans under the TALF. The facility ceased making loans collateralized by newly issued and legacy ABS on March 31, 2010. As a result, we are no longer able to obtain additional TALF loans as a source of financing for investments in legacy CMBS.

The PPIP is designed to encourage the transfer of certain illiquid legacy real estate-related assets off of the balance sheets of financial institutions, restarting the market for these assets and supporting the flow of credit and other capital into the broader economy. As of March 31, 2010, the Invesco PPIP Fund stopped accepting investment subscriptions and the fund was deemed closed.

The Dodd-Frank Act enacted on July 21, 2010, contains numerous provisions affecting the financial and mortgage industries, many of which may have an impact on our operating environment and the target assets in which we invest. Consequently, the Dodd-Frank Act may affect our cost of doing business, may limit our investment opportunities and may affect the competitive balance within our industry and market areas.

## **Investment Activities**

As of September 30, 2010, 20.1% of our equity was invested in Agency RMBS, 58.5% in Non-Agency RMBS, 10.4% in CMBS, and 11.0% in the Invesco PPIP Fund. We use leverage on our target assets to achieve our return objectives. For our investments in Agency RMBS, we focus on securities we believe provide attractive returns when levered approximately 6 to 8 times. For our investments in Non-Agency RMBS, we invest in securities that provide attractive returns leveraged 1 to 2 times. The leverage on each class of asset may periodically exceed the stated ranges as we adjust our borrowings to obtain the best available source and minimize total interest expense, while maintaining our overall portfolio leverage guidelines.

As of September 30, 2010, we had approximately \$707.1 million in 30-year fixed rate securities that offered higher coupons and call protection based on the collateral attributes. We balanced this with approximately \$697.5 million in 15-year fixed rate, approximately \$34.8 million in hybrid adjustable-rate mortgages ("ARMs") and approximately \$8.2 million in ARMs we believe to have similar durations based on prepayment speeds. As of September 30, 2010, we had purchased approximately \$759.2 million Non-Agency RMBS.

Our investments in CMBS are securities for which we were able to obtain financing under the TALF. We have also financed, and may do so again in the future, our investments in CMBS through repurchase agreements and private financing sources. Our primary focus is on investing in AAA-rated securities issued prior to 2008. As of September 30, 2010, we owned approximately \$227.5 million in CMBS and financed such assets with a \$151.8 million TALF loan and \$18.3 million in repurchase agreements. In addition, as of September 30, 2010, we had purchased approximately \$23.5 million in CMOs.

## Investment Portfolio

The following table summarizes certain characteristics of our investment portfolio as of September 30, 2010:

<u>\$ in thousands</u>	<u>Principal Balance</u>	<u>Unamortized Premium (Discount)</u>	<u>Amortized Cost</u>	<u>Unrealized Gain/ (Loss)</u>	<u>Fair Value</u>	<u>Net Weighted Average Coupon <sup>(1)</sup></u>	<u>Average Yield <sup>(2)</sup></u>
Agency RMBS:							
15 year fixed-rate	656,387	33,487	689,874	7,648	697,522	4.88%	3.24%
30 year fixed-rate	652,555	44,993	697,548	9,568	707,116	5.82%	3.87%
ARM	8,247	180	8,427	(245)	8,182	3.04%	2.23%
Hybrid ARM	33,112	1,081	34,193	630	34,823	4.08%	3.14%
Total Agency	<u>1,350,301</u>	<u>79,741</u>	<u>1,430,042</u>	<u>17,601</u>	<u>1,447,643</u>	5.30%	3.54%
MBS-CMO	22,085	889	22,974	540	23,514	5.89%	4.52%
Non-Agency MBS	1,078,638	(341,410)	737,228	21,984	759,212	4.68%	6.68%
CMBS	211,512	(2,899)	208,613	18,889	227,502	5.17%	5.45%
Total	<u>2,662,536</u>	<u>(263,679)</u>	<u>2,398,857</u>	<u>59,014</u>	<u>2,457,871</u>	5.05%	4.68%

(1) Net weighted average coupon ("WAC") is presented net of servicing and other fees.

(2) Average yield incorporates future prepayment assumptions.

The following table summarizes certain characteristics of our investment portfolio, at fair value, according to their estimated weighted average life classifications as of September 30, 2010:

<u>\$ in thousands</u>	<u>September 30, 2010</u>
Less than one year	42,502
Greater than one year and less than five years	1,881,136
Greater than or equal to five years	534,233
Total	<u>2,457,871</u>

The following table presents certain information about the carrying value of our available for sale MBS at September 30, 2010:

<u>\$ in thousands</u>	<u>September 30, 2010</u>
Principal balance	2,662,536
Unamortized premium	82,433
Unamortized discount	(346,112)
Gross unrealized gains	70,935
Gross unrealized losses	(11,921)
Carrying value/estimated fair value	<u>2,457,871</u>

*Financing and Other Liabilities.* We enter into repurchase agreements to finance the majority of our Agency RMBS, Non-Agency RMBS and a portion of our CMBS. These agreements are secured by our Agency RMBS, Non-Agency RMBS and a portion of our CMBS and bear interest at rates that have historically moved in close relationship to the London Interbank Offer Rate ("LIBOR"). As of September 30, 2010, we had entered into repurchase agreements totaling \$1.7 billion. In addition, we funded most of our CMBS portfolio with borrowings of \$151.8 million under the TALF. The TALF loans are non-recourse and mature in February 2013, July 2014, August 2014, December 2014 and January 2015. Finally, we committed to invest up to \$100.0 million in the Invesco PPIP fund, which, in turn, invests in our target assets. As of September 30, 2010, approximately \$55 million of our commitment to the Invesco Fund has been called.

*Hedging Instruments.* We generally hedge as much of our interest rate risk as we deem prudent in light of market conditions. No assurance can be given that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Our investment policies do not contain specific requirements as to the percentages or amount of interest rate risk that we are required to hedge.

Interest rate hedging may fail to protect or could adversely affect us because, among other things:

- available interest rate hedging may not correspond directly with the interest rate risk for which protection is sought;
- the duration of the hedge may not match the duration of the related liability;
- the party owing money in the hedging transaction may default on its obligation to pay;
- the credit quality of the party owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
- the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value. Downward adjustments (“mark-to-market losses”) would reduce our shareholders’ equity.

As of September 30, 2010, we have entered into interest rate swap agreements designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swap agreements provide for fixed interest rates indexed off of one-month LIBOR and effectively fix the floating interest rates on \$925.0 million of borrowings under our repurchase agreements as of September 30, 2010. We intend to continue to add interest rate hedge positions according to our hedging strategy.

The following table summarizes our hedging activity as of September 30, 2010:

<b>Counterparty</b>	<b>Notional Amount \$ in thousands</b>	<b>Maturity Date</b>	<b>Fixed Interest Rate in Contract</b>
The Bank of New York Mellon	175,000	8/5/2012	2.07%
SunTrust Bank	100,000	7/15/2014	2.79%
Credit Suisse International	100,000	2/24/2015	3.26%
Credit Suisse International	100,000	3/24/2015	2.76%
The Bank of New York Mellon	100,000	5/24/2013	1.83%
Wells Fargo Bank, N.A.	100,000	7/15/2015	2.85%
The Bank of New York Mellon	200,000	7/15/2013	1.73%
Wells Fargo Bank, N.A.	50,000	7/15/2015	2.44%
Total/Weighted Average	925,000		2.35%

### **Book Value per Share**

Our book value was \$20.28 and \$20.39 as of September 30, 2010 and December 31, 2009, respectively, on a fully diluted basis, after giving effect to our units of limited partnership interest in our operating partnership, which may be converted to common shares at the sole election of the Company.

### **Critical Accounting Policies**

Our consolidated financial statements are prepared in accordance with U.S. GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. Our most critical accounting policies involve decisions and assessments that could affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our consolidated financial statements are based are reasonable at the time made and based upon information available to us at that time. We rely upon independent pricing of our assets at each quarter’s end to arrive at what we believe to be reasonable estimates of fair market value. The complete listing of our Critical Accounting Policies was disclosed in our 2009 annual report on Form 10-K, as amended, as filed with the SEC on March 24, 2010, and there have been no material changes to our Critical Accounting Policies as disclosed therein.

## Results of Operations

The table below presents certain information from our Consolidated Statement of Operations for the three and nine month periods ending September 30, 2010 and September 30, 2009.

\$ in thousands, except per share data	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
<b>Revenues</b>				
Interest income	36,067	10,983	83,284	10,983
Interest expense	8,873	2,070	18,904	2,070
<b>Net interest income</b>	<b>27,194</b>	<b>8,913</b>	<b>64,380</b>	<b>8,913</b>
<b>Other income (loss)</b>				
Gain (loss) on sale of investments	(311)	—	1,064	—
Equity in earnings and fair value change in unconsolidated limited partnerships	3,793	—	5,888	—
Loss on other-than-temporarily impaired securities	(124)	—	(510)	—
Unrealized loss on interest rate swaps	(9)	(13)	(44)	(13)
<b>Total other income</b>	<b>3,349</b>	<b>(13)</b>	<b>6,398</b>	<b>(13)</b>
<b>Expenses</b>				
Management fee – related party	2,039	753	5,094	753
General and administrative	263	245	729	349
Insurance	236	354	929	369
Professional Fees	386	375	1,181	388
<b>Total expenses</b>	<b>2,924</b>	<b>1,727</b>	<b>7,933</b>	<b>1,859</b>
Net income (loss)	27,619	7,173	62,845	7,041
Net income attributable to non-controlling interest	1,433	970	3,860	970
Net income attributable to common shareholders	26,186	6,203	58,985	6,071
Earnings per share:				
Net income attributable to common shareholders (basic and diluted)	1.01	0.70	2.74	NM
Dividends declared per common share	1.00	—	2.52	—
Weighted average number of shares of common stock:				
Basic	26,047	8,886	21,552	NM
Diluted	27,478	10,311	22,981	NM

## Net Income Summary

For the three months ended September 30, 2010, our net income was \$26.2 million or \$1.01 basic and diluted income per weighted average share available to common shareholders compared to \$6.2 million or \$0.70 basic and diluted income per weighted average share available to common shareholders for the three months ended September 30, 2009.

For the nine months ended September 30, 2010, our net income was \$59.0 million compared to \$6.1 million for the nine months ended September 30, 2009.

The increase to net income is primarily attributable to the growth in our investment portfolio resulting from our follow-on public offerings in January 2010 and May 2010.

### Interest Income and Average Earning Asset Yield

Our primary source of income is interest earned on our investment portfolio. We had average earning assets of \$2.4 billion and \$870.9 million and earned interest income of \$36.1 million and \$11.0 million for the three months ended September 30, 2010 and September 30, 2009, respectively. The yield on our average investment portfolio was 6.01% and 5.04% for the respective periods. The change in our average assets and the portfolio yield was primarily the result of the increase in our investment portfolio after our January 2010 and May 2010 follow-on common stock offerings.

The CPR of our portfolio impacts the amount of premium and discount on the purchase of securities that is recognized into income. Our Agency and Non-Agency RMBS had a weighted average CPR of 13.7 and 14.2 for the three months ended September 30, 2010 and June 30, 2010, respectively. The table below shows the three month CPR for our RMBS compared to bonds with similar characteristics (“Cohorts”):

	September 30, 2010		June 30, 2010	
	Company	Cohort	Company	Cohort
15 year Agency RMBS	12.3	27.0	11.4	19.0
30 year Agency RMBS	14.3	31.1	16.0	29.2
Agency Hybrid ARM RMBS	28.9	N/A	46.1	N/A
Non-Agency RMBS	17.8	N/A	16.3	N/A
Overall	13.7	N/A	14.2	N/A

On February 10, 2010, Fannie Mae and Freddie Mac announced their intention to purchase delinquent loans from certain mortgage pools guaranteed by them. For purposes of these purchases, delinquent loans are those that are 120 days or greater delinquent as of the measurement date. The impact of the increased buy-outs would accelerate the amortization of premium paid for these Agency RMBS, which would reduce our interest income. In the fourth quarter of 2009, the Company correctly anticipated the increased buy-outs and sold several Agency RMBS that were at risk. For the six month period ended June 30, 2010, the Company’s estimates the increased buy-outs reduced interest income by \$2.0 million as a result of higher premium amortization. For the quarter ended September 30, 2010, the buy-outs had no significant impact on interest income. For the Agency RMBS held in the portfolio as of September 30, 2010, the Company estimates that the completion of this buy-out program will have no significant effect on future periods.

### Interest Expense and the Cost of Funds

Our largest expense is the interest expense on borrowed funds. We had average borrowed funds of \$1.9 billion and \$662.5 million and total interest expense of \$8.9 million and \$2.1 million for the three months ended September 30, 2010 and September 30, 2009, respectively. The increase in average borrowed funds and interest expense was primarily the result of increasing our investment portfolio with the proceeds of our January 2010 and May 2010 follow-on public offerings.

Our average cost of funds was 1.90% and 1.25% for the three months ended September 30, 2010 and September 30, 2009, respectively. Since a substantial portion of our repurchase agreements are short term, changes in market rates are directly reflected in our interest expense. Interest expense includes borrowing costs under repurchase agreements, the TALF borrowing, as well as any hedging costs for our cash flow hedges.

## **Net Interest Income**

Our net interest income, which equals interest income less interest expense, totaled \$27.2 million and \$8.9 million for the three months ended September 30, 2010 and September 30, 2009, respectively. Our net interest rate margin, which equals the yield on our average assets for the period less the average cost of funds for the period, was 4.11% and 3.79% for the three months ended September 30, 2010 and September 30, 2009, respectively. The increase in net interest income was primarily the result of increasing our investment portfolio with the proceeds of our January 2010 and May 2010 follow-on public offerings.

## **Gain (Loss) on Sale of Investments**

As part of our credit process, all of our MBS are reviewed on a monthly basis to determine if they continue to meet our risk and return targets. This process involves looking at changing market assumptions and the impact those assumptions will have on the individual securities. As a result of our change in market assumptions, we sold securities and recognized net loss of approximately \$311,000 and \$0 for the three month periods ended September 30, 2010 and September 30, 2009, respectively.

## **Loss on Other-Than Temporary Impaired Securities**

For the three months ended September 30, 2010 and September 30, 2009, we recognized losses of approximately \$124,000 and \$0, respectively, on other-than-temporarily impaired securities in the consolidated statement of operations which had been included in accumulated other comprehensive income. Credit losses on Non-Agency RMBS were anticipated and included in the price paid for the asset at acquisition and are included in the security's estimated yield at acquisition.

## **Equity in Earnings and Change in Fair Value of Unconsolidated Limited Partnerships**

For the three and nine months ended September 30, 2010, we recognized equity in earnings of approximately \$2.0 million and \$3.8 million, respectively, and unrealized income on the change in fair value of our investment in the Invesco PPIP Fund of approximately \$1.8 million and \$2.1 million, respectively. The Company began contributions to the PPIP Fund in October 2009. The increase in equity in earnings and unrealized income on the change in fair value was primarily the result of an increase in the fair value of the PPIP Fund.

## **Other Income (Loss)**

Our other income (loss) relates to the unrealized loss on interest rate swaps of approximately \$9,000 and \$13,000 which represents the ineffective portion of the change in fair value of our interest rate swaps which is recognized directly in earnings for the three months ended September 30, 2010 and September 30, 2009, respectively.

## **Expenses**

We incurred management fees of \$2.0 million and \$753,000 for the three months ended September 30, 2010, and September 30, 2009, respectively, which are payable to our Manager under our management agreement. The increase in management fees is attributable to an increase in shareholders' equity resulting from our follow-on public offerings in 2010. This management fee and the relationship between the Company and the Manager are discussed further in our discussion of related party relationships.

Our general and administrative expense of approximately \$263,000 and \$245,000 for the three months ended September 30, 2010 and September 30, 2009, respectively, includes the salary and the estimated bonus of our CFO, amortization of equity based compensation related to anticipated quarterly grants of our common stock to the Company's independent directors, payable subsequent to each calendar quarter, amortization of equity based compensation related to restricted stock grants to our executive officers who are employees of our Manager, cash based payments to our Company's independent directors, derivative transaction fees, software licensing, industry memberships, filing fees, travel, and other miscellaneous general and administrative costs.

Our insurance expense of approximately \$236,000 and \$354,000 for the three months ended September 30, 2010 and September 30, 2009, respectively, represents the cost of liability insurance to indemnify our directors and officers. The decrease in insurance expense is attributed to a reduction to insurance premium costs.

Our professional fees of approximately \$386,000 and \$375,000 for the three months ended September 30, 2010 and September 30, 2009, respectively, represents the cost of legal, accounting, auditing and consulting services provided to us by third party service providers.

### **Net Income and Return on Average Equity**

Our net income was \$27.6 million and \$7.2 million for the three months ended September 30, 2010 and September 30, 2009, respectively. Our annualized return on average equity was 19.71% and 13.73% for the three months ended September 30, 2010 and September 30, 2009, respectively. The increase in net income and return on average equity was primarily the result of increasing our investment portfolio through the investment of the proceeds of our January 2010 and May 2010 follow-on offerings in our target assets.

### **Liquidity and Capital Resources**

Liquidity is a measurement of our ability to meet potential cash requirements, including ongoing commitments to pay dividends, fund investments and other general business needs. Our primary sources of funds for liquidity consists of the net proceeds from our common equity offerings, net cash provided by operating activities, cash from repurchase agreements and other financing arrangements and future issuances of equity and/or debt securities. We also have financed, and may continue to finance our assets under, and may otherwise participate in, programs established by the U.S. government.

We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings and the payment of cash dividends as required for continued qualification as a REIT. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on the balance sheet is significantly less important than our potential liquidity available under borrowing arrangements.

We allocate our equity to each of our target assets and apply leverage to obtain our net interest income. We invest in assets that provide attractive returns with an aggregate debt-to-equity ratio of 3 to 5 times. To obtain this total leverage we lever Agency RMBS 6 to 8 times, Non-Agency RMBS 1 to 2 times and CMBS 3 to 4 times. The table below shows the allocation of our equity and debt-to-equity ratio as of September 30, 2010. The leverage on each class of assets may periodically exceed the stated ranges as we adjust our borrowings to obtain the best available source and minimize total interest expense while maintaining our overall portfolio leverage guidelines.

<b><u>\$ in thousands</u></b>	<b><u>Agency</u></b>	<b><u>Non-Agency</u></b>	<b><u>CMBS</u></b>	<b><u>PPIF</u></b>	<b><u>Total</u></b>
Borrowings	1,296,368	434,262	170,096	—	1,900,726
Equity allocation	111,868	325,870	58,050	61,290	557,078
Debt / Equity Ratio	11.6	1.3	2.9	—	3.4
% of Total Equity	20.1%	58.5%	10.4%	11.0%	100.0%

We enter into repurchase agreements with various counterparties to fund our purchase of MBS. The following table summarizes our total borrowings by type of investment as of September 30, 2010 and December 31, 2009:

<u>\$ in thousands</u>	<u>September 30, 2010</u>		<u>December 31, 2009</u>	
	Amount Outstanding	Weighted Average Interest Rate	Amount Outstanding	Weighted Average Interest Rate
Repurchase Agreements				
Agency RMBS	1,296,368	0.30%	545,975	0.26%
Non-Agency RBS	434,262	1.75%	—	—
CMBS	18,339	1.29%	—	—
Total Repurchase agreements	<u>1,748,969</u>	0.67%	<u>545,975</u>	0.26%
CMBS under TALF	<u>151,757</u>	3.56%	<u>80,377</u>	3.82%
Total Borrowings	<u>1,900,726</u>	0.90%	<u>626,352</u>	0.72%

As of September 30, 2010, the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount, which we also refer to as the “haircut,” under our repurchase agreements for Agency RMBS was approximately 4.56% (weighted by borrowing amount) and under our repurchase agreements for Non-Agency RMBS was approximately 25.75%. Across our repurchase facilities for Agency RMBS, the haircuts range from a low of 3% to a high of 8% and for Non-Agency RMBS range from a low of 15% to a high of 66%. Our hedged cost of funds was approximately 1.80% and 1.32% as of September 30, 2010 and December 31, 2009, respectively. Declines in the value of our securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event would give some of our counterparties the option to terminate all repurchase transactions existing with us and require any amount due by us to the counterparties to be payable immediately.

As discussed above under “Market Conditions,” the residential mortgage market in the United States has experienced difficult economic conditions including:

- increased volatility of many financial assets, including Agency securities and other high-quality RMBS assets, due to news of potential security liquidations;
- increased volatility and deterioration in the broader residential mortgage and RMBS markets; and
- significant disruption in financing of RMBS.

If these conditions persist, then our lenders may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of required equity capital or haircut, any of which could make it more difficult or costly for us to obtain financing.

#### *Effects of Margin Requirements, Leverage and Credit Spreads*

Our securities have values that fluctuate according to market conditions and, as discussed above, the market value of our securities will decrease as prevailing interest rates or credit spreads increase. When the value of the securities pledged to secure a repurchase loan decreases to the point where the positive difference between the collateral value and the loan amount is less than the haircut, our lenders may issue a “margin call,” which means that the lender will require us to pay the margin call in cash or pledge additional collateral to meet that margin call. Under our repurchase facilities, our lenders have full discretion to determine the value of the securities we pledge to them. Most of our lenders will value securities based on recent trades in the market. Lenders also issue margin calls as the published current principal balance factors change on the pool of mortgages underlying the securities pledged as collateral when scheduled and unscheduled paydowns are announced monthly.

We experience margin calls in the ordinary course of our business. In seeking to effectively manage the margin requirements established by our lenders, we maintain a position of cash and unpledged securities. We refer to this position as our “liquidity.” The level of liquidity we have available to meet margin calls is directly affected

by our leverage levels, our haircuts and the price changes on our securities. If interest rates increase as a result of a yield curve shift, or if credit spreads widen or for another reason, then the prices of our collateral (and our unpledged assets that constitute our liquidity) will decline, we will experience margin calls, and we will use our liquidity to meet the margin calls. There can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls. If our haircuts increase, our liquidity will proportionately decrease. In addition, if we increase our borrowings, our liquidity will decrease by the amount of additional haircut on the increased level of indebtedness.

We intend to maintain a level of liquidity in relation to our assets that enables us to meet reasonably anticipated margin calls but that also allows us to be substantially invested in securities. We may misjudge the appropriate amount of our liquidity by maintaining excessive liquidity, which would lower our investment returns, or by maintaining insufficient liquidity, which would force us to liquidate assets into unfavorable market conditions and harm our results of operations and financial condition.

#### *Forward-Looking Statements Regarding Liquidity*

Based upon our current portfolio, leverage rate and available borrowing arrangements, we believe that the net proceeds of our common equity offerings and private placements, combined with cash flow from operations and available borrowing capacity, will be sufficient to enable us to meet anticipated short-term (one year or less) liquidity requirements to fund our investment activities, pay fees under our management agreement, fund our distributions to shareholders and for other general corporate expenses.

Our ability to meet our long-term (greater than one year) liquidity and capital resource requirements will be subject to obtaining additional debt financing and equity capital. We may increase our capital resources by obtaining long-term credit facilities or through public or private offerings of equity or debt securities, possibly including classes of preferred stock, common stock, and senior or subordinated notes. Such financing will depend on market conditions for capital raises and our ability to invest such offering proceeds. If we are unable to renew, replace or expand our sources of financing on substantially similar terms, it may have an adverse effect on our business and results of operations.

#### **Contractual Obligations**

On July 1, 2009, we entered into an agreement with our Manager pursuant to which our Manager is entitled to receive a management fee and the reimbursement of certain expenses. The management fee will be calculated and payable quarterly in arrears in an amount equal to 1.50% of our shareholders' equity, per annum, calculated and payable quarterly in arrears. Our Manager will use the proceeds from its management fee in part to pay compensation to its officers and personnel who, notwithstanding that certain of those individuals are also our officers, will receive no cash compensation directly from us. We are required to reimburse our Manager for operating expenses related to us incurred by our Manager, including certain salary expenses and other expenses relating to legal, accounting, due diligence and other services. Expense reimbursements to our Manager are made in cash on a monthly basis following the end of each month. Our reimbursement obligation is not subject to any dollar limitation.

#### **Contractual Commitments**

As of September 30, 2010, we had the following contractual commitments and commercial obligations:

<b>\$ in thousands</b>	<b>Payments Due by Period</b>				
	<b>Total</b>	<b>Less than 1 year</b>	<b>1-3 years</b>	<b>3-5 years</b>	<b>After 5 years</b>
Repurchase agreements	1,748,969	1,748,969	—	—	—
TALF financing	151,757	—	33,764	117,993	—
Invesco PPIP Fund investment	61,290	—	61,290	—	—
<b>Total contractual obligations</b>	<b>1,962,016</b>	<b>1,748,969</b>	<b>95,054</b>	<b>117,993</b>	<b>—</b>

As of September 30, 2010, we have approximately \$2.0 million and \$24.2 million in contractual interest payments related to our repurchase agreements and TALF financings, respectively.

### **Off-Balance Sheet Arrangements**

We committed to invest up to \$100.0 million in the Invesco PPIP Fund, which, in turn, invests in our target assets. As of September 30, 2010, approximately \$55.0 million of the commitment has been called.

### **Shareholders' Equity**

On January 15, 2010, we completed a follow-on public offering of 7,000,000 shares of common stock and an issuance of an additional 1,050,000 shares of common stock pursuant to the underwriters' full exercise of their over-allotment option at \$21.25 per share. The net proceeds to us were \$162.4 million, net of issuance costs of approximately \$8.6 million.

On May 3, 2010, we completed an additional follow-on public offering of 9,000,000 shares of common stock at \$20.75 per share. The net proceeds to us were \$177.4 million, net of issuance costs of approximately \$9.2 million. On June 2, 2010, the underwriters purchased an additional 107,800 shares of common stock at \$20.75 per share pursuant to an over-allotment option. The net proceeds to us were approximately \$2.1 million, net of issuance costs of approximately \$106,000.

### **Unrealized Gains and Losses**

Since we account for our investment securities as "available-for-sale," unrealized fluctuations in market values of assets do not impact our U.S. GAAP income but rather are reflected on our balance sheet by changing the carrying value of the asset and shareholders' equity under "Accumulated Other Comprehensive Income (Loss)." In addition, unrealized fluctuations in market values of our cash flow hedges that qualify for hedge accounting are also reflected in "Accumulated Other Comprehensive Income (Loss)."

As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting. As a result, comparisons with companies that use historical cost accounting for some or all of their balance sheet may not be meaningful.

### **Dividends**

We intend to continue to make regular quarterly distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its REIT taxable income, determined without regard to the deduction for dividends paid and excluding net capital gains, and that it pay tax at regular corporate rates to the extent that it annually distributes less than 100% of its net taxable income. We intend to pay regular quarterly dividends to our shareholders in an amount equal at least 90% of our net taxable income. Before we pay any dividend, whether for U.S. federal income tax purposes or otherwise, we must first meet both our operating requirements and debt service on our repurchase agreements and other debt payables. If our cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions, or we may make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities.

On September 20, 2010, the Company declared a dividend of \$1.00 per share of common stock. The dividend was paid on October 27, 2010 to shareholders of record as of the close of business on September 30, 2010.

## **Inflation**

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates.

## **Other Matters**

We calculate that at least 75% of our assets were qualified REIT assets, as defined in the Internal Revenue Code of 1986, as amended (the “Code”) for the period ended September 30, 2010. We also calculate that our revenue qualifies for the 75% source of income test and for the 95% source of income test rules for the period ended September 30, 2010. Consequently, we met the REIT income and asset test as of September 30, 2010. We also met all REIT requirements regarding the ownership of our common stock and the distribution of our net income as of September 30, 2010. Therefore, as of September 30, 2010, we believe that we qualified as a REIT under the Code.

We at all times intend to conduct our business so as not to become regulated as an investment company under the 1940 Act. If we were to become required to register as an investment company, then our use of leverage would be substantially reduced. Because we are a holding company that conducts our business through our operating partnership and the wholly-owned or majority-owned subsidiaries of our operating partnership, the securities issued by these subsidiaries that are excepted from the definition of “investment company” under Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, together with any other investment securities the operating partnership may own, may not have a combined value in excess of 40% of the value of the operating partnership’s total assets (exclusive of U.S. government securities and cash) on an unconsolidated basis, which we refer to as the 40% test. This requirement limits the types of businesses in which we may engage through our subsidiaries. In addition, we believe neither the company nor the operating partnership are considered an investment company under Section 3(a)(1)(A) of the 1940 Act because they do not engage primarily or hold themselves out as being engaged primarily in the business of investing, reinvesting or trading in securities. Rather, through the operating partnership’s wholly-owned or majority-owned subsidiaries, the company and the operating partnership are primarily engaged in the non-investment company businesses of these subsidiaries. IAS Asset I LLC and certain of the operating partnership’s other subsidiaries that we may form in the future rely upon the exclusion from the definition of “investment company” under the 1940 Act provided by Section 3(c)(5)(C) of the 1940 Act, which is available for entities “primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.” This exclusion generally requires that at least 55% of each subsidiary’s portfolio be comprised of qualifying assets and at least 80% be comprised of qualifying assets and real estate-related assets (and no more than 20% comprised of miscellaneous assets). Qualifying assets for this purpose include mortgage loans fully secured by real estate and other assets, such as whole pool Agency and Non-Agency RMBS, that the SEC or its staff in various no-action letters has determined are the functional equivalent of mortgage loans fully secured by real estate. We treat as real estate-related assets CMBS, debt and equity securities of companies primarily engaged in real estate businesses, Agency partial pool certificates and securities issued by pass-through entities of which substantially all of the assets consist of qualifying assets and/or real estate-related assets. Additionally, unless certain mortgage securities represent all the certificates issued with respect to an underlying pool of mortgages, the MBS may be treated as securities separate from the underlying mortgage loans and, thus, may not be considered qualifying interests for purposes of the 55% requirement. We calculate that as of September 30, 2010, we were in compliance with this requirement.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

The primary components of our market risk are related to interest rate, prepayment and market value. While we do not seek to avoid risk completely, we believe the risk can be quantified from historical experience and we seek to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

#### **Interest Rate Risk**

Interest rate risk is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations, and other factors beyond our control. We are subject to interest rate risk in connection with our investments and our repurchase agreements. Our repurchase agreements are typically of limited duration and will be periodically refinanced at current market rates. We mitigate this risk through utilization of derivative contracts, primarily interest rate swap agreements, interest rate caps and interest rate floors.

#### **Interest Rate Effect on Net Interest Income**

Our operating results depend in large part upon differences between the yields earned on our investments and our cost of borrowing and interest rate hedging activities. Most of our repurchase agreements provide financing based on a floating rate of interest calculated on a fixed spread over LIBOR. The fixed spread will vary depending on the type of underlying asset which collateralizes the financing. Accordingly, the portion of our portfolio which consists of floating interest rate assets are match-funded utilizing our expected sources of short-term financing, while our fixed interest rate assets are not match-funded. During periods of rising interest rates, the borrowing costs associated with our investments tend to increase while the income earned on our fixed interest rate investments may remain substantially unchanged. This increase in borrowing costs results in the narrowing of the net interest spread between the related assets and borrowings and may even result in losses. Further, during this portion of the interest rate and credit cycles, defaults could increase and result in credit losses to us, which could adversely affect our liquidity and operating results. Such delinquencies or defaults could also have an adverse effect on the spread between interest-earning assets and interest-bearing liabilities.

Hedging techniques are partly based on assumed levels of prepayments of our RMBS. If prepayments are slower or faster than assumed, the life of the RMBS will be longer or shorter, which would reduce the effectiveness of any hedging strategies we may use and may cause losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns.

#### **Interest Rate Effects on Fair Value**

Another component of interest rate risk is the effect that changes in interest rates will have on the market value of the assets that we acquire. We face the risk that the market value of our assets will increase or decrease at different rates than those of our liabilities, including our hedging instruments.

We primarily assess our interest rate risk by estimating the duration of our assets and the duration of our liabilities. Duration measures the market price volatility of financial instruments as interest rates change. We generally calculate duration using various financial models and empirical data. Different models and methodologies can produce different duration numbers for the same securities.

The impact of changing interest rates on fair value can change significantly when interest rates change materially. Therefore, the volatility in the fair value of our assets could increase significantly in the event interest rates change materially. In addition, other factors impact the fair value of our interest rate-sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, changes in actual interest rates may have a material adverse effect on us.

## Prepayment Risk

As we receive prepayments of principal on our investments, premiums paid on these investments are amortized against interest income. In general, an increase in prepayment rates will accelerate the amortization of purchase premiums, thereby reducing the interest income earned on the investments. Conversely, discounts on such investments are accreted into interest income. In general, an increase in prepayment rates will accelerate the accretion of purchase discounts, thereby increasing the interest income earned on the investments.

## Extension Risk

We compute the projected weighted-average life of our investments based upon assumptions regarding the rate at which the borrowers will prepay the underlying mortgages. In general, when a fixed-rate or hybrid adjustable-rate security is acquired with borrowings, we may, but are not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes our borrowing costs for a period close to the anticipated average life of the fixed-rate portion of the related assets. This strategy is designed to protect us from rising interest rates, because the borrowing costs are fixed for the duration of the fixed-rate portion of the related target asset.

However, if prepayment rates decrease in a rising interest rate environment, then the life of the fixed-rate portion of the related assets could extend beyond the term of the swap agreement or other hedging instrument. This could have a negative impact on our results from operations, as borrowing costs would no longer be fixed after the end of the hedging instrument, while the income earned on the hybrid adjustable-rate assets would remain fixed. This situation may also cause the market value of our hybrid adjustable-rate assets to decline, with little or no offsetting gain from the related hedging transactions. In extreme situations, we may be forced to sell assets to maintain adequate liquidity, which could cause us to incur losses.

## Market Risk

### *Market Value Risk*

Our available-for-sale securities are reflected at their estimated fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income pursuant to ASC Topic 320. The estimated fair value of these securities fluctuates primarily due to changes in interest rates and other factors. Generally, in a rising interest rate environment, the estimated fair value of these securities would be expected to decrease; conversely, in a decreasing interest rate environment, the estimated fair value of these securities would be expected to increase.

The sensitivity analysis table presented below shows the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments and net interest income, at September 30, 2010, assuming a static portfolio. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our Manager's expectations. The analysis presented utilized assumptions, models and estimates of our Manager based on our Manager's judgment and experience.

<u>Change in Interest Rates</u>	<u>Percentage Change in Projected Net Interest Income</u>	<u>Percentage Change in Projected Portfolio Value</u>
+1.00%	6.12%	(0.96%)
+0.50%	7.56%	(0.38%)
-0.50%	(9.15%)	0.12%
-1.00%	(17.29%)	0.11%

### *Real Estate Risk*

Residential and commercial property values are subject to volatility and may be affected adversely by a number of factors, including, but not limited to: national, regional and local economic conditions (which may be adversely affected by industry slowdowns and other factors); local real estate conditions (such as the supply of housing stock); changes or continued weakness in specific industry segments; construction quality, age and design; demographic factors; and retroactive changes to building or similar codes. In addition, decreases in property values reduce the value of the collateral and the potential proceeds available to a borrower to repay our loans, which could also cause us to suffer losses.

## **Credit Risk**

We believe that our investment strategy will generally keep our credit losses and financing costs low. However, we retain the risk of potential credit losses on all of the residential and commercial mortgage loans, as well as the loans underlying the Non-Agency RMBS and CMBS in our portfolio. We seek to manage this risk through our pre-acquisition due diligence process and through the use of non-recourse financing, which limits our exposure to credit losses to the specific pool of mortgages that are subject to the non-recourse financing. In addition, with respect to any particular asset, our Manager's investment team evaluates, among other things, relative valuation, supply and demand trends, shape of yield curves, prepayment rates, delinquency and default rates, recovery of various sectors and vintage of collateral.

## **Risk Management**

To the extent consistent with maintaining our REIT qualification, we seek to manage risk exposure to protect our investment portfolio against the effects of major interest rate changes. We generally seek to manage this risk by:

- monitoring and adjusting, if necessary, the reset index and interest rate related to our target assets and our financings;
- attempting to structure our financing agreements to have a range of different maturities, terms, amortizations and interest rate adjustment periods;
- using hedging instruments, primarily interest rate swap agreements but also financial futures, options, interest rate cap agreements, floors and forward sales to adjust the interest rate sensitivity of our target assets and our borrowings; and
- actively managing, on an aggregate basis, the interest rate indices, interest rate adjustment periods, and gross reset margins of our target assets and the interest rate indices and adjustment periods of our financings.

## **ITEM 4. CONTROLS AND PROCEDURES.**

Our management is responsible for establishing and maintaining disclosure controls and procedures that are designed to ensure that information we are required to disclose in the reports that we file or submit under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include controls and procedures designed to ensure that the required information is accumulated or communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure.

We have evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures as of September 30, 2010. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the applicable rules and forms, and that it is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

No change occurred in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the three months ended September 30, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## **PART II — OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS.**

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of September 30, 2010, we were not involved in any such legal proceedings.

### **ITEM 1A. RISK FACTORS.**

Other than the risk factor set forth below, there were no material changes during the period covered by this report to the risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2009, as filed with the SEC on March 24, 2010. Additional risks not presently known, or that we currently deem immaterial, also may have a material adverse affect on our business, financial condition and results of operation.

*We may be affected by deficiencies in foreclosure practices of third parties, as well as related delays in the foreclosure process.*

Recent announcements of deficiencies in foreclosure documentation by, among others, several large mortgage servicers have raised various concerns relating to foreclosure practices. A number of mortgage servicers have temporarily suspended foreclosure proceedings in some or all states in which they do business while they review and correct their foreclosure practices. In addition, a group consisting of state attorneys general and state bank and mortgage regulators in all 50 states and the District of Columbia has announced it is reviewing foreclosure practices in their various jurisdictions. The extension of foreclosure timelines increases the inventory backlog of distressed homes on the market and creates greater uncertainty about housing prices. Prior to making investments in non-agency RMBS, we carefully consider many factors, including housing prices and foreclosure timelines, and estimate loss assumptions. The concerns about deficiencies in foreclosure practices of servicers and related delays in the foreclosure process may impact our loss assumptions and affect the values of, and our returns on, our investments in non-agency RMBS. Our management is actively reviewing and monitoring the deficiencies and delays in the foreclosure process and assessing its potential impact on our business, financial condition, and results of operations.

### **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.**

None.

### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

None.

### **ITEM 4. RESERVED**

### **ITEM 5. OTHER INFORMATION.**

None.

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

INVESCO MORTGAGE CAPITAL INC.

November 12, 2010

By: /s/ Richard J. King  
Richard J. King  
President and Chief Executive Officer

November 12, 2010

By: /s/ Donald R. Ramon  
Donald R. Ramon  
Chief Financial Officer

## EXHIBIT INDEX

### Item 6. *Exhibits*

<u>Exhibit No.</u>	<u>Description</u>
3.1	Articles of Amendment and Restatement of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.1 to our Quarterly Report on Form 10-Q, filed with the Securities and Exchange Commission on August 12, 2009.
3.2	Amended and Restated Bylaws of Invesco Mortgage Capital Inc., incorporated by reference to Exhibit 3.2 to Amendment No. 8 to our Registration Statement on Form S-11, filed with the Securities and Exchange Commission on June 18, 2009.
31.1	Certification of Richard J. King pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Donald R. Ramon pursuant to Rule 13a-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Richard J. King pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Donald R. Ramon pursuant to Rule 13a-14(b) and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.