

LUMINENT MORTGAGE CAPITAL INC

Form 10-Q

November 09, 2005

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 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, 2005**

**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: 000-31828**

**LUMINENT MORTGAGE CAPITAL, INC.**  
(Exact name of registrant as specified in its charter)

**Maryland**  
(State or other jurisdiction of incorporation or organization)

**06-1694835**  
(I.R.S. Employer Identification No.)

**One Market, Spear Tower, 30<sup>th</sup> Floor, San Francisco, California**  
(Address of principal executive offices)

**94105**  
(Zip Code)

**(415) 978-3000**  
(Registrant's Telephone Number, Including Area Code)

**N/A**

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

The number of shares of common stock outstanding on October 31, 2005, was 41,033,188.

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**CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are those that are not historical in nature. They can often be identified by the inclusion of words such as anticipate, estimate, should, expect, believe, intend and similar expressions. Any projection of revenues, earnings or losses, capital expenditures, distributions, capital structure or other financial terms is a forward-looking statement.

Our forward-looking statements are based upon our management's beliefs, assumptions and expectations of our future operations and economic performance, taking into account the information currently available to us. Forward-looking statements involve risks and uncertainties, some of which are not currently known to us, that might cause our actual results, performance or financial condition to differ materially from the expectations of future results, performance or financial condition we express or imply in any forward-looking statements. Some of the important factors that could cause our actual results, performance or financial condition to differ materially from expectations are:

the flattening of, or other changes in the yield curve, on our investment strategies;

interest rate mismatches between our mortgage loans and mortgage-backed securities and the borrowings we use to fund our purchases of such loans and securities;

changes in interest rates and mortgage prepayment rates;

our ability to obtain or renew sufficient funding to maintain our leverage strategies;

potential impacts of our leveraging policies on our net income and cash available for distribution;

the ability of our board of directors to change our operating policies and strategies without stockholder approval or notice to you;

effects of interest rate caps on our adjustable-rate and hybrid adjustable-rate loans and mortgage-backed securities;

the degree to which our hedging strategies may or may not protect us from interest rate volatility;

the fact that Seneca could be motivated to recommend riskier investments in an effort to maximize its incentive compensation under its management agreement with us;

potential conflicts of interest arising out of our relationship with Seneca, on the one hand, and Seneca's relationships with other third parties, on the other hand;

our ability to invest up to 10% of our investment portfolio in residuals, leveraged mortgage derivative securities, and shares of other REITs as well as other investments;

your inability to review the assets that we will acquire with the net proceeds of any securities we offer before you purchase our securities; and

the other important factors described in this Quarterly Report on Form 10-Q, including those under the captions Management's Discussion and Analysis of Financial Condition and Results of Operations, Risk Factors and Quantitative and Qualitative Disclosures about Market Risk.

We undertake no obligation to update publicly or revise any forward-looking statements, whether as a result of new information, future events or otherwise. In light of these risks, uncertainties and assumptions, the events described by our forward-looking statements might not occur. We qualify any and all of our forward-looking statements by these

cautionary factors. In addition, you should carefully review the risk factors and other information described in other documents we file from time to time with the Securities and Exchange Commission.

This Quarterly Report on Form 10-Q contains market data, industry statistics and other data that have been obtained from, or compiled from, information made available by third parties. We have not independently verified their data.

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PART I  
FINANCIAL INFORMATION

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**LUMINENT MORTGAGE CAPITAL, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**

| <b>(in thousands, except share and per share amounts)</b>   | <b>September<br/>30,<br/>2005</b> | <b>December<br/>31,<br/>2004</b> |
|---|-----------------------------------|----------------------------------|
| <b>Assets:</b>  |                                   |                                  |
| Cash and cash equivalents   | \$ 10,690                         | \$ 10,581                        |
| Mortgage-backed securities available-for-sale, at fair value  | 193,917                           | 186,351                          |
| Mortgage-backed securities available-for-sale, pledged as collateral, at fair value   | 4,457,724                         | 4,641,604                        |
| Loans held-for-investment, net  | 143,848                           |                                  |
| Interest receivable   | 21,404                            | 18,861                           |
| Principal receivable  | 23,303                            | 13,426                           |
| Derivative contracts, at fair value   | 9,451                             | 7,900                            |
| Other assets  | 4,888                             | 1,105                            |
| <br>  |                                   |                                  |
| Total assets  | \$ 4,865,225                      | \$ 4,879,828                     |
| <br>  |                                   |                                  |
| <b>Liabilities:</b>   |                                   |                                  |
| Repurchase agreements   | \$ 4,239,040                      | \$ 4,436,456                     |
| Warehouse lending facilities  | 140,378                           |                                  |
| Junior subordinated notes   | 49,978                            |                                  |
| Cash distributions payable  | 4,502                             | 15,959                           |
| Derivatives, at fair value  |                                   | 1,073                            |
| Accrued interest expense  | 14,338                            | 17,333                           |
| Management compensation payable, incentive compensation payable, and other related party liabilities  | 1,543                             | 2,952                            |
| Accounts payable and accrued expenses   | 660                               | 552                              |
| <br>  |                                   |                                  |
| Total liabilities   | 4,450,439                         | 4,474,325                        |
| <br>  |                                   |                                  |
| <b>Stockholders Equity:</b>   |                                   |                                  |
| Preferred stock, par value \$0.001:<br>10,000,000 shares authorized; no shares issued and outstanding at<br>September 30, 2005 and December 31, 2004                                    |                                   |                                  |
| Common stock, par value \$0.001:<br>100,000,000 shares authorized; 40,770,410 and 37,113,011 shares issued and<br>outstanding at September 30, 2005 and December 31, 2004, respectively | 41                                | 37                               |
| Additional paid-in capital  | 515,973                           | 478,457                          |
| Deferred compensation   | (2,366)                           | (2,207)                          |
| Accumulated other comprehensive loss  | (90,706)                          | (61,368)                         |
| Accumulated distributions in excess of accumulated earnings   | (8,156)                           | (9,416)                          |

|  |              |              |
|--|--------------|--------------|
| Total stockholders' equity                 | 414,786      | 405,503      |
| Total liabilities and stockholders' equity | \$ 4,865,225 | \$ 4,879,828 |

See notes to condensed consolidated financial statements

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**LUMINENT MORTGAGE CAPITAL, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

| (in thousands, except share and per share amounts)  | For the Three Months<br>Ended<br>September 30, |            | For the Nine Months<br>Ended<br>September 30, |            |
|---|--|------------|---|------------|
|   | 2005   | 2004       | 2005  | 2004       |
| <b>Revenues:</b>                                    |  |            |   |            |
| Net interest income:                                |  |            |   |            |
| Interest income                                     | \$ 46,346                                      | \$ 34,261  | \$ 131,324                                    | \$ 81,683  |
| Interest expense                                    | 38,241   | 16,632     | 90,878  | 32,649     |
| Net interest income                                 | 8,105  | 17,629     | 40,446  | 49,034     |
| <b>Other income (losses):</b>                       |  |            |   |            |
| Other income (losses)                               | 588  |            | (311)   |            |
| Losses on sales of mortgage-backed securities       | (69)   |            | (69)  |            |
| Total other income (losses)                         | 519  |            | (380)   |            |
| <b>Expenses:</b>                                    |  |            |   |            |
| Management compensation expense to related party    | 1,074  | 1,096      | 3,254   | 2,969      |
| Incentive compensation expense to related parties   | 255  | 1,367      | 1,128   | 3,463      |
| Salaries and benefits                               | 846  | 112        | 1,702   | 318        |
| Professional services                               | 512  | 191        | 1,588   | 836        |
| Board of directors expense                          | 116  | 52         | 351   | 171        |
| Insurance expense                                   | 140  | 137        | 415   | 494        |
| Custody expense                                     | 125  | 113        | 319   | 274        |
| Other general and administrative expenses           | 327  | 67         | 937   | 261        |
| Total expenses                                      | 3,395  | 3,135      | 9,694   | 8,786      |
| Net income  | \$ 5,229                                       | \$ 14,494  | \$ 30,372                                     | \$ 40,248  |
| Net income per share basic                          | \$ 0.13  | \$ 0.39    | \$ 0.79                                       | \$ 1.22    |
| Net income per share diluted                        | \$ 0.13  | \$ 0.39    | \$ 0.79                                       | \$ 1.22    |
| Weighted-average number of shares outstanding basic | 40,021,698                                     | 36,814,000 | 38,478,679                                    | 32,916,190 |

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|   |         |            |            |            |            |
|---|---------|------------|------------|------------|------------|
| Weighted-average number of shares outstanding | diluted | 40,226,523 | 36,867,233 | 38,615,869 | 32,938,893 |
|---|---------|------------|------------|------------|------------|

See notes to condensed consolidated financial statements

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**LUMINENT MORTGAGE CAPITAL, INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY**  
**(Unaudited)**

| (in thousands)  | Common<br>Stock<br>Shares | Par<br>Value | Additional<br>Paid-in<br>Capital | Deferred<br>Compensation | Other<br>Comprehensive<br>Loss | Accumulated<br>Distributions<br>in Excess<br>of<br>Accumulated<br>Comprehensive<br>Earnings | Comprehensive<br>Income/(Loss) | Total      |
|---|---------------------------|--------------|----------------------------------|--------------------------|--------------------------------|---|--------------------------------|------------|
| Balance, January 1,<br>2005   | 37,113                    | \$ 37        | \$ 478,457                       | \$ (2,207)               | \$ (61,368)                    | \$ (9,416)  |                                | \$ 405,503 |
| Net income  |                           |              |                                  |                          |                                | 30,372  | \$ 30,372                      | 30,372     |
| Mortgage-backed<br>securities<br>Available-for-sale, fair<br>value adjustment |                           |              |                                  |                          | (30,304)                       |   | (30,304)                       | (30,304)   |
| Derivatives, fair value<br>adjustment   |                           |              |                                  |                          | 961                            |   | 961                            | 961        |
| Futures contracts, net<br>realized losses                                     |                           |              |                                  |                          | 5                              |   | 5                              | 5          |
| Comprehensive<br>income   |                           |              |                                  |                          |                                |   | \$ 1,034                       |            |
| Distributions to<br>stockholders  |                           |              |                                  |                          |                                | (29,112)  |                                | (29,112)   |
| Issuance of common<br>stock   | 3,657                     | 4            | 37,514                           | (1,529)                  |                                |   |                                | 35,989     |
| Amortization of stock<br>options  |                           |              | 2                                |                          |                                |   |                                | 2          |
| Amortization of<br>restricted common<br>stock                                 |                           |              |                                  | 1,370                    |                                |   |                                | 1,370      |
| Balance,<br>September 30, 2005  | 40,770                    | \$ 41        | \$ 515,973                       | \$ (2,366)               | \$ (90,706)                    | \$ (8,156)  |                                | \$ 414,786 |

See notes to condensed consolidated financial statements



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**LUMINENT MORTGAGE CAPITAL, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

| <b>(in thousands)</b>   | <b>Nine months ended September 30,</b> |              |
|---|--|--------------|
|   | <b>2005</b>                            | <b>2004</b>  |
| <b>Cash flows from operating activities:</b>  |  |              |
| Net income  | \$ 30,372                              | \$ 40,248    |
| Adjustments to reconcile net income to net cash provided by operating activities:                               |  |              |
| Amortization of premium/discount on loans held-for-investment and mortgage-backed securities available-for-sale | 20,671                                 | 21,855       |
| Amortization of stock options   | 2                                      | 4            |
| Ineffectiveness (gains)/losses on cash flow hedges  | (187)                                  | 108          |
| Losses on other derivative instruments  | 229                                    |              |
| Net loss on sales of mortgage-backed-securities available-for-sale  | 69                                     |              |
| Changes in operating assets and liabilities:  |  |              |
| Decrease/(increase) in interest receivable, net of purchased interest   | 2,408                                  | (1,126)      |
| Increase in other assets  | (3,942)                                | (4,476)      |
| Increase/(decrease) in accounts payable and accrued expenses  | 163                                    | (984)        |
| Increase/(decrease) in accrued interest expense   | (2,995)                                | 2,015        |
| Increase in management compensation payable, incentive compensation payable and other related party liabilities | 251                                    | 4,478        |
| <br>  |  |              |
| Net cash provided by operating activities   | 47,041                                 | 62,122       |
| <br>  |  |              |
| <b>Cash flows from investing activities:</b>  |  |              |
| Purchases of mortgage-backed securities available-for-sale  | (1,220,271)                            | (3,378,328)  |
| Proceeds from sales of mortgage-backed securities available-for-sale  | 136,549                                |              |
| Principal payments of mortgage-backed securities  | 1,194,191                              | 789,645      |
| Purchase of loans held-for-investment   | (146,541)                              |              |
| Principal payments of loans held-for-investment   | 2,836                                  |              |
| <br>  |  |              |
| Net cash used in investing activities   | (33,236)                               | (2,588,683)  |
| <br>  |  |              |
| <b>Cash flows from financing activities:</b>  |  |              |
| Net proceeds from issuance of common stock  | 35,802                                 | 157,508      |
| Borrowings under repurchase agreements  | 15,337,837                             | 24,883,625   |
| Borrowings under warehouse lending facilities   | 140,378                                |              |
| Principal payments on repurchase agreements   | (15,535,253)                           | (22,491,079) |
| Distributions to stockholders   | (40,569)                               | (31,567)     |
| Borrowing under junior subordinated notes, net of debt issuance costs   | 49,978                                 |              |
| Borrowing under margin loan   |  | 2,278        |
| Borrowing under note payable, net   |  | (92)         |
| Amortization of net realized gains on Eurodollar futures contracts  | (1,395)                                |              |

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|   |            |              |
|---|------------|--------------|
| Realized gains on Eurodollar futures contracts  | 1,400      | 2,475        |
| Purchases of other derivative instruments   | (1,874)    |              |
| Net cash (used in) provided by financing activities   | (13,696)   | 2,523,148    |
| <b>Net increase (decrease) in cash and cash equivalents</b>   | 109        | (3,413)      |
| <b>Cash and cash equivalents, beginning of the period</b>   | 10,581     | 7,219        |
| <b>Cash and cash equivalents, end of the period</b>   | \$ 10,690  | \$ 3,806     |
| <b>Supplemental disclosure of cash flow information:</b>  |            |              |
| Interest paid   | \$ 102,608 | \$ 30,373    |
| <b>Non-cash investing and financing activities:</b>   |            |              |
| Decrease in unsettled security purchases  | \$         | \$ (156,127) |
| Increase in principal receivable  | (9,877)    | (13,208)     |
| Incentive compensation payable settled through issuance of restricted common stock                  | 1,660      | 2,384        |
| Accounts payable and accrued expenses settled through issuance of restricted common stock           | 55         |              |
| Deferred compensation reclassified to stockholders' equity upon issuance of restricted common stock | (159)      | (1,588)      |

See notes to condensed consolidated financial statements

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**LUMINENT MORTGAGE CAPITAL, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

**NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Luminent Mortgage Capital, Inc., Luminent, or the Company, is a real estate investment trust which, together with its subsidiaries, invests in two core mortgage investment strategies. The Spread strategy invests primarily in U.S. agency and other highly-rated single-family, adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage-backed securities. The Residential Mortgage Credit Portfolio strategy invests in mortgage loans originated in partnership with selected high quality providers within certain established criteria as well as subordinated mortgage-backed securities that have credit ratings below AAA.

Seneca Capital Management LLC, or the Manager, manages the Company's Spread investment portfolio pursuant to a management agreement. The Company manages the Residential Mortgage Credit Portfolio.

The information furnished in these unaudited condensed consolidated interim statements reflects all adjustments that are, in the opinion of management, necessary for a fair statement of the results for the periods presented. These adjustments are of a normal recurring nature, unless otherwise disclosed in this Form 10-Q. The results of operations in the interim statements do not necessarily indicate the results that may be expected for the full year. The interim financial information should be read in conjunction with the Company's 2004 Annual Report on Form 10-K filed with the Securities and Exchange Commission, or SEC, on March 14, 2005 (file number 001-31828).

Descriptions of the significant accounting policies of the Company are included in Note 2 to the financial statements in the Company's 2004 Annual Report on Form 10-K. There have been no significant changes to these policies during 2005. See description of newly adopted and newly applicable accounting policies below.

**Loans Held-for-Investment**

The Company purchases pools of residential mortgage loans through its network of origination partners. Mortgage loans are designated as held-for-investment as the Company has the intent and ability to hold them for the foreseeable future and until maturity or payoff. Mortgage loans that are considered to be held-for-investment are carried at their unpaid principal balances, including unamortized premium or discount and allowance for loan losses.

**Loan Interest Income Recognition**

Interest income on mortgage loans is accrued and credited to income based on the carrying amount and contractual terms of the assets using the effective yield method. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When an interest accrual is discontinued, all associated unpaid accrued interest income is reversed against current period operating results. Interest income is subsequently recognized only to the extent cash payments are received.

**Allowance and Provision for Loan Losses**

To estimate the allowance for loan losses, the Company first identifies impaired loans. Loans are generally evaluated for impairment individually, but loans purchased on a pooled basis with relatively smaller balances and substantially similar characteristics may be evaluated collectively for impairment. Loans are considered impaired when, based on current information, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement, including interest payments. Impaired loans are carried at the lower of the recorded investment in the loan or the fair value of the collateral, if the loan is collateral dependent.

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**LUMINENT MORTGAGE CAPITAL, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

**Borrowings**

The Company finances the acquisition of its mortgage-backed securities primarily through the use of repurchase agreements and finances the acquisition of its loans held-for-investment through warehouse lending facilities. These repurchase agreements and warehouse lending facilities are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements. Accrued interest expense for repurchase agreements and warehouse lending facilities are included in accrued interest on the balance sheet.

**Investment in Subsidiary Trust and Junior Subordinated Notes**

On March 15, 2005, Diana Statutory Trust I, or the Trust, was created for the sole purpose of issuing and selling preferred securities. Diana Statutory Trust I is a special purpose entity. In accordance with Financial Accounting Standards Board Interpretation, or FIN, 46(R), *Consolidation of Variable Interest Entities*, the Trust is not consolidated into the Company's consolidated financial statements, because the Company's investment in the Trust is not considered to be a variable interest. The Company's investment in the Trust is recorded in other assets on the balance sheet.

Junior subordinated notes issued to the Trust are accounted for as liabilities on the balance sheet net of deferred debt issuance costs. Interest expense on the notes and amortization of debt issue costs is recorded in the income statement.

See Note 12 for further discussion on the preferred securities of the Trust and junior subordinated notes.

**Purchased Beneficial Interests**

The Company purchases certain beneficial interests in securitized financial assets required to be accounted for in accordance with Emerging Issues Task Force, or EITF, 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*. Purchased beneficial interests are carried on the balance sheet at fair value and are included in mortgage-backed securities available-for-sale. In the event that a security becomes impaired, the cost of the security is written down and the difference is reflected in current earnings. Interest income is recognized using the effective yield method. The prospective method is used for adjusting the level yield used to recognize interest income when estimates of future cash flows over the remaining life of a security either increase or decrease. Cash flows are projected based on management's assumptions for prepayment rates and credit losses. Actual economic conditions may produce cash flows that could differ significantly from projected cash flows, and could result in an increase or decrease in the yield used to record interest income or could result in an impairment charge.

We estimate the fair value of our purchased beneficial interests using available market information and other appropriate valuation methodologies. We believe the estimates we use reflect the market values we may be able to receive should we choose to sell them. Our estimates involve matters of uncertainty, judgment in interpreting relevant market data and are inherently subjective in nature. Many factors are necessary to estimate market values, including, but not limited to interest rates, prepayment rates, amount and timing of credit losses, supply and demand, liquidity, cash flows, and other market factors. We apply these factors to our credit portfolio as appropriate, in order to determine market values.

**Share-based Compensation**

In December 2004, the Financial Accounting Standards Board, or FASB, issued SFAS No. 123(R) (revised 2004), *Share-Based Payment*. This Statement requires compensation expense to be recognized in an amount equal to the estimated fair value at the grant date of stock options and similar awards granted to employees. The accounting



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**LUMINENT MORTGAGE CAPITAL, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

provisions of this Statement are effective for awards granted, modified or settled after July 1, 2005. The Company adopted this statement as of January 1, 2005, and has applied its provisions to awards granted to employees and directors. Adoption of SFAS No. 123(R) did not affect the accounting for restricted common stock issued to the Manager, and did not have a material impact on the Company's financial condition or results of operations.

**Derivative Financial Instruments**

The Company may enter into a variety of derivative contracts, including futures contracts, swaption contracts and interest rate swap contracts, as a means of mitigating the Company's interest rate risk on forecasted interest expense. At inception, these contracts, i.e., hedging instruments, are evaluated in order to determine if the hedging instrument will be highly effective in achieving offsetting changes in the hedging instrument and hedged item attributable to the risk being hedged in order to determine whether they qualify for hedge accounting under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted. All qualifying hedging instruments are carried on the balance sheet at fair value and any ineffectiveness that arises during the hedging relationship is recognized in interest expense in the statement of operations during the period in which it arises. Hedging instruments that do not qualify for hedge accounting under SFAS No. 133 are carried on the balance sheet at fair value and any change in the fair value of the hedging instrument is recognized in other losses.

The Company may enter into commitments to purchase mortgage loans, or purchase commitments, from the Company's network of origination partners. Each purchase commitment is evaluated in accordance with SFAS No. 133 to determine whether the purchase commitment meets the definition of a derivative instrument. Purchase commitments that meet the definition of a derivative instrument are recorded at fair value on the balance sheet and any change in fair value of the purchase commitment is recognized in other losses. Upon settlement of the loan purchase, the purchase commitment derivative is derecognized and included in the cost basis of the loans purchased.

**NOTE 2 MORTGAGE-BACKED SECURITIES**

The following table summarizes the Company's mortgage-backed securities classified as available-for-sale at September 30, 2005, which are carried at fair value:

| <b>(in thousands)</b> | <b>Adjustable-<br/>Rate<br/>Securities</b> | <b>Hybrid<br/>Adjustable-Rate<br/>Securities</b> | <b>Balloon<br/>Maturity<br/>Securities</b> | <b>Other<br/>Securities</b> | <b>Total<br/>Mortgage-<br/>Backed<br/>Securities</b> |
|-----------------------|--|--|--|-----------------------------|--|
| Amortized cost        | \$ 81,494                                  | \$ 4,430,804                                     | \$ 54,509                                  | \$ 184,435                  | \$ 4,751,242   |
| Unrealized gains      |  | 32   |  | 921                         | 953  |
| Unrealized losses     | (1,384)                                    | (95,948)   | (1,555)                                    | (1,667)                     | (100,554)  |
| Fair value            | \$ 80,110                                  | \$ 4,334,888                                     | \$ 52,954                                  | \$ 183,689                  | \$ 4,651,641   |
| % of total            | 1.7%                                       | 93.2%  | 1.1%                                       | 4.0%                        | 100.0%   |

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**LUMINENT MORTGAGE CAPITAL, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

The following table summarizes the Company's mortgage-backed securities classified as available-for-sale at December 31, 2004, which are carried at fair value:

| (in thousands)    | Adjustable-<br>Rate<br>Securities | Hybrid<br>Adjustable-Rate<br>Securities | Balloon<br>Maturity<br>Securities | Total<br>Mortgage-<br>Backed<br>Securities |
|-------------------|-----------------------------------|---|-----------------------------------|--|
| Amortized cost    | \$ 127,360                        | \$ 4,714,759                            | \$ 55,134                         | \$ 4,897,253                               |
| Unrealized gains  | 33                                | 739                                     |                                   | 772  |
| Unrealized losses | (1,618)                           | (67,340)                                | (1,112)                           | (70,070)                                   |
| <br>              |                                   |   |                                   |  |
| Fair value        | \$ 125,775                        | \$ 4,648,158                            | \$ 54,022                         | \$ 4,827,955                               |
| <br>              |                                   |   |                                   |  |
| % of total        | 2.6%                              | 96.3%                                   | 1.1%                              | 100.0%                                     |

The Company's portfolio of other mortgage-backed securities available-for-sale at September 30, 2005 included beneficial interests in securitized financial assets that the Company purchased from third parties. At September 30, 2005 and December 31, 2004, none of the Company's portfolio consisted of fixed-rate mortgage-backed securities.

At September 30, 2005 and December 31, 2004, 67.2% and 61.4%, respectively, of the Company's mortgage-backed securities portfolio, as measured by its fair value, was agency-guaranteed.

Actual maturities of mortgage-backed securities are generally shorter than stated contractual maturities. Actual maturities of the Company's mortgage-backed securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal and prepayments of principal. The following table summarizes the Company's mortgage-backed securities at September 30, 2005, according to their estimated weighted-average life classifications:

| (in thousands)                                 | Weighted-Average Life | Fair Value   | Amortized<br>Cost | Weighted-<br>Average<br>Coupon |
|--|-----------------------|--------------|-------------------|--------------------------------|
| Less than one year                             |                       | \$ 483,235   | \$ 492,221        | 3.97%                          |
| Greater than one year and less than five years |                       | 4,025,268    | 4,114,686         | 4.42                           |
| Greater than five years                        |                       | 143,138      | 144,335           | 5.09                           |
| <br>   |                       |              |                   |                                |
| Total  |                       | \$ 4,651,641 | \$ 4,751,242      | 4.40%                          |

The following table summarizes the Company's mortgage-backed securities at December 31, 2004, according to their estimated weighted-average life classifications:

| (in thousands) | Weighted-Average Life | Fair Value | Amortized<br>Cost | Weighted-<br>Average<br>Coupon |
|----------------|-----------------------|------------|-------------------|--------------------------------|
|----------------|-----------------------|------------|-------------------|--------------------------------|

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**(in thousands)**

|  |              |              |       |
|--|--------------|--------------|-------|
| Less than one year                             | \$ 211,475   | \$ 215,099   | 3.76% |
| Greater than one year and less than five years | 4,616,480    | 4,682,154    | 4.24  |
| Greater than five years                        |              |              |       |
| Total  | \$ 4,827,955 | \$ 4,897,253 | 4.22% |

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**LUMINENT MORTGAGE CAPITAL, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

The weighted-average lives of the mortgage-backed securities at September 30, 2005 and December 31, 2004 in the tables above are based upon data provided through subscription-based financial information services, assuming constant prepayment rates to the balloon or reset date for each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rates of the outstanding loans, loan age, margin and volatility.

The actual weighted-average lives of the mortgage-backed securities in the Company's investment portfolio could be longer or shorter than the estimates in the table above depending on the actual prepayment rates experienced over the lives of the applicable securities and are sensitive to changes in both prepayment rates and interest rates.

During the three months ended September 30, 2005, the Company sold mortgage-backed securities totaling \$136.3 million and realized gains of \$60 thousand and losses of \$129 thousand. The Company had no other sales of mortgage-backed securities during the nine months ended September 30, 2005. The Company did not sell any mortgage-backed securities during the nine months ended September 30, 2004.

The following table shows the fair value of the Company's mortgage-backed securities and the gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at September 30, 2005:

| (in thousands)                               | Less than 12 Months |                         | 12 Months or More |                         | Total        |                         |
|--|---------------------|-------------------------|-------------------|-------------------------|--------------|-------------------------|
|  | Fair Value          | Gross Unrealized Losses | Fair Value        | Gross Unrealized Losses | Fair Value   | Gross Unrealized Losses |
| Agency-backed mortgage-backed securities     | \$ 1,356,496        | \$ (18,122)             | \$ 1,756,550      | \$ (43,358)             | \$ 3,113,046 | \$ (61,480)             |
| Non-agency-backed mortgage-backed securities | 473,911             | (9,159)                 | 977,615           | (29,915)                | 1,451,526    | (39,074)                |
| Total temporarily impaired securities        | \$ 1,830,407        | \$ (27,281)             | \$ 2,734,165      | \$ (73,273)             | \$ 4,564,572 | \$ (100,554)            |

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

The following table shows the fair value of the Company's mortgage-backed securities and the gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2004:

| (in thousands)                               | Less than 12 Months |                         | 12 Months or More |                         | Total        |                         |
|--|---------------------|-------------------------|-------------------|-------------------------|--------------|-------------------------|
|  | Fair Value          | Gross Unrealized Losses | Fair Value        | Gross Unrealized Losses | Fair Value   | Gross Unrealized Losses |
| Agency-backed mortgage-backed securities     | \$ 2,473,670        | \$ (35,605)             | \$ 379,814        | \$ (5,701)              | \$ 2,853,484 | \$ (41,306)             |
| Non-agency-backed mortgage-backed securities | 1,468,329           | (22,189)                | 251,452           | (6,575)                 | 1,719,781    | (28,764)                |
| Total temporarily impaired securities        | \$ 3,941,999        | \$ (57,794)             | \$ 631,266        | \$ (12,276)             | \$ 4,573,265 | \$ (70,070)             |

At September 30, 2005, 97.6% of the Company's portfolio that had unrealized losses was invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities. At December 31, 2004, all of the Company's portfolio that had unrealized losses was invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities. The temporary impairment of the available-for-sale securities results from the fair value of the mortgage-backed securities falling below their amortized cost basis and is solely attributed to changes in interest rates. At September 30, 2005 and December 31, 2004, none of the securities held by the Company had been downgraded by a credit rating agency since their purchase. The Company intends and has the ability to hold the securities for a period of time, to maturity if necessary, sufficient to allow for the anticipated recovery in fair value of the securities held. Certain non-agency mortgage-backed securities are accounted for in accordance with EITF 99-20. Changes in fair value of these securities are solely due to interest rate changes. As such, the Company does not believe any of the securities held at September 30, 2005 or December 31, 2004, are other-than-temporarily impaired.

**NOTE 3 LOANS HELD-FOR-INVESTMENT**

The following table summarizes the Company's loans classified as held-for-investment at September 30, 2005, which are carried at amortized cost:

| (in thousands)             | Principal | Unamortized Premium | Amortized Cost |
|----------------------------|-----------|---------------------|----------------|
| Residential mortgage loans | \$142,757 | \$ 1,091            | \$143,848      |

At September 30, 2005, the Company had not recorded an allowance for loan losses as none of the loans held in the portfolio were considered impaired. The Company intends to securitize loans held-for-investment and account for securitizations as financings. All loans held-for-investment at September 30, 2005 are pending securitization. See Note 13 for more information regarding securitization activities.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

At September 30, 2005, loans held-for-investment consisted of the following:

| (in thousands)   | Interest<br>Rate<br>Type | Interest<br>Rate | Maturity<br>Date | Principal<br>Balance | Delinquent<br>Balance<br>(90<br>Days) |    |
|--|--------------------------|------------------|------------------|----------------------|---------------------------------------|----|
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 3-Year<br>Hybrid         | 4.00             | 5.00%            | 2035                 | \$ 456                                | \$ |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 3-Year<br>Hybrid         | 5.01             | 6.00%            | 2035                 | 25,362                                |    |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 3-Year<br>Hybrid         | 6.01             | 7.00%            | 2035                 | 7,999                                 |    |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 3-Year<br>Hybrid         | 7.01             | 7.50%            | 2035                 | 128                                   |    |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 5-Year<br>Hybrid         | 4.00             | 5.00%            | 2035                 | 453                                   |    |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 5-Year<br>Hybrid         | 5.01             | 6.00%            | 2035                 | 61,441                                |    |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 5-Year<br>Hybrid         | 6.01             | 7.00%            | 2035                 | 46,918                                |    |
|  |                          |                  |                  |                      | \$ 142,757                            | \$ |

The weighted-average coupon of the Company's loans held-for-investment at September 30, 2005 was 5.98%.

At September 30 2005, our 514 residential mortgage loans consisted of Alt-A first lien, three-year and five-year hybrid adjustable-rate mortgages acquired from third party originators and secured by one to four-family residences, individual condominium units and individual co-operative units having an aggregate balance of approximately \$142.8 million. Hybrid adjustable-rate mortgages have an initial fixed rate period and then the interest rate borne by each mortgage loan will be adjusted annually based on One-Year LIBOR or One-Year U.S. Treasury, each referred to as the index, computed in accordance with the related note plus the related gross margin, generally subject to rounding and to certain other limitations including a maximum lifetime mortgage rate and in certain cases a maximum upward or downward adjustment on each interest adjustment date. Consistent with characteristics typical of the Alt-A market, a large segment of this loan portfolio is scheduled to receive interest only payments during the initial fixed rate period and a large segment was underwritten under either a reduced or limited documentation program.

**NOTE 4 REPURCHASE  
AGREEMENTS,  
WAREHOUSE  
LENDING  
FACILITIES  
AND OTHER  
BORROWINGS**

The Company has entered into repurchase agreements with third party financial institutions to finance the purchase of most of its mortgage-backed securities. The repurchase agreements are short-term borrowings that bear interest rates that have historically moved in close relationship to the three-month London Interbank Offered Rate, or LIBOR.

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At September 30, 2005 and December 31, 2004, the Company had repurchase agreements with an outstanding balance of \$4.2 billion and \$4.4 billion, respectively, and with weighted-average interest rates of 3.83% and 2.38%, respectively. At September 30, 2005 and December 31, 2004, securities pledged as collateral for repurchase agreements had estimated fair values of \$4.5 billion and \$4.6 billion, respectively.

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At September 30, 2005, the repurchase agreements had remaining maturities as summarized below:

| (in thousands)   | <b>Overnight<br/>(1 day<br/>or<br/>less)</b> | <b>Between<br/>2 and 30<br/>days</b> | <b>Between<br/>31 and 90<br/>days</b> | <b>Between<br/>91 and 329<br/>days</b> | <b>Total</b> |
|--|--|--------------------------------------|---------------------------------------|--|--------------|
| <b>Agency-backed mortgage-backed securities:</b>                   |  |                                      |                                       |  |              |
| Amortized cost of securities sold, including accrued interest      | \$   | \$390,860                            | \$1,519,040                           | \$1,124,750                            | \$3,034,650  |
| Fair market value of securities sold, including accrued interest   |  | 385,081                              | 1,487,882                             | 1,102,366                              | 2,975,329    |
| Repurchase agreement liabilities associated with these securities  |  | 366,612                              | 1,412,778                             | 1,044,580                              | 2,823,970    |
| Weighted-average interest rate of repurchase agreement liabilities | %  | 3.80%                                | 3.83%                                 | 3.78%                                  | 3.81%        |
| <b>Non-agency-backed mortgage-backed securities:</b>               |  |                                      |                                       |  |              |
| Amortized cost of securities sold, including accrued interest      | \$   | \$166,451                            | \$ 695,846                            | \$ 677,939                             | \$1,540,236  |
| Fair market value of securities sold, including accrued interest   |  | 163,804                              | 678,784                               | 659,605                                | 1,502,193    |
| Repurchase agreement liabilities associated with these securities  |  | 147,012                              | 640,734                               | 627,324                                | 1,415,070    |
| Weighted-average interest rate of repurchase agreement liabilities | %  | 4.13%                                | 3.85%                                 | 3.87%                                  | 3.89%        |
| <b>Total:</b>  |  |                                      |                                       |  |              |
| Amortized cost of securities sold, including accrued interest      | \$   | \$557,311                            | \$2,214,886                           | \$1,802,689                            | \$4,574,886  |
| Fair market value of securities sold, including accrued interest   |  | 548,885                              | 2,166,666                             | 1,761,971                              | 4,477,522    |
| Repurchase agreement liabilities associated with these securities  |  | 513,624                              | 2,053,512                             | 1,671,904                              | 4,239,040    |
| Weighted-average interest rate of repurchase agreement liabilities | %  | 3.90%                                | 3.83%                                 | 3.81%                                  | 3.83%        |



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**(Unaudited)**

At December 31, 2004, the repurchase agreements had remaining maturities as summarized below:

| (in thousands)   | <b>Overnight<br/>(1 day or<br/>less)</b> | <b>Between<br/>2 and 30<br/>days</b> | <b>Between<br/>31 and 90<br/>days</b> | <b>Between<br/>91 and 602<br/>days</b> | <b>Total</b> |
|--|--|--------------------------------------|---------------------------------------|--|--------------|
| <b>Agency-backed mortgage-backed securities:</b>                   |  |                                      |                                       |  |              |
| Amortized cost of securities sold, including accrued interest      | \$20,203                                 | \$153,656                            | \$1,017,753                           | \$1,702,727                            | \$2,894,339  |
| Fair market value of securities sold, including accrued interest   | 20,010                                   | 152,100                              | 1,005,208                             | 1,677,425                              | 2,854,743    |
| Repurchase agreement liabilities associated with these securities  | 19,058                                   | 144,512                              | 956,307                               | 1,596,914                              | 2,716,791    |
| Weighted-average interest rate of repurchase agreement liabilities | 2.36%                                    | 2.28%                                | 2.41%                                 | 2.35%                                  | 2.37%        |
| <b>Non-agency-backed mortgage-backed securities:</b>               |  |                                      |                                       |  |              |
| Amortized cost of securities sold, including accrued interest      | \$17,795                                 | \$ 53,278                            | \$ 998,982                            | \$ 763,429                             | \$1,833,484  |
| Fair market value of securities sold, including accrued interest   | 17,555                                   | 52,706                               | 982,301                               | 752,376                                | 1,804,938    |
| Repurchase agreement liabilities associated with these securities  | 16,719                                   | 50,132                               | 936,901                               | 715,913                                | 1,719,665    |
| Weighted-average interest rate of repurchase agreement liabilities | 2.36%                                    | 2.27%                                | 2.44%                                 | 2.35%                                  | 2.35%        |
| <b>Total:</b>  |  |                                      |                                       |  |              |
| Amortized cost of securities sold, including accrued interest      | \$37,998                                 | \$206,934                            | \$2,016,735                           | \$2,466,156                            | \$4,727,823  |
| Fair market value of securities sold, including accrued interest   | 37,565                                   | 204,806                              | 1,987,509                             | 2,429,801                              | 4,659,681    |
| Repurchase agreement liabilities associated with these securities  | 35,777                                   | 194,644                              | 1,893,208                             | 2,312,827                              | 4,436,456    |
| Weighted-average interest rate of repurchase agreement liabilities | 2.36%                                    | 2.28%                                | 2.43%                                 | 2.35%                                  | 2.38%        |

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**LUMINENT MORTGAGE CAPITAL, INC.**  
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**(Unaudited)**

At September 30, 2005, the repurchase agreements had the following counterparties, amounts at risk and weighted-average remaining maturities:

| <b>Repurchase Agreement Counterparties</b>  | <b>Amount at Risk<sup>(1)</sup><br/>(in thousands)</b> | <b>Weighted-Average Maturity of Repurchase Agreements<br/>(in days)</b> |
|---|--|---|
| Banc of America Securities LLC  | \$ 7,113   | 245   |
| Barclays Capital  | 3,504  | 25  |
| Bear Stearns & Co.  | 68,718   | 92  |
| Countrywide Securities Corporation  | 7,918  | 187   |
| Credit Suisse First Bank  | 2,597  | 12  |
| Deutsche Bank Securities Inc.   | 30,061   | 153   |
| Goldman Sachs & Co.   | 8,352  | 77  |
| Greenwich Capital Markets   | 9,673  | 50  |
| Merrill Lynch Government Securities Inc./Merrill Lynch Pierce, Fenner & Smith, Inc. | 21,026   | 125   |
| Morgan Stanley & Co. Inc.   | 2,525  | 66  |
| Nomura Securities International, Inc.   | 23,636   | 169   |
| Salomon Smith Barney  | 7,642  | 266   |
| UBS Securities LLC  | 24,438   | 238   |
| Wachovia Securities, LLC  | 4,937  | 169   |
| Washington Mutual   | 3,015  | 25  |
| <b>Total</b>  | <b>\$ 225,155</b>                                      | <b>131</b>  |

(1) Equal to the sum of the fair value of the securities sold and accrued interest income minus the sum of repurchase agreement liabilities and accrued interest expense.

At December 31, 2004, the repurchase agreements had the following counterparties, amounts at risk and weighted-average remaining maturities:

**Weighted-Average Maturity of**

| <b>Repurchase Agreement Counterparties</b>   | <b>Amount at<br/>Risk<sup>(1)</sup><br/>(in<br/>thousands)</b> | <b>Repurchase<br/>Agreements<br/>(in days)</b> |
|--|--|--|
| Banc of America Securities LLC   | \$ 11,970  | 61   |
| Bear Stearns & Co.   | 60,106   | 100  |
| Countrywide Securities Corporation   | 4,534  | 115  |
| Deutsche Bank Securities Inc.  | 42,589   | 142  |
| Goldman Sachs & Co.  | 23,489   | 51   |
| Lehman Brothers, Inc.  | 4,244  | 151  |
| Merrill Lynch Government Securities Inc./Merrill Lynch Pierce, Fenner & Smith Inc. | 8,509  | 125  |
| Morgan Stanley & Co. Inc.  | 2,039  | 124  |
| Nomura Securities International, Inc.  | 9,355  | 114  |
| Salomon Smith Barney   | 12,151   | 69   |
| UBS Securities LLC   | 23,413   | 314  |
| Wachovia Securities, LLC   | 3,493  | 154  |
| <b>Total</b>   | <b>\$ 205,892</b>  | <b>133</b>                                     |

(1) Equal to the sum of the fair value of the securities sold and accrued interest income minus the sum of repurchase agreement liabilities and accrued interest expense.

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**LUMINENT MORTGAGE CAPITAL, INC.**  
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During the quarter, the Company entered into a warehouse lending facility to finance its residential mortgage loan acquisitions prior to securitization. This warehouse lending facility is a short-term borrowing that is secured by the loans and bears interest based on LIBOR. In general, the warehouse lending facility provides financing for loans for a maximum of 120 days. At September 30, 2005, the borrowing capacity and outstanding balance of the warehouse lending facility was \$500.0 million and \$140.4 million, respectively. Mortgage loans with a carrying value of \$140.4 million have been pledged as collateral under this facility.

The Company has a margin lending facility with its primary custodian whereby it may borrow money in connection with the purchase or sale of securities. The terms of the borrowings, including the rate of interest payable, are agreed to with the custodian for each amount borrowed. Borrowings are repayable upon demand by the custodian. No borrowings were outstanding under the margin lending facility at September 30, 2005 or December 31, 2004.

**NOTE 5 CAPITAL STOCK AND NET INCOME PER SHARE**

At September 30, 2005 and December 31, 2004, the Company's charter authorized the issuance of 100,000,000 shares of common stock, par value \$0.001 per share, and 10,000,000 shares of preferred stock, par value \$0.001 per share. At September 30, 2005 and December 31, 2004, 40,770,410 and 37,113,011 shares of common stock, respectively, were outstanding and no shares of preferred stock were outstanding.

In June 2004, the Company reserved 10,000,000 shares of common stock for issuance in connection with the payment of incentive compensation under the Company's Management Agreement dated as of June 11, 2003 with the Manager. On March 26, 2005, effective as of March 1, 2005, the Company and the Manager entered into an Amended and Restated Management Agreement, or Amended Agreement. Under the Amended Agreement, none of the incentive compensation payable to the Manager is payable in the Company's common stock. On August 3, 2005, the Company unreserved the remaining balance of 9,641,649 unissued shares that had been reserved for the payment of incentive compensation. These shares are now deemed authorized but unissued and unreserved shares of common stock of the Company. At December 31, 2004, 9,726,111 shares were reserved for issuance in connection with the payment of incentive compensation under the Company's Management Agreement dated as of June 11, 2003.

On January 3, 2005, the Company filed a shelf registration statement on Form S-3 with the SEC. This registration statement was declared effective by the SEC on January 21, 2005. Under the shelf registration statement, the Company may offer and sell any combination of common stock, preferred stock, warrants to purchase common stock or preferred stock and debt securities in one or more offerings up to total proceeds of \$500.0 million. Each time the Company offers to sell securities, a supplement to the prospectus will be provided containing specific information about the terms of that offering. At September 30, 2005, total proceeds of up to \$468.9 million remain available to the Company to offer and sell under this shelf registration statement.

On February 7, 2005, the Company entered into a Controlled Equity Offering Sales Agreement with Cantor Fitzgerald & Co., or Cantor Fitzgerald, through which the Company may sell common stock or preferred stock from time to time through Cantor Fitzgerald acting as agent and/or principal in privately negotiated and/or at-the-market transactions. During the nine months ended September 30, 2005, the Company sold approximately 2.8 million shares of common stock pursuant to this Agreement and the Company received proceeds, net of commissions and other offering costs, of approximately \$30.0 million.

On June 3, 2005, the Company filed a registration statement on Form S-3 with the SEC to register the Company's Direct Stock Purchase and Dividend Reinvestment Plan, or the Plan. This registration statement was declared effective by the SEC on June 28, 2005. The Plan offers stockholders, or persons who agree to become

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**LUMINENT MORTGAGE CAPITAL, INC.**  
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**(Unaudited)**

stockholders, the option to purchase shares of the Company and/or to automatically reinvest all or a portion of their quarterly dividends in shares of the Company. During the three and nine months ended September 30, 2005, the Company issued 619,293 shares of common stock through direct stock purchase for net proceeds of \$5.8 million.

The Company calculates basic net income per share by dividing net income for the period by the weighted-average number of shares of common stock outstanding for that period. Diluted net income per share takes into account the effect of dilutive instruments, such as 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.

The following table presents a reconciliation of basic and diluted net income per share for the three and nine months ended September 30, 2005:

|   | <b>For the Three Months<br/>Ended September 30, 2005</b> |                | <b>For the Nine Months<br/>Ended September 30, 2005</b> |                |
|---|--|----------------|---|----------------|
|   | <b>Basic</b>   | <b>Diluted</b> | <b>Basic</b>  | <b>Diluted</b> |
| Net income (in thousands)   | \$ 5,229   | \$ 5,229       | \$ 30,372   | \$ 30,372      |
| Weighted-average number of common shares outstanding                | 40,021,698   | 40,021,698     | 38,478,679  | 38,478,679     |
| Additional shares due to assumed conversion of dilutive instruments |  | 204,825        |   | 137,190        |
| Adjusted weighted-average number of common shares outstanding       | 40,021,698   | 40,226,523     | 38,478,679  | 38,615,869     |
| Net income per share  | \$ 0.13  | \$ 0.13        | \$ 0.79   | \$ 0.79        |

The following table presents a reconciliation of basic and diluted net income per share for the three and nine months ended September 30, 2004:

|   | <b>For the Three Months<br/>Ended September 30, 2004</b> |                | <b>For the Nine Months<br/>Ended September 30, 2004</b> |                |
|---|--|----------------|---|----------------|
|   | <b>Basic</b>   | <b>Diluted</b> | <b>Basic</b>  | <b>Diluted</b> |
| Net income (in thousands)   | \$ 14,494  | \$ 14,494      | \$ 40,248   | \$ 40,248      |
| Weighted-average number of common shares outstanding                | 36,814,000   | 36,814,000     | 32,916,190  | 32,916,190     |
| Additional shares due to assumed conversion of dilutive instruments |  | 53,233         |   | 22,703         |
| Adjusted weighted-average number of common shares outstanding       | 36,814,000   | 36,867,233     | 32,916,190  | 32,938,893     |
| Net income per share  | \$ 0.39  | \$ 0.39        | \$ 1.22   | \$ 1.22        |

**NOTE 6 2003 STOCK INCENTIVE PLANS**

The Company adopted a 2003 Stock Incentive Plan, effective June 4, 2003, and a 2003 Outside Advisors Stock Incentive Plan, effective June 4, 2003, pursuant to which up to 1,000,000 shares of the Company's common stock is authorized to be awarded at the discretion of the Compensation Committee of the Board of Directors. On

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May 25, 2005, these plans were amended to increase the total number of shares reserved for issuance from 1,000,000 shares to 2,000,000 shares and to set the share limits at 1,850,000 shares for the 2003 Stock Incentive Plan and 150,000 shares for the 2003 Outside Advisors Stock Incentive Plan. The plans provide for the grant of a variety of long-term incentive awards to employees and officers of the Company or individual consultants or advisors who render or have rendered bona fide services as an additional means to attract, motivate, retain and reward eligible persons. These plans provide for the grant of awards that meet the requirements of Section 422 of the Internal Revenue Code, non-qualified stock options, stock appreciation rights, restricted stock, stock units and other stock-based awards and dividend equivalent rights. The maximum term of each grant is determined on the grant date by the Compensation Committee and may not exceed 10 years. The exercise price and the vesting requirement of each grant are determined on the grant date by the Compensation Committee.

The following table illustrates the common stock available for grant at September 30, 2005:

|                              | <b>2003 Stock<br/>Incentive Plan</b> | <b>2003 Outside<br/>Advisors<br/>Stock<br/>Incentive<br/>Plan</b> | <b>Total</b> |
|------------------------------|--------------------------------------|---|--------------|
| Shares reserved for issuance | 1,850,000                            | 150,000   | 2,000,000    |
| Granted                      | 216,666                              |   | 216,666      |
| Forfeited                    |                                      |   |              |
| Expired                      |                                      |   |              |
| Total available for grant    | 1,633,334                            | 150,000   | 1,783,334    |

At September 30, 2005, the Company had outstanding options under the plans with expiration dates of 2013. The following table summarizes all stock option transactions during the nine months ended September 30, 2005:

|                                  | <b>Number of<br/>Options</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Price</b> |
|----------------------------------|------------------------------|---|
| Outstanding, beginning of period | 55,000                       | \$ 14.82  |
| Granted                          |                              |   |
| Exercised                        |                              |   |
| Forfeited                        |                              |   |
| Outstanding, end of period       | 55,000                       | \$ 14.82  |

The following table summarizes certain information about stock options outstanding at September 30, 2005:

| <b>Range of<br/>Exercise Prices</b> | <b>Number<br/>of<br/>Options</b> | <b>Outstanding</b>   | <b>Weighted-<br/>Average<br/>Exercise<br/>Price</b> | <b>Exercisable</b>               |   |
|-------------------------------------|----------------------------------|--|---|----------------------------------|---|
|                                     |                                  | <b>Weighted-<br/>Average<br/>Remaining<br/>Life (in<br/>years)</b> |   | <b>Number<br/>of<br/>Options</b> | <b>Weighted-<br/>Average<br/>Exercise<br/>Price</b> |

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|                 |        |     |         |        |         |
|-----------------|--------|-----|---------|--------|---------|
| \$13.00-\$14.00 | 5,000  | 8.1 | \$13.00 | 1,667  | \$13.00 |
| \$14.01-\$15.00 | 50,000 | 7.8 | 15.00   | 33,333 | 15.00   |
| \$13.00-\$15.00 | 55,000 |     | \$14.82 | 35,000 | \$14.90 |



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The following table illustrates the changes in nonvested stock options during the nine months ended September 30, 2005:

|                                    | <b>Number of<br/>Options</b> | <b>Weighted-<br/>Average<br/>Grant-Date<br/>Fair Value</b> |
|------------------------------------|------------------------------|--|
| Nonvested, beginning of the period | 36,666                       | \$ 0.22  |
| Granted                            |                              |  |
| Vested                             | (16,666)                     | 0.22   |
| Forfeited                          |                              |  |
| Nonvested, end of the period       | 20,000                       | \$ 0.22  |

Total stock-based employee compensation expense related to stock option awards for the three months ended September 30, 2005 and 2004 was \$1 thousand. Total stock-based employee compensation expense related to stock option awards for the nine months ended September 30, 2005 and 2004 was \$2 thousand and \$4 thousand, respectively. At September 30, 2005, stock-based employee compensation expense of \$1 thousand related to nonvested stock options is expected to be recognized over a weighted-average period of 0.8 years.

The following table illustrates the changes in common stock awards during the nine months ended September 30, 2005:

|                                  | <b>Number of<br/>Common<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Issue<br/>Price</b> |
|----------------------------------|--|--|
| Outstanding, beginning of period | 25,122                                 | \$ 12.06   |
| Issued                           | 131,707                                | 11.37  |
| Repurchased                      |  |  |
| Outstanding, end of period       | 156,829                                | \$ 11.48   |

The following table illustrates the changes in nonvested common stock awards during the nine months ended September 30, 2005:

|                                    | <b>Number of<br/>Common<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Grant-Date<br/>Fair Value</b> |
|------------------------------------|--|--|
| Nonvested, beginning of the period | 25,122                                 | \$ 12.06   |
| Granted                            | 131,707                                | 11.37  |
| Vested                             | (3,302)                                | 12.14  |
| Repurchased                        |  |  |

|                              |         |         |
|------------------------------|---------|---------|
| Nonvested, end of the period | 153,527 | \$11.47 |
|------------------------------|---------|---------|

Total stock-based employee compensation expense related to common stock awards for the three months ended September 30, 2005 and 2004, was \$118 thousand and \$23 thousand, respectively. Total stock-based employee compensation expense related to common stock awards for the nine months ended September 30, 2005 and 2004, was \$257 thousand and \$47 thousand, respectively. At September 30, 2005, stock-based employee compensation expense of \$1.5 million related to nonvested common stock awards is expected to be recognized over a weighted-average period of 1.8 years.

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**NOTE 7 THE MANAGEMENT AGREEMENT**

The Company entered into the Amended Agreement, dated as of March 1, 2005 with the Manager that provides, among other things, that the Company will pay to the Manager, in exchange for investment management and certain administrative services, certain fees and reimbursements, summarized as follows:

base management compensation equal to a percentage of the Company's applicable average net worth, as defined in the Amended Agreement, paid quarterly in arrears, calculated at the following rates per annum: (1) 0.90% of the first \$750 million; plus (2) 0.70% of the next \$750 million; plus (3) 0.50% of the amount in excess of \$1.5 billion;

incentive management compensation equal to a percentage of applicable average net worth, as defined in the Amended Agreement, paid annually, calculated at the following rates per annum: (1) 0.35% for the first \$750 million of applicable average net worth; (2) 0.20% for the next \$750 million of applicable average net worth; and (3) 0.15% for the applicable average net worth in excess of \$1.5 billion) if the return on assets, as defined in the Amended Agreement, for any such fiscal year exceeds the threshold return, defined as the average of the weekly values for any period of the sum of (i) the 10-year U.S. Treasury rate for such period and (ii) two percent (2%); and

out-of-pocket expenses and certain other costs incurred by the Manager and related directly to the Company.

Under the Amended Agreement, the base management compensation and incentive management compensation are paid to the Manager by the Company in cash. Base management and incentive compensation are only earned by the Manager for assets which are managed by the Manager.

The Company is entitled to terminate the Amended Agreement without cause provided that the Company gives the Manager at least 60 days' prior written notice and pays a termination fee and other unpaid costs and expenses reimbursable to the Manager. If the Company terminates the Amended Agreement without cause, the Company is required to pay the Manager a termination fee equal to two times the amount of the highest annual base management compensation and the highest annual incentive management compensation, for a particular year, earned by the Manager during any of the three years (or on an annualized basis if a lesser period) preceding the effective date of the termination, multiplied by a fraction, where the numerator is the positive difference (if any) resulting from thirty-six (36) minus the number of months (rounded to the nearest whole month) between the effective date of the Amended Agreement and the termination date, and the denominator is thirty-six (36).

The Company is also entitled to terminate the Amended Agreement for cause, in which case the Company is only obligated to reimburse unpaid costs and expenses. In addition, the Manager will forfeit any then-unvested stock of the Company pursuant to the terms of the restricted stock award agreements issued at the time of the stock grants.

The Amended Agreement contains certain provisions requiring the Company to indemnify the Manager for costs (e.g., legal costs) the Manager could potentially incur in fulfilling its duties prescribed in the Amended Agreement or in other agreements related to the Company's activities. The indemnification provisions do not apply under all circumstances (e.g., if the Manager is grossly negligent, acted with reckless disregard or engaged in willful misconduct or active fraud). The provisions contain no limitation on maximum future payments. The Company evaluated the impact of these indemnification provisions on its financial statements and determined that they are immaterial.

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The base management compensation for the three and nine months ended September 30, 2005 was \$1.1 million and \$3.3 million, respectively. No incentive compensation was earned by the Manager for the three months and nine months ended September 30, 2005. Incentive compensation expense was \$240 thousand and \$1.1 million for the three and nine months ended September 30, 2005, respectively, and relates to restricted common stock awards granted for incentive compensation earned by the Manager in prior periods that vested during the current periods.

Prior to the Amended Agreement, the Company had entered into a Management Agreement, dated as of June 11, 2003, or Prior Agreement. Under the Prior Agreement, the Company was required to pay the Manager, in exchange for investment management and certain administrative services, certain fees and reimbursements, summarized as follows:

a base management compensation equal to a percentage of the Company's average net worth during each fiscal year, as defined in the Prior Agreement (1% of the first \$300 million plus 0.8% of the amount in excess of \$300 million);

incentive compensation based on the excess of a tiered percentage (as defined in the Prior Agreement as the weighted-average of the following rates based upon the Company's average net invested assets, as defined in the Prior Agreement: (1) 20% for the first \$400 million of average net invested assets; and (2) 10% for the average net invested assets in excess of \$400 million) of the difference between the Company's net income (defined in the Prior Agreement as taxable income before incentive compensation, net operating losses from prior periods and items permitted by the Internal Revenue Code when calculating taxable income for a REIT) and the threshold return (the amount of net income for the period that would produce an annualized return on equity, calculated by dividing the net income, as defined in the Prior Agreement, by the average net invested assets, as defined in the Prior Agreement, equal to the 10-year U.S. Treasury rate for the period plus 2.0%) for the fiscal period; and

out-of-pocket expenses and certain other costs incurred by the Manager and related directly to the Company.

Under the Prior Agreement, the base management compensation and incentive compensation was paid quarterly and was subject to adjustment at the end of each fiscal year based on annual results. One-half of the incentive compensation was paid to the Manager in cash and one-half was paid in the form of a restricted stock award. The number of shares issued was based on (a) one-half of the total incentive compensation for the period, divided by (b) the average of the closing prices of the common stock over the 30-day period ending three calendar days prior to the grant date, less a fair market value discount determined by the Company's Board of Directors. These shares are restricted shares for varying periods of time, and are forfeitable if the Manager ceases to perform management services for the Company before the end of the restriction periods. The restrictions lapse and full rights of ownership vest for one-third of the shares on the first anniversary of the end of the period in which the incentive compensation is calculated, for one-third of the shares on the second anniversary and for the last one-third of the shares on the third anniversary. Vesting is predicated on the continuing involvement of the Manager in providing services to the Company. In accordance with SFAS No. 123, and related interpretations, and EITF 96-18, 15.2% of the restricted stock portion of the incentive compensation was expensed in the period incurred.

The base management compensation for the three and nine months ended September 30, 2004 was \$1.1 million and \$3.0 million, respectively.

Under the Prior Agreement, incentive compensation was earned by the Manager when REIT taxable net income (before deducting incentive compensation, net operating losses and certain other items) relative to the net invested assets for the period, defined in the Prior Agreement, exceeds the threshold return taxable income that would produce an annualized return on equity equal to the sum of the 10-year U.S. Treasury rate plus 2% for the same period. For the three months ended September 30, 2004, REIT taxable income (before deducting incentive

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compensation, net operating losses and certain other items) was \$16.9 million and was greater than the threshold return taxable income of \$7.7 million. For the nine months ended September 30, 2004, REIT taxable income (before deducting incentive compensation, net operating losses and certain other items) was \$43.6 million and was greater than the threshold return taxable income of \$20.1 million.

For the three and nine months ended September 30, 2004, total incentive compensation earned by the Manager was \$1.9 million and \$5.1 million, respectively, one-half payable in cash and one-half payable in the form of the Company's restricted common stock. The cash portion of the incentive compensation of \$950 thousand and \$2.5 million for the three and nine months ended September 30, 2004, respectively, was expensed in that period as well as 15.2% of the restricted common stock portion of the incentive compensation, or \$145 thousand and \$384 thousand, respectively.

In accordance with the terms of his employment agreement, the Company's chief financial officer is eligible to earn incentive compensation. The incentive compensation is accounted for in the same manner as the incentive compensation earned by the Manager; however, at the measurement date of the incentive compensation earned by the chief financial officer for a given fiscal year, an adjustment is made to the cumulative awards and the awards are recorded at the final grant date fair value in accordance with SFAS No. 123(R). No incentive compensation was earned by the chief financial officer for the three and nine months ended September 30, 2005. Incentive compensation expense of \$16 thousand for the three and nine months ended September 30, 2005 relates to restricted common stock awards granted for incentive compensation earned by the chief financial officer in prior periods that vested during the period. This balance reflects the adjustment made to the final grant date fair value of the chief financial officer's 2004 cumulative awards.

The chief financial officer earned incentive compensation of \$95 thousand and \$253 thousand for the three and nine months ended September 30, 2004, respectively. This incentive compensation was payable one-half in cash and one-half in the form of a restricted common stock award under the Company's 2003 Stock Incentive Plan. The shares vest over the same vesting schedule as the stock issued to the Manager. The cash portion of the incentive compensation of \$47 thousand and \$126 thousand for the three and nine months ended September 30, 2004, respectively, was expensed in the period incurred. In addition, \$7 thousand and \$19 thousand for the three and nine months ended September 30, 2004, respectively, related to the restricted common stock portion of the incentive compensation was expensed.

**NOTE 8 RELATED PARTY TRANSACTIONS**

At September 30, 2005 and December 31, 2004, the Company was indebted to the Manager for base management fees of \$1.1 million. At September 30, 2005, the Company was not indebted to the Manager for any incentive compensation and at December 31, 2004, the Company was indebted to the Manager for incentive compensation of \$1.6 million. The Company was not indebted to the Manager for reimbursement of expenses at September 30, 2005, and was indebted to the Manager for reimbursement of expense of \$3 thousand at December 31, 2004. At September 30, 2005, the Company was not indebted to the Company's chief financial officer for incentive compensation and at December 31, 2004, the Company was indebted to the Company's chief financial officer for incentive compensation of \$167 thousand. The Company was indebted to the officers and employees of the Company for bonuses and expense reimbursement of \$452 thousand and \$10 thousand at September 30, 2005, and December 31, 2004, respectively. These amounts are included in management fee payable, incentive compensation payable and other related party liabilities.

The Manager's financial relationship with the Company was governed by the Prior Agreement and is now governed by the Amended Agreement, dated as of March 1, 2005. Under the Amended Agreement, the Manager shall be responsible for all expenses of the personnel employed by the Manager, and all facilities and overhead expenses of the Manager required for the day-to-day operations of the Company, and the expenses of a

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sub-manager, if any. The Company shall reimburse the Manager for its pro-rata portion of facilities and overhead expenses to the extent that the Company's employees (who are not also employed by the Manager) use such facilities or incur such expenses pursuant to a cost-sharing agreement entered into between the Company and the Manager. At September 30, 2005 and December 31, 2004, no expenses were payable to the Manager pursuant to the cost-sharing agreement. During the three and nine months ended September 30, 2005, the Company paid the Manager \$3 thousand and \$21 thousand pursuant to the cost-sharing agreement, respectively. During the three and nine months ended September 30, 2004, the Company paid the Manager \$6 thousand and \$18 thousand pursuant to the cost-sharing agreement, respectively. The Company will pay all other expenses on behalf of the Company, and will reimburse the Manager for all direct expenses incurred on the Company's behalf that are not the Manager's specific responsibility as defined in the Amended Agreement.

**NOTE 9 FAIR VALUE OF FINANCIAL INSTRUMENTS**

SFAS No. 107, *Disclosure About Fair Value of Financial Instruments*, requires disclosure of the fair value of financial instruments for which it is practicable to estimate that value. The fair value of mortgage-backed securities available-for-sale and derivative contracts is equal to their carrying value presented in the balance sheet. The fair value of cash and cash equivalents, interest receivable, principal receivable, repurchase agreements, warehouse lending facilities, unsettled securities purchases and accrued interest expense approximates cost at September 30, 2005 and December 31, 2004 due to the short-term nature of these instruments. The carrying value and fair value of the Company's junior subordinated notes was \$51.6 million and \$51.0 million at September 30, 2005, respectively. In addition, the carrying value and fair value of the Company's loans held-for-investment was \$143.8 million and \$143.0 million at September 30, 2005, respectively. There were no outstanding balances of junior subordinated notes or loans held-for-investment at December 31, 2004.

**NOTE 10 ACCUMULATED OTHER COMPREHENSIVE LOSS**

The following is a summary of the components of accumulated other comprehensive loss at September 30, 2005 and December 31, 2004:

| <b>(in thousands)</b>  | <b>September<br/>30,<br/>2005</b> | <b>December<br/>31,<br/>2004</b> |
|--|-----------------------------------|----------------------------------|
| Unrealized holding losses on mortgage-backed securities available-for-sale   | \$ (99,670)                       | \$ (69,297)                      |
| Reclassification adjustment for net losses on mortgage-backed securities available-for-sale included in net income | 69                                |                                  |
| Net unrealized losses on mortgage-backed securities available-for-sale   | (99,601)                          | (69,297)                         |
| Net deferred realized and unrealized gains on cash flow hedges   | 8,895                             | 7,929                            |
| Accumulated other comprehensive loss   | \$ (90,706)                       | \$ (61,368)                      |

**NOTE 11 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

The Company seeks to manage its interest rate risk exposure and protect the Company's liabilities against the effects of major interest rate changes. Such interest rate risk may arise from the issuance and forecasted rollover and repricing of short-term liabilities with fixed rate cash flows or from liabilities with a contractual variable rate based on LIBOR. Interest rate risk may also arise from the issuance of long-term fixed rate or floating rate debt through securitization activities. Among other strategies, the Company may use Eurodollar futures contracts, swaption contracts, interest rate swap contracts and interest rate caps to manage these interest rate risks.



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The following table is a summary of derivative instruments held at September 30, 2005:

| <b>(in thousands)</b>                   | <b>Estimated<br/>Fair Value</b> |
|---|---------------------------------|
| Eurodollar futures contracts sold short | \$4,404                         |
| Interest rate swap contracts            | 3,571                           |
| Swaption contracts                      | 1,476                           |

The following table is a summary of derivative instruments held at December 31, 2004:

| <b>(in thousands)</b>                   | <b>Estimated<br/>Fair Value</b> |
|---|---------------------------------|
| Eurodollar futures contracts sold short | \$(1,073)                       |
| Interest rate swap contracts            | 7,900                           |

*Cash Flow Hedging Strategies*

Hedging instruments are designated as cash flow hedges, as appropriate, based upon the specifically identified exposure, or hedged item.

*Hedging Strategies for Short-Term Debt*

The hedged transaction is the forecasted interest expense on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements for a specified future time period. The hedged risk is the variability in those payments attributable to changes in the benchmark rate. Hedging transactions are structured at inception so that the notional amounts of the hedge are matched with an equal amount of repurchase agreements forecasted to be outstanding in that specified period for which the borrowing rate is not yet fixed. Cash flow hedging strategies include the utilization of Eurodollar futures contracts and interest rate swap contracts. Hedging instruments under these strategies are deemed to be broadly designated to the outstanding repurchase portfolio and the forecasted rollover thereof. Such forecasted rollovers would also include other types of borrowing arrangements that may replace the repurchase funding during the identified hedge time periods. At September 30, 2005 and December 31, 2004, the maximum length of time over which the Company is hedging its exposure was 6.5 years and 15 months, respectively.

The Company may use Eurodollar futures contracts to hedge the forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements for a specified future time period, which is defined as the calendar quarter immediately following the contract expiration date. Gains and losses on each contract are associated with forecasted interest expense for the specified future period.

The Company may use interest rate swap contracts to hedge the forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements for the period defined by maturity of the interest rate swap. Cash flows that occur each time the swap is repriced will be associated with forecasted interest expense for a specified future period, which is defined as the calendar period preceding each repricing date with the same number of months as the repricing frequency.



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The hedge instrument must be highly effective in achieving offsetting changes in the hedged item attributable to the risk being hedged in order to qualify for hedge accounting. In order to determine whether the hedge instrument is highly effective, the Company uses regression methodology to assess the effectiveness of these hedging strategies. Specifically, at the inception of each new hedge and on an ongoing basis, the Company assesses effectiveness using ordinary least squares regression to evaluate the correlation between the rates consistent with the hedge instrument and the underlying hedged items. A hedge instrument is highly effective if the changes in the fair value of the derivative provide offset of at least 80% and not more than 125% of the changes in fair value or cash flows of the hedged item attributable to the risk being hedged. The Eurodollar futures and interest rate swap contracts are carried on the balance sheet at fair value. Any ineffectiveness that arises during the hedging relationship is recognized in interest expense during the period in which it arises.

*Hedging Strategies for Long-Term Debt*

The hedged transaction is the forecasted interest expense on long-term fixed rate or floating rate debt expected to be issued through securitization activities. The hedged risk is the variability in those payments attributable to changes in the benchmark rate. Hedging transactions are structured at inception so that the notional amounts of the hedge are matched with the forecasted principal balances of the long-term debt. Cash flow hedging strategies include the use of Eurodollar futures contracts and amortizing interest rate swap contracts to hedge the forecasted interest expense for a specified future time period, which is defined as estimated life of the long-term debt issued. At September 30, 2005, the maximum length of time over which the Company is hedging its exposure was 4.0 years. During the year ended December 31, 2004, the Company had not engaged in hedging activities under these hedge strategies.

Following the closing of a securitization in which floating rate debt securities are collateralized by fixed rate or hybrid adjustable-rate mortgage loans, the Company may use an amortizing interest rate swap or amortizing interest rate cap to immunize the Company against changes in interest expense attributable to changes in the benchmark rate relating to the floating rate debt. Hedging transactions are structured at inception so that the notional amounts of the hedge are matched with the forecasted principal balances of the long-term debt. During the nine months ended September 30, 2005 and the year ended December 31, 2004, the Company had not engaged in hedging activities under these hedge strategies.

The hedge instrument must be highly effective in achieving offsetting changes in the hedged item attributable to the risk being hedged in order to qualify for hedge accounting. In order to determine whether the hedge instrument is highly effective, the Company uses a qualitative test to assess the effectiveness of these hedging strategies at the inception of each new hedge. On an ongoing basis, the Company assesses effectiveness using a dollar offset test. The Eurodollar futures and amortizing interest rate swap contracts are carried on the balance sheet at fair value. Any ineffectiveness that arises during the hedging relationship is recognized in interest expense during the period in which it arises.

Prior to the end of the specified hedge time period, the effective portion of all contract gains and losses (whether realized or unrealized) is recorded in other comprehensive income or loss. Realized gains and losses are reclassified into earnings as an adjustment to interest expense during the specified hedge time period.

During the three months ended September 30, 2005 and 2004, losses of \$430 thousand and \$244 thousand, respectively, were recognized in interest expense due to hedge ineffectiveness. During the nine months ended September 30, 2005 and 2004, gains of \$43 thousand and \$1.7 million, respectively, were recognized in interest expense due to hedge ineffectiveness. During the three months ended September 30, 2005, interest expense was increased by \$799 thousand of amortization of net realized losses on Eurodollar futures contracts, but was decreased by \$4.2 million of net interest income received from swap contract counterparties. During the three months ended September 30, 2004, interest expense was decreased by \$685 thousand of amortization of net realized gains on

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Eurodollar futures contracts, but was increased by \$1.9 million of net interest paid to swap contract counterparties. During the nine months ended September 30, 2005, interest expense was decreased by \$1.4 million of amortization of net realized gains on Eurodollar futures contracts and \$7.4 million of net interest income received from swap contract counterparties. During the nine months ended September 30, 2004, interest expense was decreased by \$272 thousand of amortization of realized gains on Eurodollar futures contracts, but was increased by \$2.4 million of net interest paid to swap contract counterparties. Based upon the combined amounts of \$1.4 million of net deferred realized gains and \$3.9 million of net unrealized gains from Eurodollar futures contracts included in accumulated other comprehensive income and loss at September 30, 2005, the Company expects to recognize lower interest expense during the remainder of 2005 through part of 2010. This amount could differ from amounts actually realized due to changes in the benchmark rate between September 30, 2005 and when the Eurodollar futures contracts sold short at September 30, 2005 are covered as well as the addition of other hedges subsequent to September 30, 2005.

*Free Standing Derivatives*

The Company had swaption contracts outstanding at September 30, 2005 that were not designated as hedges under SFAS No. 133. The contracts are carried on the balance sheet at fair value and the gain of \$501 thousand and the loss of \$398 thousand resulted from the change of the fair value of the contracts for the three months and nine months ended September 30, 2005, respectively, was recognized in other income and expense. At December 31, 2004, the Company had not entered into swaption contracts.

**NOTE 12 PREFERRED  
SECURITIES OF  
SUBSIDIARY  
TRUST AND  
JUNIOR  
SUBORDINATED  
NOTES**

On March 15, 2005, the Trust issued 50,000 Floating Rate Preferred Securities, or Preferred Securities, for gross proceeds of \$50.0 million. The combined proceeds from the issuance of the Preferred Securities and the issuance to the Company of the Common Securities of the Trust were invested by the Trust in \$51.6 million aggregate principal amount of Junior Subordinated Notes issued by the Company. The Junior Subordinated Notes are the sole assets of the Trust and are due March 31, 2035, and bear interest at the fixed rate of 8.16% per annum commencing on March 15, 2005 through March 30, 2010. Thereafter, the Junior Subordinated Notes bear interest at a variable rate equal to three-month LIBOR plus 3.75% per annum through maturity. Interest is payable quarterly.

The Junior Subordinated Notes are redeemable on any interest payment date at the option of the Company in whole, but not in part, on or after March 30, 2010 at the redemption rate of 100% plus accrued and unpaid interest. Prior to March 30, 2010, upon the occurrence of a special event relating to certain federal income tax matters, the Company may redeem the Junior Subordinated Notes in whole, but not in part, at the redemption rate of 107.5% plus accrued and unpaid interest.

The holders of the Preferred Securities and the Common Securities, or Trust Securities, are entitled to receive distributions at the fixed rate of 8.16% per annum of the stated liquidation amount of \$1,000 per security commencing on March 15, 2005 through March 30, 2010. Thereafter, the Trust Securities are entitled to receive distributions at a variable rate equal to three-month LIBOR plus 3.75% per annum of the stated liquidation amount of \$1,000 per security through maturity. Distributions are payable quarterly. The Trust Securities do not have a stated maturity date; however, they are subject to mandatory redemption upon the maturity of the Junior Subordinated Notes.

Unamortized deferred issuance costs associated with the Junior Subordinated Notes amounted to \$1.6 million at September 30, 2005, and is being amortized using the effective yield method over the term of the Junior Subordinated Notes. There was \$510 thousand of unpaid interest on the Junior Subordinated Notes at September 30, 2005.



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**LUMINENT MORTGAGE CAPITAL, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**(Unaudited)**

**NOTE 13 SUBSEQUENT EVENTS**

On October 7, 2005, the Company entered into a \$500.0 million warehouse lending facility with Bear Stearns as an additional source of funding for the Company's residential mortgage loan portfolio.

In October 2005, the Company completed the purchase of approximately \$349.4 million of residential mortgage loans, primarily comprised of first lien, single-family hybrid adjustable-rate residential mortgage loans, all with the same maturity date of 2035 and with interest rates ranging from 4.00% to 7.00%. These loans were acquired in anticipation of completing a securitization of these assets combined with other loans purchased during the third quarter of 2005. The loans were financed by our short-term warehouse lending facilities.

On November 2, 2005, the Company issued \$520.6 million of securities consisting of a series of private-label multi-class mortgage-backed securities which will match the income earned on mortgage assets with the cost of the related liabilities, otherwise referred to as match funding the Company's balance sheet. The collateral was transferred to a separate bankruptcy-remote legal entity, Luminent Mortgage Trust 2005-1, or LUM 2005-1. Collateral for the securitization included approximately \$486.4 million of residential mortgage loans, as well as prefunding of approximately \$34.2 million of residential mortgage loans to be identified and transferred to the Trust within ninety days of the closing of the securitization. On a consolidated basis this securitization was accounted for as a financing and, therefore, no gain or loss was recorded in connection with the securitization. The residential mortgage loans will remain as assets on the Company's consolidated balance sheets subsequent to securitization. The assets owned by LUM 2005-1 collateralized the LUM 2005-1 mortgage-backed securities, and as a result, those investments are not available to the Company, its creditors or stockholders. The securitization is considered to be a financing for both tax and GAAP. The Company retained \$20.3 million of the resulting securities for its securitized residential mortgage loan portfolio and placed \$500.3 million with third-party investors, thereby providing long-term collateralized financing for its assets. Of the securities retained, 66.7% were rated Investment Grade and 33.3% were rated less than Investment Grade. All classes of the securities were priced at par with interest indexed as one-month LIBOR floaters. The servicing of the mortgage loans is performed by third parties under servicing arrangements that resulted in no servicing asset or liability. All discussions relating to securitizations in this Form 10-Q are on a consolidated basis and do not necessarily reflect the separate legal ownership of the loans by the related bankruptcy-remote legal entity.

Concurrently with the issuance of the LUM 2005-1 mortgage-backed securities, the proceeds received were used to pay down the Company's warehouse lending facility. Principal is paid on the securities issued following receipt of principal payments on the loans. The collateral specific to each mortgage-backed security series will be the sole source of their repayment.

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

*The following discussion of our financial condition and results of operations should be read in conjunction with the financial statements and notes to those statements included elsewhere in this Form 10-Q Report. This discussion may contain forward-looking statements that involve risks and uncertainties. The words believe, expect, anticipate, estimate, may, or could and similar expressions or the negatives of these words or phrases are intended to identify forward-looking statements. As a result of many factors, such as those set forth under Risk Factors and elsewhere in this Form 10-Q Report, our actual results may differ materially from those anticipated in such forward-looking statements.*

**Executive Summary**

Our mission is to produce high quality, reliable cash flows to our shareholders over the long term. The mortgage finance market, which benefits from the monthly payments of homeowners to service their mortgages, is the vehicle through which we deliver on our mission. We began with an initial Spread strategy of investing in high quality, fixed-rate, adjustable-rate and hybrid adjustable-rate mortgage-backed securities and leveraging these investments primarily through repurchase agreements. While this strategy has a reduced level of credit risk, it also has considerable interest rate exposure. Recognizing that the impact of the Federal Reserve's drive to raise rates would reduce returns available to our shareholders, we expanded our business model at the beginning of 2005 to include a broader investment strategy. The new strategy includes investments in lower credit quality mortgage-backed securities as well as whole loan purchases and securitizations of those loans, in a manner that should reduce our exposure to interest rates over time. As a result of the increases in short-term interest rates over the past 15 months, the net interest spread on our investment portfolio has decreased to 0.50% from 1.58% for the three months ended September 30, 2005 compared to the three months ended September 30, 2004, respectively, and decreased to 0.96% and 1.80% for the nine months ended September 30, 2005 compared to the same periods in 2004, respectively. These decreases are primarily due to increases in the cost of funds on our repurchase agreements used to fund the mortgage-backed securities in our Spread portfolio. See additional information on the components of our net interest spread and interest expense at Results of Operations.

Our Residential Mortgage Credit Portfolio strategy aims to complement our high-quality, but interest rate sensitive Spread portfolio, with investments that are far less sensitive to interest rates and that are therefore more predictable and sustainable. This strategy seeks to structure, acquire and fund mortgage loans which will provide long-term reliable income to our shareholders. We will accomplish this goal primarily through the purchase of mortgage loans which we design and originate in partnership with selected high quality providers with whom we have long and well-established relationships. We will securitize those loans with an optimal structure, retain the most valuable pieces of the securitization and thereby lock in profitable spread income over the life of the structure. Over time, these securitizations will reduce our sensitivity to interest rates and will help match the income we earn on our mortgage assets with the cost of our related liabilities. The debt that we incur in these securitizations will be non-recourse to our Company. As a secondary strategy, we will invest in subordinated mortgage-backed securities that have credit ratings below AAA. We will do this opportunistically, as we discover value and credit arbitrage opportunities in the market.

**General**

Luminent Mortgage Capital, Inc. is a real estate investment trust, or REIT, headquartered in San Francisco, California. We were incorporated in April 2003 to invest primarily in U.S. agency and other highly-rated, single-family, adjustable-rate, hybrid adjustable-rate and fixed-rate mortgage-backed securities, which we acquire in the secondary market. Substantive operations began in mid-June 2003, after completing a private placement of our common stock. In 2005, we expanded our mortgage investment strategy to include mortgage loan origination and securitization, as well as investments in mortgage-backed securities that have credit ratings of lower than AAA.

Using these investment strategies, we seek to acquire mortgage-related assets, finance these purchases in the capital markets and use leverage in order to provide an attractive return on stockholders' equity. We have

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acquired and will seek to acquire additional assets that will produce competitive returns, taking into consideration the amount and nature of the anticipated returns from the investment, our ability to pledge the investment for secured, collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments.

Our business is affected by the following economic and industry factors that may have a material adverse effect on our financial condition and results of operations:

interest rate trends and changes in the yield curve;

rates of prepayment on our mortgage loans and the mortgages underlying our mortgage-backed securities;

highly competitive markets for investment opportunities; and

other market developments, including changes in the yield curve

In addition, several factors relating to our business may also impact our financial condition and operating performance. These factors include:

overall leverage of our portfolio;

access to funding and adequate borrowing capacity;

increases in our borrowing costs;

the ability to use derivatives to mitigate our interest rate and prepayment risks;

the market value of our investments; and

compliance with REIT requirements and the requirements to qualify for an exemption under the Investment Company Act of 1940.

Refer to **Risk Factors** for additional discussion regarding these and other risk factors that affect our business. Refer to **Interest Rate Risk** in Item 3, **Quantitative and Qualitative Disclosure About Market Risk**, for additional interest rate risk discussion.

**Critical Accounting Policies**

Our financial statements are prepared in accordance with GAAP, which require us to make some complex and subjective decisions and assessments. Our most critical accounting policies involve decisions and assessments that could significantly 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 financial statements are based were reasonable at the time made based upon information available to us at that time. See Note 2 to our financial statements included in Item 8 of our 2004 Annual Report on Form 10-K for a more complete discussion of our significant accounting policies. Management has identified our most critical accounting policies to be the following:

*Classifications of Investment Securities*

Our investments in mortgage-backed securities are classified as available-for-sale securities, which are carried on the balance sheet at their fair value. The classification of the securities as available-for-sale results in changes in fair value being recorded as adjustments to accumulated other comprehensive income or loss, which is a component of stockholders' equity, rather than immediately through earnings. If available-for-sale securities were classified as trading securities, we could experience substantially greater volatility in income or loss from period to period.

**Table of Contents***Valuations of Mortgage-backed Securities*

Our mortgage-backed securities have fair values based on estimates provided by independent pricing services and dealers in mortgage-backed securities. Because the price estimates may vary between sources, management makes certain judgments and assumptions about the appropriate price to use. Different judgments and assumptions could result in different presentations of value.

We estimate the fair value of our purchased beneficial interests using available market information and other appropriate valuation methodologies. We believe the estimates we use reflect the market values we may be able to receive should we choose to sell them. Our estimates involve matters of uncertainty, judgment in interpreting relevant market data and are inherently subjective in nature. Many factors are necessary to estimate market values, including, but not limited to interest rates, prepayment rates, amount and timing of credit losses, supply and demand, liquidity, cash flows, and other market factors. We apply these factors to our credit portfolio as appropriate, in order to determine market values.

When the fair value of an available-for-sale security is less than amortized cost, management considers whether there is an other-than-temporary impairment in the value of the security. The determination of other-than-temporary impairment is a subjective process, requiring the use of judgments and assumptions. If management determines an other-than-temporary impairment exists, the cost basis of the security is written down to the then-current fair value, and the unrealized loss is recorded as a reduction of current earnings as if the loss had been realized in the period of impairment.

Management considers several factors when evaluating securities for an other-than-temporary impairment, including the length of time and extent to which the market value has been less than the amortized cost, whether the security has been downgraded by a rating agency and the continued intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in market value. At September 30, 2005, we had unrealized losses on our mortgage-backed securities classified as available-for-sale of \$100.6 million, which if not recovered may result in the recognition of future losses.

The determination of other-than-temporary impairment is evaluated at least quarterly. If future evaluations conclude that impairment is other-than-temporary, we may need to realize a loss that would have an impact on income.

*Loans Held-for-Investment*

We purchase pools of residential mortgage loans through our network of origination partners. Mortgage loans are designated as held-for-investment as we have the intent and ability to hold them for the foreseeable future, and until maturity or payoff. Mortgage loans that are considered to be held-for-investment are carried at their unpaid principal balances, including unamortized premium or discount, adjustments for unamortized derivative gains and losses during the commitment period and reserve for loan losses.

*Interest Income Recognition*

Interest income on our mortgage-backed securities is accrued based on the coupon rate and the outstanding principal amount of the underlying mortgages. Premiums and discounts are amortized or accreted as adjustments to interest income over the lives of the securities using the effective yield method adjusted for the effects of estimated prepayments based on Statement of Financial Accounting Standards, or SFAS, No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*. If our estimate of prepayments is incorrect, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income. Purchased beneficial interests in securitized financial assets are accounted for in accordance with Emerging Issues Task Force, or EITF, 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets*. Interest income is recognized using the effective yield method. The prospective method is used for adjusting the level yield used to recognize interest income when estimates of future cash flows over the

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remaining life of the security either increase or decrease. Cash flows are projected based on management's assumptions for prepayment rates and credit losses. Actual economic conditions may produce cash flows that could differ significantly from projected cash flows, and differences could result in an increase or decrease in the yield used to record interest income or could result in an impairment charge.

Interest income on our mortgage loans is accrued and credited to income based on the carrying amount and contractual terms of the assets using the effective yield method in accordance with SFAS No. 91. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When an interest accrual is discontinued, all associated unpaid accrued interest income is reversed against current period operating results. Interest income is subsequently recognized only to the extent cash payments are received.

*Allowance and Provision for Loan Losses*

To estimate the allowance for loan losses, we first identify impaired loans. Loans are generally evaluated for impairment individually, but loans purchased on a pooled basis with relatively smaller balances and substantially similar characteristics may be evaluated collectively for impairment. Loans are considered impaired when, based on current information, it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement, including interest payments. Impaired loans are carried at the lower of the recorded investment in the loan or the fair value of the collateral, if the loan is collateral dependent.

*Accounting for Derivative Financial Instruments and Hedging Activities*

Our policies permit us to enter into derivative contracts as a means of mitigating our interest rate risk on forecasted interest expense associated with forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements and the forecasted interest expense associated with forecasted securitization activities, or hedged items, for a future time period. Our policies allow us to enter into Eurodollar futures contracts, interest rate swap contracts and interest rate caps. These hedge instruments may be designated as cash flow hedges and are evaluated at inception and on an ongoing basis in order to determine whether they qualify for hedge accounting under SFAS No. 133, as amended and interpreted. The hedge instrument must be highly effective in achieving offsetting changes in the hedged item attributable to the risk being hedged in order to qualify for hedge accounting. Hedge instruments are carried on the balance sheet at fair value. Any ineffectiveness that arises during the hedging relationship is recognized in interest expense during the period in which it arises. Prior to the end of the specified hedge time period, the effective portion of all contract gains and losses, whether realized or unrealized, is recorded in other comprehensive income or loss. Realized gains and losses on hedge instruments are reclassified into earnings as an adjustment to interest expense during the specified hedge time period. For REIT taxable net income purposes, realized gains and losses on hedge instruments are reclassified into earnings immediately when positions are closed or have expired.

We are not required to account for derivative contracts using hedge accounting as described above. If we decided not to designate derivative contracts as hedges and to monitor their effectiveness as hedges, changes in the fair values of these instruments would be recorded in our statement of operations, potentially resulting in increased volatility in our earnings.

We may enter into commitments to purchase mortgage loans, or purchase commitments, from our network of origination partners. Each purchase commitment is evaluated in accordance with SFAS No. 133 to determine whether the purchase commitment meets the definition of a derivative instrument. Purchase commitments that meet the definition of a derivative instrument are recorded at their estimated fair value on the balance sheet and any change in fair value of the purchase commitment is recognized in other income. Upon settlement of the loan purchase, the purchase commitment derivative is derecognized and included in the cost basis of the loans purchased.

See Note 11 to the financial statements for further discussion about accounting for derivative financial instruments and hedging activities.



**Table of Contents***Management Incentive Compensation Expense*

On March 26, 2005, we entered into an Amended and Restated Management Agreement, or Amended Agreement, as of March 1, 2005 with Seneca, which supersedes the Management Agreement as of June 11, 2003, or Prior Agreement. The Amended Agreement provides for the payment of incentive compensation to Seneca if our financial performance exceeds certain benchmarks. During each quarter of the fiscal year, we calculate the incentive compensation expense on a cumulative basis, making any necessary adjustments for amounts that were recognized in previous quarters. As a result, if we experience poor quarterly performance in a particular quarter and this performance causes the cumulative incentive compensation expense for the current quarter to be lower than the cumulative incentive compensation for the prior quarter, we will record a negative incentive compensation expense in the current quarter. The incentive compensation is payable annually in cash and is accrued and expensed during the period for which it is calculated.

Under the Prior Agreement, incentive compensation was paid one-half in the form of our restricted common stock. We account for the restricted stock portion of the incentive compensation in accordance with SFAS No. 123, *Accounting for Stock-based Compensation*, and related interpretations, and EITF 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*.

Under the Prior Agreement, each incentive compensation restricted stock grant to Seneca was divided into three tranches. The first tranche vests over a one-year period and is expensed over approximately five quarters, beginning in the quarter in which it was earned. The second tranche vests over a two-year period and is expensed over approximately nine quarters beginning in the quarter in which it was earned. The third tranche vests over a three-year period and is expensed over approximately 13 quarters beginning in the quarter in which it was earned. Upon vesting of each tranche, an adjustment is made to account for the vested tranche at fair value. As a result of this vesting schedule for the restricted stock granted to Seneca, we incur incentive compensation expense in each of the periods following the grant of the restricted stock over a three-year period. We will continue to incur incentive compensation expense related to each restricted stock grant, even in subsequent periods in which Seneca did not earn incentive compensation.

As the price of our common stock changes in future periods, the fair value of the unvested portions of shares issued to Seneca pursuant to the Prior Agreement will be marked-to-market, with corresponding entries on the balance sheet. The net effect of any mark-to-market adjustments to the value of the unvested portions of the restricted stock will be expensed in future periods, on a ratable basis, according to the remaining vesting schedules of each respective tranche of restricted common stock. Accordingly, incentive compensation expense related to the portion of the incentive compensation paid to Seneca in each restricted stock grant may be higher or lower from one reporting period to the next, and may vary throughout the vesting period. For example, future incentive compensation expense related to previously issued but unvested restricted stock will be higher during periods of increasing stock prices and lower during periods of decreasing stock prices. In addition, over the vesting period for each restricted stock grant, our stockholders' equity will increase or decrease based upon the current market price of our stock.

Under the Prior Agreement, Seneca was granted multiple tranches of restricted common stock for incentive compensation. Management compensation expense will increase or decrease due to the vesting schedules and the mark-to-market impact of the unvested portions of the restricted stock grants, even in periods where there is little change in our income or stock price.

We also pay incentive compensation to our chief financial officer in accordance with the terms of his employment agreement. The incentive compensation is accounted for in the same manner as the incentive compensation earned by Seneca; however, at the measurement date of the incentive compensation earned by the chief financial officer for a given fiscal year, an adjustment is made to the cumulative awards and the awards are recorded at the final grant date fair value in accordance with SFAS No. 123(R).

**Table of Contents****Financial Condition**

All of our assets at September 30, 2005 were acquired with the proceeds from our private placement and public offerings of our common stock, the proceeds from our preferred securities offering, our warehouse lending facility and the use of leverage. On February 7, 2005, we entered into a Controlled Equity Offering Sales Agreement with Cantor Fitzgerald & Co., or Cantor Fitzgerald, through which we may sell common stock or preferred stock from time to time through Cantor Fitzgerald acting as agent and/or principal in privately negotiated and/or at-the-market transactions. During the nine months ended September 30, 2005, we sold approximately 2.8 million shares of common stock pursuant to this agreement and we received net proceeds of approximately \$30.0 million. On March 15, 2005, Diana Statutory Trust I, or the Trust, was created for the sole purpose of issuing and selling preferred securities in the amount of \$50.0 million. We received proceeds, net of debt issuance costs, from the preferred securities offering in the amount of \$48.4 million. We have established a Direct Stock Purchase and Dividend Reinvestment Plan, effective June 28, 2005, which offers stockholders, or persons who agree to become stockholders, the option to purchase shares of our common stock. During the three months ended September 30, 2005, we issued 619,293 shares of common stock through direct stock purchase for net proceeds of \$5.8 million.

*Mortgage-Backed Securities*

At September 30, 2005, we held \$4.7 billion of mortgage-backed securities at fair value, net of unrealized gains of \$953 thousand and unrealized losses of \$100.6 million. At December 31, 2004, we held \$4.8 billion of mortgage-backed securities at fair value, net of unrealized gains of \$772 thousand and unrealized losses of \$70.1 million. The increase in mortgage-backed securities held is primarily due to the purchase of mortgage-backed securities with a cost basis of \$1.2 billion, principal payments of \$1.2 billion and premium amortization of \$20.6 million during the nine months ended September 30, 2005. At September 30, 2005 and December 31, 2004, substantially all of the mortgage-backed securities in our portfolio were purchased at a premium to their par value and our total portfolio had a weighted-average amortized cost, excluding residual interests which were purchased at deep discounts, of 101.1% and 101.7% of face amount, respectively. At September 30, 2005 and December 31, 2004, none of our portfolio consisted of fixed-rate mortgage-backed securities.

At September 30, 2005, 96.0% of our mortgage-backed securities portfolio was invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities and 4.0% was invested in non-agency mortgage-backed securities with a weighted-average credit rating of BBB-. At December 31, 2004, our entire portfolio was invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities.

Fair value was below amortized cost for certain of the securities held at September 30, 2005 and December 31, 2004. At September 30, 2005, 97.6% of our portfolio that had unrealized losses was invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities. At December 31, 2004, all of our portfolio that had unrealized losses was invested in AAA-rated non-agency-backed or agency-backed mortgage-backed securities. None of the securities held had been downgraded by a credit rating agency since their purchase. We intend and have the ability to hold the securities for a period of time, to maturity if necessary, sufficient to allow for the anticipated recovery in fair value of the securities held. Certain non-agency mortgage-backed securities are accounted for in accordance with EITF 99-20. Changes in fair value of these securities are solely due to interest rate changes. As such, we do not believe any of the securities held are other-than-temporarily impaired at September 30, 2005 and December 31, 2004. At September 30, 2005, we had unrealized losses on our mortgage-backed securities classified as available-for-sale of \$100.6 million, which if not recovered may result in the recognition of future losses.

The stated contractual final maturity of the mortgage loans underlying our portfolio of mortgage-backed securities ranges up to 40 years. However, the expected maturities are subject to change based on the prepayments of the underlying mortgage loans.

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The following table sets forth the maturity dates, by year, and percentage composition of the mortgage-backed securities assets, or MBS, in our investment portfolio at September 30, 2005 and December 31, 2004:

| Asset                      | September 30, 2005              |            | December 31, 2004               |            |
|----------------------------|---------------------------------|------------|---------------------------------|------------|
|                            | Weighted-Average Final Maturity | % of Total | Weighted-Average Final Maturity | % of Total |
| Adjustable-Rate MBS        | 2033                            | 1.7%       | 2033                            | 2.6%       |
| Hybrid Adjustable-Rate MBS | 2034                            | 93.2       | 2034                            | 96.3       |
| Balloon MBS                | 2008                            | 1.1        | 2008                            | 1.1        |
| Other MBS                  | 2038                            | 4.0        | n/a                             | n/a        |

Actual maturities of mortgage-backed securities are generally shorter than stated contractual maturities. Actual maturities of our mortgage-backed securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal and prepayments of principal.

The following table summarizes our mortgage-backed securities at September 30, 2005 according to their estimated weighted-average life classifications:

| Weighted-Average Life<br>(in thousands)        | Fair Value   | Amortized Cost | Weighted-Average Coupon |
|--|--------------|----------------|-------------------------|
| Less than one year                             | \$ 483,235   | \$ 492,221     | 3.97%                   |
| Greater than one year and less than five years | 4,025,268    | 4,114,686      | 4.42                    |
| Greater than five years                        | 143,138      | 144,335        | 5.09                    |
| Total  | \$ 4,651,641 | \$ 4,751,242   | 4.40%                   |

The following table summarizes our mortgage-backed securities at December 31, 2004 according to their estimated weighted-average life classifications:

| Weighted-Average Life<br>(in thousands)        | Fair Value   | Amortized Cost | Weighted-Average Coupon |
|--|--------------|----------------|-------------------------|
| Less than one year                             | \$ 211,475   | \$ 215,099     | 3.76%                   |
| Greater than one year and less than five years | 4,616,480    | 4,682,154      | 4.24                    |
| Greater than five years                        |              |                |                         |
| Total  | \$ 4,827,955 | \$ 4,897,253   | 4.22%                   |

The weighted-average lives of the mortgage-backed securities at September 30, 2005 and December 31, 2004 in the tables above are based upon data provided through subscription-based financial information services, assuming constant prepayment rates to the balloon or reset date for each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loan, loan age, margin and volatility.

The actual weighted-average lives of the mortgage-backed securities in our investment portfolio could be longer or shorter than the estimates in the table above depending on the actual prepayment rates experienced over the lives of the applicable securities and are sensitive to changes in both prepayment rates and interest rates.

At September 30, 2005 and December 31, 2004, 93.2% and 96.3%, respectively, of our investment portfolio was invested in hybrid adjustable-rate mortgage-backed securities. Assuming constant payment rates, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities at September 30, 2005 and December 31, 2004 had a weighted-average term to next rate adjustment of approximately 28 months and 25 months, respectively. The phrase weighted-average term to next rate adjustment refers to the average of the periods of time that must elapse before the interest rates adjust for all of the mortgages underlying our hybrid adjustable-rate mortgage-backed securities in our portfolio, which average is weighted in proportion to the book values of the applicable securities

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The mortgages underlying our hybrid adjustable-rate mortgage-backed securities are typically subject to periodic and lifetime interest rate caps. Periodic interest rate caps limit the amount that the interest rate of a mortgage can increase during any given period. Lifetime interest rate caps limit the amount an interest rate can increase through the maturity of a mortgage. At September 30, 2005 and December 31, 2004, 79.6% and 76.7%, respectively, of the hybrid adjustable-rate securities in our investment portfolio were subject to interest rate caps. At September 30, 2005, the percentage of hybrid adjustable-rate mortgage-backed securities in our investment portfolio that were subject to periodic interest rate caps every six months or annually were 13.6% and 86.4%, respectively. At December 31, 2004, the percentage of hybrid adjustable-rate mortgage-backed securities in our investment portfolio that were subject to periodic interest rate caps every six months or annually were 17.1% and 82.9%, respectively. At September 30, 2005 and December 31, 2004, the mortgages underlying our hybrid adjustable-rate mortgage-backed securities with specific annual caps had average annual caps of 2.32% and 2.24%, respectively. The average lifetime cap was 9.99% at both September 30, 2005 and December 31, 2004.

The periodic adjustments to the interest rates of the mortgages underlying our mortgage-backed securities are based on changes in an objective index. Substantially all of the mortgages underlying our mortgage-backed securities adjust their interest rates based on one of two main indices, the U.S. Treasury index, which is a monthly or weekly average yield of benchmark U.S. Treasury securities published by the Federal Reserve Board, or the London Interbank Offered Rate, or LIBOR. The percentages of the mortgages underlying the hybrid adjustable-rate mortgage-backed securities in our investment portfolio at September 30, 2005 with interest rates that reset based on the U.S. Treasury or LIBOR indices were 35.4% and 64.6%, respectively. The percentages of the mortgages underlying the hybrid adjustable-rate mortgage-backed securities in our investment portfolio at December 31, 2004 with interest rates that reset based on the U.S. Treasury or LIBOR indices were 36.3% and 63.7%, respectively.

The principal payment rate on our mortgage-backed securities, an annual rate of principal paydowns for our mortgage-backed securities relative to the outstanding principal balance of our mortgage-backed securities, was 33% and 25% for the three months ended September 30, 2005 and December 31, 2004, respectively. The principal payment rate attempts to predict the percentage of principal that will paydown over the next 12 months based on historical principal paydowns. The principal payment rate cannot be considered an indication of future principal repayment rates because actual changes in interest rates will have a direct impact on the principal prepayments in our portfolio.

At September 30, 2005 and December 31, 2004, the weighted-average effective duration of the securities in our overall mortgage-backed securities portfolio, assuming constant prepayment rates, or CPR, to the balloon or reset date, or the CPB duration, was 1.7 years. CPR is a measure of the rate of prepayment for our mortgage-backed securities, expressed as an annual rate relative to the outstanding principal balance of our mortgage-backed securities. CPB duration is similar to CPR except that it also assumes that the hybrid adjustable-rate mortgage-backed securities prepay in full at their next reset date.

*Loans Held-for-Investment*

During the three months ended September 30, 2005, we completed our first acquisition of residential mortgage loans. At September 30, 2005, our residential mortgage loan portfolio totaled \$143.8 million, including unamortized premium of \$1.1 million.

At September 30, 2005 residential mortgage loans with a carrying value of \$140.4 million were pledged as collateral for borrowings under our warehouse lending facility.

At September 30, 2005, we had not recorded an allowance for loan losses as none of the loans held in the portfolio were considered impaired. We intend to securitize loans held-for-investment and account for securitizations as financings. All loans held-for-investment at September 30, 2005 are pending securitization. See Note 13 to the financial statements for more information regarding securitization activities.

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At September 30, 2005, loans held-for-investment consisted of the following:

| (in thousands)   | Interest<br>Rate<br>Type | Interest |       | Maturity | Principal  | Delinquent<br>Balance |
|--|--------------------------|----------|-------|----------|------------|-----------------------|
|  |                          | Rate     | Rate  | Date     | Balance    | (90<br>Days)          |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 3-Year<br>Hybrid         | 4.00     | 5.00% | 2035     | \$ 456     | \$                    |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 3-Year<br>Hybrid         | 5.01     | 6.00% | 2035     | 25,362     |                       |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 3-Year<br>Hybrid         | 6.01     | 7.00% | 2035     | 7,999      |                       |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 3-Year<br>Hybrid         | 7.01     | 7.50% | 2035     | 128        |                       |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 5-Year<br>Hybrid         | 4.00     | 5.00% | 2035     | 453        |                       |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 5-Year<br>Hybrid         | 5.01     | 6.00% | 2035     | 61,441     |                       |
| First Lien Adjustable Rate<br>Residential Mortgage Loans | 5-Year<br>Hybrid         | 6.01     | 7.00% | 2035     | 46,918     |                       |
|  |                          |          |       |          | \$ 142,757 | \$                    |

The weighted-average coupon of our loans held-for-investment at September 30, 2005 was 5.98%.

At September 30 2005, our 514 residential mortgage loans consisted of Alt-A first lien, three-year and five-year hybrid adjustable-rate mortgages acquired from third party originators and secured by one to four-family residences, individual condominium units and individual co-operative units having an aggregate balance of approximately \$142.8 million. Hybrid adjustable-rate mortgages have an initial fixed rate period and then the interest rate borne by each mortgage loan will be adjusted annually based on One-Year LIBOR or One-Year U.S. Treasury, each referred to as the index, computed in accordance with the related note plus the related gross margin, generally subject to rounding and to certain other limitations including a maximum lifetime mortgage rate and in certain cases a maximum upward or downward adjustment on each interest adjustment date. Consistent with characteristics typical of the Alt-A market, a large segment of this loan portfolio is scheduled to receive interest only payments during the initial fixed rate period and a large segment was underwritten under either a reduced or limited documentation program.

*Equity Securities*

Our investment policies allow us to acquire a limited amount of equity securities, including common and preferred shares issued by other real estate investment trusts. At September 30, 2005, we held common shares issued by other real estate investment trusts of \$1.1 million which is included in other assets. At December 31, 2004, we did not hold any such equity securities.

*Unsettled Securities Purchases*

At September 30, 2005 and December 31, 2004, we had no unsettled securities purchases.

*Other Assets*

We had other assets of \$49.6 million and \$33.4 million at September 30, 2005 and December 31, 2004, respectively. Other assets at September 30, 2005 consisted primarily of interest receivable of \$21.4 million, principal receivable of \$23.3 million, a common stock investment in a subsidiary trust of \$1.6 million, a common stock investment in other real estate investment trusts of \$1.1 million, collateral pledged to counterparties of our derivative



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contracts of \$1.1 million, prepaid warehouse lending facilities commitment fees of \$573 thousand and prepaid directors and officers liability insurance of \$281 thousand. Other assets at December 31, 2004 consisted primarily of interest receivable of \$18.9 million, principal receivable of \$13.4 million, prepaid directors and officers liability insurance of \$137 thousand, deferred financing costs of \$174 thousand, and deferred compensation of \$732 thousand. The increase in both interest receivable and principal receivable from December 31, 2004 is primarily due to the increase in our mortgage-backed securities portfolio.

*Hedging Instruments*

Hedging involves risk and typically involves costs, including transaction costs. The costs of hedging can increase as the period covered by the hedging increases and during periods of rising and volatile interest rates. We may increase our hedging activity and, thus, increase our hedging costs during such periods when interest rates are volatile or rising. We generally intend to hedge as much of the interest rate risk as we determine is in the best interest of our stockholders, after considering the cost of such hedging transactions and our desire to maintain our status as a REIT. Our policies do not contain specific requirements as to the percentages or amount of interest rate risk that we are required to hedge. There can be no assurance that our hedging activities will have the desired beneficial impact on our results of operations or financial condition. Moreover, no hedging activity can completely insulate us from the risks associated with changes in interest rates and prepayment rates.

At September 30, 2005 and December 31, 2004, we have engaged in short sales of Eurodollar futures contracts as a means of mitigating our interest rate risk on forecasted interest expense associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements and the forecasted interest expense on long-term floating rate debt expected to be issued through securitization activities. At September 30, 2005, we had short positions on 2,856 Eurodollar futures contracts, with expiration dates ranging from March 2006 to September 2009. The total notional amount of the contracts was \$2.9 billion. The value of futures contracts is marked-to-market daily in our margin account with the custodian. Based upon the daily market value of futures contracts, we either receive funds into, or wire funds into, our margin account with the custodian to ensure that an appropriate margin account balance is maintained at all times through the expiration of the contracts. At December 31, 2004, we had short positions on 4,740 Eurodollar futures contracts, with expiration dates ranging from March 2005 to March 2006. The total notional amount of the contracts was \$4.7 billion. At September 30, 2005 and December 31, 2004, the fair value of the Eurodollar futures contracts was \$4.4 million recorded in assets and \$1.1 million recorded in liabilities, respectively.

At September 30, 2005, we have entered into interest rate swap contracts to mitigate our interest rate risk associated with the benchmark rate on forecasted rollover/reissuance of repurchase agreements or the interest rate repricing of repurchase agreements for the period defined by maturity of the interest rate swap. Cash flows that occur each time the swap is repriced are associated with forecasted interest expense for a specified future period, which is defined as the calendar period preceding each repricing date with the same number of months as the repricing frequency. At September 30, 2005 and December 31, 2004, the current notional amount of interest rate swap contracts totaled \$855.0 million and \$1.6 billion, respectively, and the fair value of the interest rate swap contracts at those dates was \$3.6 million and \$7.9 million, respectively, recorded in assets. Counterparties to our interest rate swap contracts are well-known financial institutions and default risk is considered low.

We have outstanding swaption contracts at September 30, 2005 that were not designated as hedges under SFAS No. 133. The contracts are carried on the balance sheet at fair value. The fair value of the contracts at September 30, 2005 was \$1.5 million. At December 31, 2004, we had not entered into swaption contracts.

*Liabilities*

We have entered into repurchase agreements to finance some of our acquisitions of mortgage-backed securities. None of the counterparties to these agreements are affiliates of Seneca or us. These agreements are secured by our mortgage-backed securities and bear interest rates that have historically moved in close relationship to LIBOR. At September 30, 2005 and December 31, 2004, we had established 19 borrowing arrangements and 17 borrowing arrangements, respectively, with various investment banking firms and other lenders, 15 of which were in use at September 30, 2005, and 12 of which were in use at December 31, 2004.





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At September 30, 2005, we had outstanding \$4.2 billion of repurchase agreements with a weighted-average current borrowing rate of 3.83%, \$513.6 million of which matures within 30 days, \$2.1 billion of which matures between 31 and 90 days and \$1.7 billion of which matures in greater than 90 days. At December 31, 2004, we had outstanding \$4.4 billion of repurchase agreements with a weighted-average current borrowing rate of 2.38%, \$230.4 million of which matures within 30 days, \$1.9 billion of which matures between 31 and 90 days and \$2.3 billion of which matures in greater than 90 days. The decrease in outstanding repurchase agreements is primarily due to the use of cash flows from principal and interest payments to repay repurchase agreement liabilities. It is our present intention to seek to renew the repurchase agreements outstanding at September 30, 2005 as they mature under the then-applicable borrowing terms of the counterparties to our repurchase agreements. At September 30, 2005 and December 31, 2004, the repurchase agreements were secured by mortgage-backed securities with an estimated fair value of \$4.5 billion and \$4.6 billion, respectively, and had a weighted-average maturity of 131 days and 133 days, respectively. At September 30, 2005 and December 31, 2004, the repurchase agreements had a weighted-average term to next rate adjustment of approximately 76 days and 101 days, respectively. The net amount at risk, defined as the sum of the fair value of securities sold plus accrued interest income minus the sum of repurchase agreement liabilities plus accrued interest expense, with all counterparties was \$225.2 million and \$205.9 million at September 30, 2005 and December 31, 2004, respectively.

On March 15, 2005, we issued junior subordinated notes to our wholly owned subsidiary, Diana Statutory Trust I, in the amount of \$51.6 million. At September 30, 2005, junior subordinated notes, net of debt issuance costs, were \$50.0 million and there was \$510 thousand of unpaid interest on the junior subordinated notes. See Note 12 to the financial statements for further discussion about the junior subordinated notes.

The weighted-average days to rate reset of our total liabilities was 249 days and 275 days at September 30, 2005 and December 31, 2004, respectively.

We had \$21.0 million and \$36.8 million of other liabilities at September 30, 2005 and December 31, 2004, respectively. Other liabilities at September 30, 2005 consisted primarily of \$4.5 million of cash distributions payable, \$14.3 million of accrued interest expense on repurchase agreements, warehouse lending facilities and junior subordinated notes, \$661 thousand of accounts payable and accrued expenses and \$1.5 million of management compensation payable and other related party liabilities. Other liabilities at December 31, 2004 consisted primarily of \$16.0 million of cash distributions payable, \$17.3 million of accrued interest expense on repurchase agreements and interest rate swap contracts, and \$3.0 million of management compensation payable, incentive compensation payable and other related party liabilities.

We have a margin lending facility with our primary custodian from which we may borrow money in connection with the purchase or sale of securities. The terms of the borrowings, including the rate of interest payable, are agreed to with the custodian for each amount borrowed. Borrowings are repayable upon demand by the custodian. No borrowings were outstanding under the margin lending facility at September 30, 2005 and December 31, 2004.

During the quarter, we established a warehouse lending facility with Morgan Stanley to finance loans held-for-investment. The facility has a total borrowing capacity of \$500.0 million and outstanding balance of \$140.4 million at September 30, 2005. A warehouse lending facility is a short term credit facility. This facility expires on August 28, 2006 and bears interest based on LIBOR and reprices accordingly. This facility has covenants that are standard for industry practice, and we were in compliance with all such covenants at September 30, 2005.

*Stockholders Equity*

Stockholders equity at September 30, 2005 and December 31, 2004 was \$414.8 million and \$405.5 million, respectively, which included \$99.6 million and \$69.3 million, respectively, of net unrealized losses on mortgage-backed securities available-for-sale and \$8.9 million and \$7.9 million, respectively, of net deferred realized and unrealized gains on cash flow hedges presented as accumulated other comprehensive loss.

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Weighted-average stockholders' equity and return on average equity for the three months ended September 30, 2005 and 2004 were \$420.3 million and \$424.2 million, respectively, and 4.9% and 13.6%, respectively. Return on average equity is defined as annualized net income divided by weighted-average stockholders' equity.

Weighted-average stockholders' equity and return on average equity for the nine months ended September 30, 2005 and 2004 were \$419.3 million and \$379.8 million, respectively, and 9.7% and 14.2%, respectively.

Our book value at September 30, 2005 was as follows:

|   | <b>Total<br/>Stockholders<br/>Equity</b> | <b>Book Value<br/>per<br/>Share<sup>(1)</sup></b> |
|---|--|---|
| <b>(in thousands, except per share amounts)</b>   |  |   |
| Total stockholders' equity (GAAP)   | \$ 414,786                               | \$ 10.17  |
| <i>Addback/(Subtract)</i>   |  |   |
| Accumulated other comprehensive loss on mortgage-backed securities  | 99,601                                   | 2.44  |
| Accumulated other comprehensive income on interest rate swap contracts  | (3,558)                                  | (0.08)  |
| Total stockholders' equity, excluding accumulated other comprehensive income and loss on mortgage-backed securities and interest rate swap contracts (NON-GAAP) | \$ 510,829                               | \$ 12.53  |

(1) Based on  
40,770,410  
shares  
outstanding at  
September 30,  
2005.

Our book value at December 31, 2004 was as follows:

|   | <b>Total<br/>Stockholders<br/>Equity</b> | <b>Book Value<br/>per<br/>Share<sup>(1)</sup></b> |
|---|--|---|
| <b>(in thousands, except per share amounts)</b>   |  |   |
| Total stockholders' equity (GAAP)   | \$ 405,503                               | \$ 10.93  |
| <i>Addback/(Subtract)</i>   |  |   |
| Accumulated other comprehensive loss on mortgage-backed securities  | 69,298                                   | 1.86  |
| Accumulated other comprehensive income on interest rate swap contracts  | (7,748)                                  | (0.21)  |
| Total stockholders' equity, excluding accumulated other comprehensive income and loss on mortgage-backed securities and interest rate swap contracts (NON-GAAP) | \$ 467,053                               | \$ 12.58  |

(1) Based on  
37,113,011  
shares  
outstanding at

December 31,  
2004.

Management believes that total stockholders' equity, excluding accumulated other comprehensive income and loss on mortgage-backed securities and interest rate swap contracts, is a useful measure to investors because book value unadjusted for temporary changes in fair value more closely represents the cost basis of our invested assets, net of our leverage, which is the basis for our net interest income and our distributions to stockholders under the provisions of the Internal Revenue Code governing REIT distributions.

### **Results of Operations**

For the three months ended September 30, 2005 and 2004, net income was \$5.2 million or \$0.13 per weighted-average share outstanding (basic and diluted) and \$14.5 million or \$0.39 per weighted-average share outstanding (basic and diluted), respectively. For the same periods, interest income, net of premium amortization, was approximately \$46.3 million and \$34.3 million, respectively, and was primarily earned from investments in mortgage-backed securities. Interest expense for the three months ended September 30, 2005 and 2004 was \$38.2 million and \$16.6 million, respectively, and was primarily due to costs of short-term borrowings. This increase in interest income is primarily due to the increase in size of our investment portfolio. The increase in interest expense is primarily due to an increase in the average balance of outstanding repurchase agreement liabilities and an increase in average interest rate on those liabilities as a result of short-term borrowing rate hikes by the Federal Reserve.

For the nine months ended September 30, 2005 and 2004, net income was \$30.4 million or \$0.79 per weighted-average share outstanding (basic and diluted) and \$40.2 million or \$1.22 per weighted-average share outstanding (basic and diluted), respectively. For the same periods, interest income, net of premium amortization,

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was approximately \$131.3 million and \$81.7 million, respectively, and was primarily earned from investments in mortgage-backed securities. Interest expense for the nine months ended September 30, 2005 and 2004 was \$90.9 million and \$32.6 million, respectively, and was primarily due to costs of short-term borrowings. This increase in interest income is primarily due to the increase in size of our investment portfolio. The increase in interest expense is primarily due to an increase in the average balance of outstanding repurchase agreement liabilities and an increase in average interest rate on those liabilities as a result of short-term borrowing rate increases by the Federal Reserve Board.

Other income and losses, which represent realized gains and losses of derivative instruments, for the three and nine months ended September 30, 2005 were income of \$588 thousand and loss of \$311 thousand, respectively. There was no such income or loss for the same periods in 2004. During the three months ended September 30, 2005, we sold \$136.3 million of mortgage-backed securities to reduce leverage and rebalance our portfolios. For the three and nine months ended September 30, 2005 we realized a net loss on sales of mortgage-backed securities of \$69 thousand. There were no sales of mortgage-backed securities during the same periods in 2004.

For the three months ended September 30, 2005 and 2004, the weighted-average yield on average earning assets, net of amortization of premium, was 3.79% and 3.30%, respectively, and our cost of funds on our repurchase agreement liabilities, junior subordinated notes and warehouse lending facilities was 3.29% and 1.72%, respectively, resulting in a net interest spread of 0.50% and 1.58%, respectively. For the nine months ended September 30, 2005 and 2004, the weighted-average yield on average earning assets, net of amortization of premium, was 3.70% and 3.16%, respectively, and our cost of funds on our repurchase agreement liabilities, junior subordinated notes and warehouse lending facilities was 2.74% and 1.36%, respectively, resulting in a net interest spread of 0.96% and 1.80%, respectively. Cost of funds is defined as total interest expense divided by average repurchase agreement liabilities, loans outstanding from warehouse lending facilities and junior subordinated notes. Refer to the section titled *Critical Accounting Policies* for a description of our accounting policy for derivative instruments and hedging activities and the impact on interest expense.

Interest expense for the three and nine months ended September 30, 2005 and 2004 was calculated as follows:

|  | <b>Three Months</b>             |  | <b>Nine Months</b>              |  |
|--|---------------------------------|--|---------------------------------|--|
|  | <b>Ended September 30, 2005</b> | <b>Percentage of Average Liabilities</b> | <b>Ended September 30, 2005</b> | <b>Percentage of Average Liabilities</b> |
| <b>(in thousands)</b>  |                                 |  |                                 |  |
| Interest expense on repurchase agreement liabilities                                 | \$ 39,578                       | 3.41%                                    | \$ 96,865                       | 2.92%                                    |
| Interest expense on warehouse lending facilities                                     | 585                             | 0.05                                     | 585                             | 0.02                                     |
| Interest expense on junior subordinated notes  | 1,034                           | 0.09                                     | 2,239                           | 0.06                                     |
| Net hedge ineffectiveness (gains)/losses on futures and interest rate swap contracts | 430                             | 0.03                                     | (42)                            | nm                                       |
| Amortization of net realized (gains)/losses on futures contracts                     | 799                             | 0.07                                     | (1,395)                         | (0.04)                                   |
| Net interest income on interest rate swap contracts                                  | (4,196)                         | (0.36)                                   | (7,395)                         | (0.22)                                   |
| Other  | 11                              | nm                                       | 21                              | nm                                       |
| <b>Total interest expense</b>  | <b>\$ 38,241</b>                | <b>3.29%</b>                             | <b>\$ 90,878</b>                | <b>2.74%</b>                             |

nm = not  
meaningful

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|  | <b>Three Months</b>             |  | <b>Nine Months</b>              |  |
|--|---------------------------------|--|---------------------------------|--|
|  | <b>Ended September 30, 2004</b> | <b>Percentage of Average Liabilities</b> | <b>Ended September 30, 2004</b> | <b>Percentage of Average Liabilities</b> |
| <b>(in thousands)</b>  |                                 |  |                                 |  |
| Interest expense on repurchase agreement liabilities                                 | \$ 15,133                       | 1.56%                                    | \$ 32,193                       | 1.34%                                    |
| Net hedge ineffectiveness (gains)/losses on futures and interest rate swap contracts | 244                             | 0.03                                     | (1,740)                         | (0.07)                                   |
| Amortization of net realized gains on futures contracts                              | (685)                           | (0.07)                                   | (272)                           | (0.01)                                   |
| Net interest expense on interest rate swap contracts                                 | 1,901                           | 0.20                                     | 2,412                           | 0.10                                     |
| Other  | 39                              | nm                                       | 56                              | nm                                       |
| Total interest expense   | \$ 16,632                       | 1.72%                                    | \$ 32,649                       | 1.36%                                    |

nm = not meaningful

The net hedge ineffectiveness gains recognized in interest expense during the nine months ended September 30, 2004 are primarily due to an adjustment to the construction of the hypothetical derivative during the three months ended June 30, 2004 in accordance with our SFAS No. 133 accounting policy which is used to measure hedge ineffectiveness on our Eurodollar futures contracts. We changed the term of our forecasted repurchase agreement liabilities to conform more closely with common industry issuance terms. We do not anticipate further changes to the term of our forecasted repurchase agreement liabilities, and therefore we believe that we will incur no future ineffectiveness from this change. As required by SFAS No. 133, we recognized one-time gains of \$2.0 million in the form of hedge ineffectiveness on our Eurodollar futures contracts during the three months ended June 30, 2004. The impact of this ineffectiveness was that a portion of the liabilities we had hedged in anticipation of rising interest rates was recognized as gains or offsets to our interest expense in the second quarter of 2004. At September 30, 2005, the maximum length of time over which we were hedging our exposure was 6.5 years.

Average repurchase agreement liabilities, loans from warehouse lending facilities and junior subordinated notes during the three months ended September 30, 2005 and 2004 were \$4.5 billion and \$3.8 billion, respectively. Average repurchase agreement liabilities, loans from warehouse lending facilities and junior subordinated notes during the nine months ended September 30, 2005 and 2004 were \$4.4 billion and \$3.1 billion, respectively.

Operating expenses for the three months ended September 30, 2005 and 2004 were \$3.4 million and \$3.1 million, respectively.

Base management compensation to Seneca, which was \$1.1 million for the three months ended September 30, 2005 and 2004, is based on a percentage of our average net worth. Average net worth for these purposes is calculated on a monthly basis and equals the difference between the aggregate book value of our consolidated assets prior to accumulated depreciation and other non-cash items, including the fair market value adjustment on mortgage-backed securities, minus the aggregate book value of our consolidated liabilities.

Incentive compensation expense to related parties for the three months ended September 30, 2005 and 2000 was \$255 thousand and \$1.4 million, respectively. The decrease in expense is primarily related to the Amended Agreement signed on March 26, 2005, which revised the computation of incentive compensation paid to Seneca. Under the Amended Agreement, no incentive compensation was earned by Seneca for the three months ended September 30,

2005. The incentive compensation expense of \$255 thousand for the three months ended September 30, 2005, related to restricted common stock awards granted for incentive compensation earned in prior periods that vested during the period. For the three months ended September 30, 2004, total incentive compensation earned by Seneca was \$1.9 million, one-half payable in cash and one-half payable in the form of our common stock. The cash portion of the incentive compensation of \$950 thousand for the three months ended September 30, 2004 was expensed in the period as well as 15.2% of the restricted common stock portion of the incentive compensation, or \$145 thousand. In accordance with the terms of his employment agreement, our chief financial officer is eligible to earn incentive compensation. No incentive compensation was earned by our chief financial officer for the three months ended September 30, 2005. For the three months ended September 30, 2004, total incentive compensation earned by our chief financial officer was \$95 thousand. This portion of the incentive compensation was also payable



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one-half in cash and one-half in the form of a restricted stock award under our 2003 Stock Incentive Plan. The cash portion of the incentive compensation of \$47 thousand for the three months ended September 30, 2004, was expensed in that period as well as 15.2% of the restricted stock portion of the incentive compensation, or \$7 thousand. The remaining incentive compensation for the three months ended September 30, 2004, consists primarily of the change in fair value of unvested restricted stock awards.

Salaries and benefits expense for the three months ended September 30, 2005 and 2004 was \$846 thousand and \$112 thousand, respectively. The increase is primarily due to increased employee headcount.

Professional services expense for the three months ended September 30, 2005 and 2004 was \$512 thousand and \$191 thousand, respectively, and includes legal, accounting and other professional services provided to us. The increase in professional service expense is primarily due to the implementation of our portfolio diversification strategy.

Operating expenses for the nine months ended September 30, 2005 and 2004 were \$9.7 million and \$8.8 million, respectively.

Base management compensation to Seneca, which was \$3.3 million and \$3.0 million for the nine months ended September 30, 2005 and 2004, respectively, is based on a percentage of our average net worth as previously described.

Incentive compensation expense to related parties for the nine months ended September 30, 2005 and 2004, was \$1.1 million and \$3.5 million, respectively. The decrease in expense is primarily related to the Amended Agreement with Seneca as previously described. No incentive compensation was earned by Seneca for the nine months ended September 30, 2005. The incentive compensation expense of \$1.1 million for the nine months ended September 30, 2005 relates to restricted common stock awards granted for incentive compensation earned in prior periods that vested during the period. For the nine months ended September 30, 2004, total incentive compensation earned by Seneca was \$5.1 million, one-half payable in cash and one-half payable in the form of our common stock. The cash portion of the incentive compensation of \$2.5 million for the nine months ended September 30, 2004 was expensed in the period as well as 15.2% of the restricted common stock portion of the incentive compensation, or \$384 thousand. No incentive compensation was earned by our chief financial officer for the nine months ended September 30, 2005. For the nine months ended September 30, 2004, total incentive compensation earned by our chief financial officer was \$253 thousand. This portion of the incentive compensation was also payable one-half in cash and one-half in the form of a restricted stock award under our 2003 Stock Incentive Plan. The cash portion of the incentive compensation of \$126 thousand for the nine months ended September 30, 2004 was expensed in that period as well as 15.2% of the restricted stock portion of the incentive compensation, or \$19 thousand. The remaining incentive compensation for the nine months ended September 30, 2004, consisted primarily of the change in fair value of unvested restricted stock awards.

Salaries and benefits expense for the nine months ended September 30, 2005 and 2004 was \$1.7 million and \$318 thousand, respectively. The increase is primarily due to increased employee headcount.

Professional services expense for the nine months ended September 30, 2005 and 2004 was \$1.6 million and \$836 thousand, respectively, and includes legal, accounting and other professional services provided to us. The increase in professional service expense is primarily due to the implementation of our portfolio diversification strategy.

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REIT taxable net income is calculated according to the requirements of the Internal Revenue Code rather than GAAP. The following table reconciles GAAP net income to REIT taxable net income for the three and nine months ended September 30, 2005 and 2004:

| <b>(in thousands)</b>  | <b>For the Three Months<br/>Ended<br/>September 30,</b> |             | <b>For the Nine Months<br/>Ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2005</b>   | <b>2004</b> | <b>2005</b>  | <b>2004</b> |
| GAAP net income  | \$ 5,229  | \$ 14,494   | \$ 30,372  | \$ 40,248   |
| Adjustments to GAAP net income:  |   |             |  |             |
| Amortization of organizational costs   | (8)   | (8)         | (24)   | (24)        |
| Add back of stock compensation expense for unvested stock options  |   | 1           | 2  | 5           |
| Add back stock compensation expense for unvested restricted stock  | 358   | 458         | 1,370  | 899         |
| Subtract stock compensation expense for vested restricted stock  | (328)   |             | (631)  |             |
| Add back (subtract) net hedge ineffectiveness (gains)/losses on futures and interest rate swap contracts | 590   | 244         | (187)  | 108         |
| Subtract dividend equivalent rights on restricted stock  | (49)  | (81)        | (362)  | (130)       |
| Add back (subtract) amortization of net realized (gains)/losses on futures instruments                   | 799   | (685)       | (1,395)  |             |
| Add back net losses on sales of mortgage-backed securities   | 69  |             | 69   |             |
| Add back/(subtract) realized and unrealized (gains)/losses on other derivative instruments               | (592)   |             | 307  |             |
| Add back net realized gains on futures contracts   | 1,415   | 2,514       | 1,400  | 2,475       |
| Net adjustments to GAAP net income   | 2,254   | 2,443       | 549  | 3,333       |
| REIT taxable net income  | \$ 7,483  | \$ 16,937   | \$ 30,921  | \$ 43,581   |

Undistributed REIT taxable net income for the three and nine months ended September 30, 2005 and 2004 was as follows:

| <b>(in thousands, except per share data)</b>   | <b>For the Three Months<br/>Ended<br/>September 30,</b> |             | <b>For the Nine Months<br/>Ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2005</b>   | <b>2004</b> | <b>2005</b>  | <b>2004</b> |
| Undistributed REIT taxable net income, beginning of period   | \$ 934  | \$ 673      | \$ 1,794   | \$ 281      |
| REIT taxable net income earned during period   | 7,483   | 16,937      | 30,921   | 43,581      |
| Distributions declared during period, net of dividend equivalent rights on restricted common stock | (4,452)   | (15,830)    | (28,750)   | (42,082)    |

|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Undistributed REIT taxable net income, end of period | \$ 3,965 | \$ 1,780 | \$ 3,965 | \$ 1,780 |
| Cash distributions per share declared during period  | \$ 0.11  | \$ 0.43  | \$ 0.74  | \$ 1.28  |
| Percentage of REIT taxable net income distributed    | 59.5%    | 93.5%    | 93.0%    | 96.6%    |

During the three and nine months ended September 30, 2005, we distributed 59.5% and 93.0%, respectively, of the REIT taxable net income earned during those periods. For the year ending December 31, 2005, we intend to distribute at least 90% of our REIT taxable net income in order to retain our status as a REIT.

We believe that these presentations of our REIT taxable net income are useful to investors because they are directly related to the distributions we are required to make in order to retain our REIT status. REIT taxable net income entails certain limitations, and by itself it is an incomplete measure of our financial performance over any period. As a result, our REIT taxable net income should be considered in addition to, and not as a substitute for, our GAAP-based net income as a measure of our financial performance.

### **Liquidity and Capital Resources**

Our primary source of funds at September 30, 2005 consisted of repurchase agreements totaling \$4.2 billion with a weighted-average current borrowing rate of 3.83% that we used to finance the acquisition of mortgage-backed securities for our spread and credit sensitive strategies. We expect to continue to borrow funds in the form of repurchase agreements. At September 30, 2005, we had established 19 borrowing arrangements with various investment banking firms and other lenders, 15 of which were in use on September 30, 2005. Increases in interest rates could negatively impact the valuation of our mortgage-related assets, which could limit our borrowing ability or cause our lenders to initiate margin calls. Amounts due upon maturity of our repurchase agreements will be funded primarily through the rollover/reissuance of repurchase agreements and monthly principal and interest payments received on our mortgage-backed securities. We generally seek to borrow between eight and 12 times the amount of our equity. Our leverage ratio, defined as total repurchase agreements plus warehouse lending facilities and junior subordinated notes divided by total stockholders' equity, was 10.7 at September 30, 2005.

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At September 30, 2005, the primary source of funding for our residential mortgage loan portfolio was a \$500.0 million warehouse lending facility with Morgan Stanley, in the form of a repurchase agreement that was established in August 2005. Subsequent to September 30, 2005, we secured a \$500.0 million warehouse lending facility with Bear Stearns. At September 30, 2005, \$140.4 million was outstanding under the warehouse lending facility with Morgan Stanley.

We acquire residential mortgage loans through our network of origination partners. The loans we acquire are financed through warehouse lending facilities pending securitization for our portfolio. The loans we acquired under our Residential Mortgage Credit Portfolio strategy are first lien, single-family, adjustable-rate residential mortgage loans with original terms to maturity of not more than thirty years and are either fully amortizing or are interest-only for up to a certain period of time, and fully amortizing thereafter.

All residential mortgage loans that we acquire for our portfolio bear an interest rate tied to an interest rate index. Most loans have periodic and lifetime constraints on how much the loan interest rate can change on any predetermined interest rate reset date. Hybrid adjustable-rate residential mortgage loans have a fixed rate for an initial period, generally 3 to 10 years, and then convert to traditional adjustable-rate mortgage loans for their remaining term to maturity.

We acquire residential mortgage loans for our portfolio with the intention of securitizing them and retaining the securitized mortgage loans in our tax and GAAP portfolio to match the income we earn on our mortgage assets with the cost of our related liabilities, also referred to as match funding our balance sheet. In order to facilitate the securitization or financing of our loans, we will generally create subordinate certificates, providing a specified amount of credit enhancement, which we intend to retain in our portfolio.

On November 2, 2005, we issued \$520.6 million of securities consisting of a series of private-label multi-class mortgage-backed securities which will match the income earned on mortgage assets with the cost of the related liabilities, otherwise referred to as match funding the balance sheet. The collateral was transferred to a separate bankruptcy-remote legal entity, Luminent Mortgage Trust 2005-1, or LUM 2005-1. Collateral for the securitization included approximately \$486.4 million of residential mortgage loans, as well as prefunding of approximately \$34.2 million of residential mortgage loans to be identified and transferred to the Trust within ninety days of the closing of the securitization. On a consolidated basis this securitization was accounted for as a financing and, therefore, no gain or loss was recorded in connection with the securitization. The residential mortgage loans will remain as assets on our consolidated balance sheets subsequent to securitization. The assets owned by LUM 2005-1 collateralized the LUM 2005-1 mortgage-backed securities, and as a result, those investments are not available to us, our creditors or stockholders. The securitization is considered to be a financing for both tax and GAAP. We retained \$20.3 million of the resulting securities for its securitized residential mortgage loan portfolio and placed \$500.3 million with third-party investors, thereby providing long-term collateralized financing for its assets. Of the securities retained, 66.7% were rated Investment Grade and 33.3% were rated less than Investment Grade. All classes of the securities were priced at par with interest indexed as one-month LIBOR floaters. The servicing of the mortgage loans is performed by third parties under servicing arrangements that resulted in no servicing asset or liability. All discussions relating to securitizations in this Form 10-Q are on a consolidated basis and do not necessarily reflect the separate legal ownership of the loans by the related bankruptcy-remote legal entity.

Concurrently with the issuance of the LUM 2005-1 mortgage-backed securities, the proceeds received were used to pay down our warehouse lending facility. Principal is paid on the securities issued following receipt of principal payments on the loans. The collateral specific to each mortgage-backed security series will be the sole source of their repayment.

We have a margin lending facility with our primary custodian from which we may borrow money in connection with the purchase or sale of securities. The terms of the borrowings, including the rate of interest payable, are agreed to with the custodian for each amount borrowed. Borrowings are repayable upon demand by the custodian. At September 30, 2005, we had no borrowings outstanding under the margin lending facility.

For liquidity, we also rely on cash flows from operations, primarily monthly principal and interest payments to be received on our mortgage-backed securities, as well as any primary securities offerings authorized by our board of directors.



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On May 20, 2005, we paid a cash distribution of \$0.36 per share to our stockholders of record on April 12, 2005. On August 8, 2005, we paid a cash distribution of \$0.27 per share to our stockholders of record on July 11, 2005. On November 9, 2005, we paid a cash distribution of \$0.11 per share to our stockholders of record on October 12, 2005. These distributions are taxable dividends and not considered a return of capital. Distributions are funded with cash flows from our ongoing operations, including principal and interest payments received on our mortgage-backed securities. We did not distribute \$1.8 million of our REIT taxable net income for the year ended December 31, 2004. We declared a spillback distribution in this amount during 2005.

We believe that equity capital, combined with the cash flows from operations and the utilization of borrowings, will be sufficient to enable us to meet anticipated liquidity requirements. However, an increase in interest rates substantially above our expectations could cause a liquidity shortfall. If our cash resources are at any time insufficient to satisfy our liquidity requirements, we may be required to liquidate mortgage-backed securities or sell debt or additional equity securities. If required, the sale of mortgage-backed securities at prices lower than the carrying value of such assets could result in losses and reduced income. At September 30, 2005, we had net unrealized losses on mortgage-backed securities classified as available-for-sale of approximately \$100.6 million, which if not recovered may result in the recognition of future losses. During the three months ended September 30, 2005, we had adequate cash flow, liquid assets and unpledged collateral with which to meet our margin requirements.

We intend to increase our capital resources by making additional offerings of equity and debt securities, possibly including classes of preferred stock, common stock, commercial paper, medium-term notes, collateralized mortgage obligations and senior or subordinated notes. Such financings will depend on market conditions for capital raises and for the investment of any net proceeds therefrom. All debt securities, other borrowings and classes of preferred stock will be senior to our common stock in any liquidation by us.

On January 3, 2005, we filed a shelf registration statement on Form S-3 with the SEC. This registration statement was declared effective by the SEC on January 21, 2005. Under the shelf registration statement, we may offer and sell any combination of common stock, preferred stock, warrants to purchase common stock or preferred stock and debt securities in one or more offerings up to total proceeds of \$500.0 million. Each time we offer to sell securities, a supplement to the prospectus will be provided containing specific information about the terms of that offering. At September 30, 2005, total proceeds of up to \$468.9 million remain available to us to offer and sell under this shelf registration statement.

On February 7, 2005, we entered into a Controlled Equity Offering Sales Agreement with Cantor Fitzgerald & Co., or Cantor Fitzgerald, through which we may sell common stock or preferred stock from time to time through Cantor Fitzgerald acting as agent and/or principal in privately negotiated and/or at-the-market transactions. During the nine months ended September 30, 2005, we sold approximately 2.8 million shares of common stock pursuant to this Agreement and we received net proceeds of approximately \$30.0 million.

On June 3, 2005, we filed a registration statement on Form S-3 with the SEC to register our Direct Stock Purchase and Dividend Reinvestment Plan, or the Plan. This registration statement was declared effective by the SEC on June 28, 2005. The Plan offers stockholders, or persons who agree to become stockholders, the option to purchase shares of the Company and/or to automatically reinvest all or a portion of their quarterly dividends in our shares. For the three and nine months ended September 30, 2005, we issued 619,293 shares of common stock through direct stock purchase for net proceeds of \$5.8 million.

**Table of Contents****Inflation**

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates and other factors influence our performance far more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with accounting principles generally accepted in the United States and our distributions are determined by our board of directors based primarily by our net income as calculated for tax purposes; in each case, our activities and balance sheet are measured with reference to historical cost and or fair market value without considering inflation.

**Contractual Obligations and Commitments**

The table below summarizes our contractual obligations as of September 30, 2005. The table excludes accrued interest payable, interest rate swaps and the Amended Agreement that we have with our Manager because those contracts do not have fixed and determinable payments:

| (in millions)              | Total      | Payments Due by Period |           |           |                   |
|----------------------------|------------|------------------------|-----------|-----------|-------------------|
|                            |            | Less than 1 year       | 1 3 years | 3 5 years | More than 5 years |
| Repurchase agreements      | \$ 4,239.0 | \$ 4,239.0             | \$        | \$        | \$                |
| Warehouse lending facility | 140.4      | 140.4                  |           |           |                   |
| Junior subordinated notes  | 51.6       |                        |           |           | 51.6              |
| Total                      | \$ 4,431.0 | \$ 4,379.4             | \$        | \$        | \$ 51.6           |

As of September 30, 2005, our day-to-day operations were externally managed pursuant to the Amended Agreement with Seneca, subject to the direction and oversight of our board of directors. See Note 7 to the financial statements for significant terms of the Amended Agreement.

**Off-Balance Sheet Arrangements**

On March 15, 2005, Diana Statutory Trust I was created for the sole purpose of issuing and selling preferred securities. Diana Statutory Trust I is a special purpose entity. See Note 1 to the financial statements included in Item 1 of this Quarterly Report on Form 10-Q for further discussion.

**Risk Factors**

*As used in this Quarterly Report, Luminent, Company, we, our, and us, refer to Luminent Mortgage Capital, Inc. and its subsidiaries, except where the context otherwise requires. The occurrence of one or more of these risk factors could adversely impact our results of operations or financial condition.*

**General Risks Related to our Business**

*We might not be able to find mortgage loans or mortgage-backed securities that meet our investment criteria or at favorable spreads over our borrowing costs, which would adversely impact our results of operations or financial condition.*

Our net income depends on our ability to acquire residential mortgage loans and mortgage-backed securities at favorable spreads over our borrowing costs. In acquiring mortgage loans and mortgage-backed securities, we compete with many other purchasers, including REITs, investment banking firms, savings and loan associations, banks, insurance companies and mutual funds, many of which have greater financial resources than we do. As a

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result, we may not be able to acquire a sufficient amount of mortgage loans or mortgage-backed securities at favorable spreads over our borrowing costs, which could adversely impact our results of operations or financial condition.

We have limited experience in the business of acquiring and securitizing mortgage loans and we may not be successful, which would adversely impact our results of operations or financial condition.

Loan acquisition and securitization activity within our Residential Mortgage Credit Portfolio strategy is inherently complex and involves risks related to the types of mortgage loans we seek to acquire, interest rate changes, funding sources, delinquency rates, borrower bankruptcies and other factors that we may not be able to manage successfully. It may take years to determine whether we can manage these risks successfully. Our failure to manage these and other risks could adversely impact our results of operations or financial condition.

***Our mortgage loans and mortgage-backed securities are subject to prepayments, and increased prepayment rates could adversely impact our results of operations or financial condition.***

The principal and interest payments that we receive from our mortgage loans and mortgage-backed securities are generally funded by the payments that borrowers make on the related mortgage loans pursuant to amortization schedules. When borrowers prepay their mortgage loans sooner than expected, we correspondingly receive principal cash flows from our investments earlier than anticipated. Prepayment rates generally increase when interest rates decline and decrease when interest rates rise. Changes in prepayment rates, however, tend to lag a few months behind changes in interest rates and are difficult to predict. Prepayment rates may also be affected by other factors, including the strength of the housing and financial markets, the overall economy and mortgage loan interest rates currently available to borrowers in the market.

We seek to purchase mortgage loans and mortgage-backed securities that we believe have favorable risk-adjusted expected returns relative to market interest rates at the time of purchase. If the coupon interest rate for a mortgage loan or mortgage-backed security is higher than the market interest rate at the time it is purchased, then it will be acquired at a premium to its par value. Correspondingly, if the coupon interest rate for a mortgage loan or mortgage-backed security is lower than the market interest rate at the time it is purchased, then it will be acquired at a discount to its par value.

We are required to amortize any premiums or accrete discounts related to our mortgage loans and mortgage-backed securities over their expected terms. The amortization of a premium reduces our interest income, while the accretion of a discount increases our interest income. The expected terms for mortgage loans and mortgage-backed securities are a function of the prepayment rates for the mortgage loans purchased or underlying the mortgage-backed securities purchased. If mortgage loans and mortgage-backed securities purchased at a premium subsequently are prepaid in whole or in part more quickly than anticipated, then we are required to amortize their respective premiums more quickly, which could decrease our net interest income and adversely impact our results of operations. Conversely, if mortgage loans and mortgage-backed securities purchased at a discount subsequently are prepaid in whole or in part more slowly than anticipated, then we are required to accrete their respective discounts more slowly, which could decrease our net interest income and adversely impact our results of operations or financial condition.

***Our stockholders' equity or book value is volatile and is subject to changes in interest rates.***

The fair values of the mortgage loans and mortgage-backed securities that we purchase are subject to daily fluctuations in market pricing resulting from changes in interest rates. For example, when interest rates increase, the fair value of our assets generally declines, and, when interest rates decrease, the fair value of our assets generally rises. For our mortgage loans and mortgage-backed securities that are classified as available for sale, we are required to carry these assets at fair value and to flow any changes in their fair value through the other comprehensive income or loss portion of stockholders' equity on our balance sheet. The daily fluctuations in market pricing of these mortgage loans and mortgage-backed securities, and their corresponding flow through our stockholders' equity, create volatility in our stockholders' equity, or book value.



**Table of Contents*****Our mortgage loans and mortgage-backed securities are subject to defaults, which could adversely impact our results of operations or financial condition.***

Each of our three mortgage investment strategies bears the risk of loss resulting from defaults. Our risk of loss is dependent upon the credit quality and performance of the mortgage loans that we purchase directly, as well as upon the credit quality and performance of the mortgage loans underlying the mortgage-backed securities that we purchase or securitize.

In our Spread strategy, the mortgage-backed securities that we purchase are generally backed by federal government agencies, such as Ginnie Mae, or by federally-chartered corporations, including Fannie Mae and Freddie Mac, or are rated AAA and are guaranteed by corporate guarantors. Ginnie Mae's obligations are backed by the full faith and credit of the United States. The obligations of Fannie Mae and Freddie Mac and other corporate guarantors are solely their own. A substantial deterioration in the financial strength of Fannie Mae, Freddie Mac or other corporate guarantors could increase our exposure to future delinquencies, defaults or credit losses on our holdings of mortgage-backed securities issued by these entities. If the mortgage-backed securities we purchase under our Spread strategy experience defaults, it could adversely impact our results of operations or financial condition.

In our Residential Mortgage Credit Portfolio strategy, we purchase mortgage loans that are not credit-enhanced and that do not have the backing of Ginnie Mae, Fannie Mae or Freddie Mac. Although generally we seek to purchase high-quality mortgage loans, we bear the risk of loss from borrower default, bankruptcy and special hazard losses on any loans that we purchase and subsequently securitize. In the event of a default on any mortgage loan that we hold, we would bear the net loss of principal that would adversely impact our results of operations or financial condition. As part of our Residential Mortgage Credit Portfolio strategy, we also purchase subordinated mortgage-backed securities that have credit ratings below AAA. These subordinated mortgage-backed securities are structured to absorb a disproportionate share of losses from their underlying mortgage loans. In the event of a default on any of the mortgage loans underlying the mortgage-backed securities that we hold pursuant to our Residential Mortgage Credit Portfolio strategy, we would bear the net loss of principal and it would adversely impact our results of operations.

Finally, all of our mortgage loans and mortgage-backed securities are secured by underlying real property interests. To the extent that the value of the property underlying our mortgage loans or mortgage-backed securities decreases, our security might be impaired, which might decrease the value of our assets, and might adversely impact our results of operations.

***The representations and warranties that we will make in our securitizations may subject us to liability, which could adversely impact our results of operations or financial condition.***

We will make representations and warranties regarding the mortgage loans that we transfer into securitization trusts. Each securitization's trustee has recourse to us with respect to the breach of the standard representations and warranties regarding the loans made at the time such mortgages are transferred. While we generally have recourse to our loan originators for any such breaches, there can be no assurance of the originators' abilities to honor their respective obligations. We attempt to limit generally the potential remedies of the trustee to the potential remedies we receive from the originators from whom we acquire our mortgage loans. However, in some cases, the remedies available to the trustee may be broader than those available to us against the originators of the mortgages, and should the trustee enforce its remedies against us, we may not always be able to enforce whatever remedies we have against our originators. Furthermore, if we discover, prior to the securitization of a loan, that there is any fraud or misrepresentation with respect to a mortgage loan and the originator fails to repurchase the loan, then we may not be able to sell the mortgage loan or may have to sell the loan at a discount.

***Our mortgage loans and mortgage-backed securities are subject to interest rate caps and resets that could adversely impact our results of operations or financial condition.***

The mortgage loans we purchase directly and that underlie the mortgage-backed securities that we purchase may be subject to periodic and lifetime interest rate caps. Periodic interest rate caps limit the amount that the interest rate

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on a mortgage loan can increase during any given period. Lifetime interest rate caps limit the amount that the interest rate of a mortgage loan can increase throughout the life of the loan. The periodic adjustments to the interest rates of the mortgage loans we purchase directly and that underlie our mortgage-backed securities, known as resets, are based on changes in an objective benchmark interest rate index, such as the U.S. Treasury index or LIBOR.

During a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while interest rate caps and delayed resets could limit the increases in the yields on our mortgage loans and mortgage-backed securities. This problem is magnified for mortgage loans and mortgage-backed securities that are not fully indexed. Further, some of the mortgage loans and mortgages underlying our mortgage-backed securities may be subject to periodic payment caps that result in a portion of the interest being deferred and added to the principal outstanding. As a result, we may receive less cash income on our mortgage loans and mortgage-backed securities than we need to pay interest on our related borrowings. These factors might adversely impact our results of operations or financial condition.

***The use of securitizations with over-collateralization requirements could restrict our cash flow and adversely impact our results of operations or financial condition.***

If we use over-collateralization as a credit enhancement for our securitizations, such over-collateralization will restrict our cash flow if loan delinquencies exceed certain levels. The terms of our securitizations generally will provide that, if certain delinquencies and/or losses exceed specified levels based on rating agencies (or the financial guaranty insurers, if applicable) analysis of the characteristics of the loans pledged to collateralize the securities, the required level of over-collateralization may be increased or may be prevented from decreasing as would otherwise be permitted if losses and/or delinquencies did not exceed those levels. Other tests, based on delinquency levels or other criteria, may restrict our ability to receive net interest income from a securitization transaction. We cannot assure you that the performance tests will be satisfied. Failure to satisfy performance tests could adversely impact our results of operations.

***We purchase subordinated mortgage-backed securities that are structured to absorb a disproportionate amount of any losses on the underlying mortgage loans. These purchases could adversely impact our results of operations or financial condition.***

We purchase subordinated mortgage-backed securities that have credit ratings of A or below. These subordinated mortgage-backed securities are structured to absorb a disproportionate share of our losses from their underlying mortgage loans, and expose us to high levels of volatility in net interest income, interest rate risk, prepayment risk, credit risk and market pricing volatility, any one of which might adversely impact our results of operations or financial condition.

***Our mortgage loans and mortgage-backed securities are subject to potential illiquidity, which might prevent us from selling them at reasonable prices when we found it necessary to sell them. This factor could adversely impact our results of operations or financial condition.***

From time to time, mortgage loans and mortgage-backed securities experience periods of illiquidity. A period of illiquidity might result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale. We bear the risk of being unable to dispose of our mortgage loans and our mortgage-backed securities at advantageous times and prices during periods of illiquidity, which could adversely impact our results of operations or financial condition.

***Our mortgage loans and mortgage-backed securities are subject to the overall health of the U.S. economy, and a national or regional economic slowdown could adversely impact our results of operations or financial condition.***

The health of the U.S. residential mortgage market is correlated with the overall health of the U.S. economy. An overall decline in the U.S. economy could cause a significant decrease in the values of mortgaged properties throughout the U.S. This decrease, in turn, could increase the risk of delinquency, default or foreclosure on our

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mortgage loans and on the mortgage loans underlying our mortgage-backed securities, and could adversely impact our results of operations or financial condition.

***We might not be able to obtain financing for our mortgage loans or mortgage-backed securities, which would adversely impact our results of operations or financial condition.***

The success of our business strategies depends upon our ability to obtain various types of financing for our mortgage loans and mortgage-backed securities, including repurchase agreements, warehouse financing, the issuance of debt securities and other types of long-term financing, including the issuance of preferred and common equity securities. Our inability to obtain a significant amount of financing through these sources would adversely impact our results of operations or financial condition.

***Our investment strategies employ a significant amount of leverage, and are subject to daily fluctuations in market pricing and margin calls, which could adversely impact our results of operations or financial condition.***

Both of our investment strategies employ leverage. In our Spread strategy, we generally seek to borrow between eight and 12 times the amount of our equity allocated to this strategy. Within our Residential Mortgage Credit Portfolio strategy, in our loan origination and securitization portfolio we generally seek to borrow between 12 and 20 times the amount of our equity allocated to this strategy. In our credit sensitive portfolio, we generally seek to borrow between zero and five times the amount of our equity allocated to this strategy. In both investment strategies, however, at any one time our actual borrowings may be above or below the leverage ranges stated above.

We achieve our leverage primarily by borrowing against the market value of our mortgage loans and mortgage-backed securities through a combination of repurchase agreements, warehouse financing, debt securities and other types of borrowings. Some of our sources of borrowings are from committed sources, such as warehouse facilities and debt securities, and some are from uncommitted sources, such as repurchase agreement lines. At any given time, our total indebtedness depends significantly upon our lenders' estimates of our pledged assets' market value, credit quality, liquidity and expected cash flows as well as upon our lenders' applicable asset advance rates, also known as haircuts. In addition, uncommitted borrowing sources have the right to stop lending to us at any time.

Our mortgage loans and mortgage-backed securities that we purchase are subject to daily fluctuations in market pricing resulting from changes in interest rates. As market prices change, our mortgage loans and mortgage-backed securities that are financed through repurchase agreements and warehouse financing may be subject to margin calls by our financing counterparties. A margin call requires us to post more collateral or cash with our counterparties in support of our financing. We face the risk that we might not be able to meet our debt service obligations or margin calls and, to the extent that we cannot, we might be forced to liquidate some or all of our assets at disadvantageous prices that would adversely impact our results of operations. A default on a collateralized borrowing could also result in an involuntary liquidation of the pledged asset, which would adversely impact our results of operations. Furthermore, if our lenders do not allow us to renew our borrowings or we cannot replace maturing borrowings on favorable terms or at all, we might be forced to liquidate some or all of our assets at disadvantageous prices which would adversely impact our results of operations or financial condition.

Our use of leverage also amplifies the risks associated with other risk factors detailed in this discussion of risk factors, which might adversely impact our results of operations or financial condition.

***Interest rate mismatches between our mortgage loans and mortgage-backed securities and our borrowings could adversely impact our results of operations or financial condition.***

The interest rate repricing terms of the borrowings that we use are shorter than the interest rate repricing terms of our assets. As a result, during a period of rising interest rates, we could experience a decrease in, or elimination of, our net income, or generate a net loss because the interest rates on our borrowings could increase faster than our asset yields. Conversely, during a period of declining interest rates and accompanying higher prepayment activity, we could experience a decrease in, or elimination of, our net income, or generate a net loss as a result of higher premium amortization expense.

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***Our use of certain types of financing may give our lenders greater rights in the event that either we or any of our lenders file for bankruptcy.***

Our borrowings under repurchase agreements and warehouse financing may qualify for special treatment under the bankruptcy code, giving our lenders the ability to avoid the automatic stay provisions of the bankruptcy code and to take possession of and liquidate our collateral under the repurchase agreements without delay if we file for bankruptcy. Furthermore, the special treatment of repurchase agreements and warehouse financing under the bankruptcy code may make it difficult for us to recover our pledged assets in the event that any of our lenders files for bankruptcy. Thus, the use of repurchase agreements and warehouse financing exposes our pledged assets to risk in the event of a bankruptcy filing by any of our lenders or us.

***Our hedging activities might be unsuccessful and adversely impact our results of operations and book value.***

We can use Eurodollar futures, interest rate swaps, caps and floors and other derivative instruments in order to reduce, or hedge, our interest rate risks. The amount of hedging activities that we utilize will vary over time. Our hedging activities might mitigate our interest rate risks, but cannot eliminate these risks. The effectiveness of our hedging activities will depend significantly upon whether we correctly quantify the interest rate risks being hedged, as well as our execution of and ongoing monitoring of our hedging activities. Our hedging activities could adversely impact our results of operations, our book value and our status as a REIT and, therefore, such activities could be limited. In some situations, we may sell hedging instruments at a loss in order to maintain adequate liquidity.

For our some of hedging activities, we may elect hedge accounting treatment under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended and interpreted. The ongoing monitoring requirements of SFAS No. 133 are complex and rigorous. If we fail to meet these requirements, or if certain hedging activities do not qualify for hedge accounting under SFAS No. 133, we could not designate our hedging activities as hedges under SFAS No. 133 and would be required to utilize mark-to-market accounting through our Consolidated Statements of Operations, which would adversely impact our results of operations or financial condition.

***Our mortgage loans may not be serviced effectively, which might adversely impact our results of operations or financial condition.***

The success of our loan originations and securitizations within our Residential Mortgage Credit Portfolio strategy will depend upon our ability to ensure that our mortgage loans are serviced effectively. We do not intend to service our mortgage loans ourselves, and intend to transfer the servicing of our loans to a third party with whom we have established a sub-servicing relationship. We cannot assure that we will be able to supervise effectively a sub-servicing relationship. Failure to service our mortgage loans properly could adversely impact our results of operations or financial condition.

***If we are unable to securitize our mortgage loans successfully, we may be unable to grow or fully execute our business strategies and our earnings my decrease.***

We intend to structure our securitization transactions so that we must account for them as secured borrowings in accordance with Statement of Financial Accounting Standards (SFAS) No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, and as a result, we are precluded from using sale accounting to recognize any gain or loss. To securitize our mortgage loans, we may create a wholly-owned subsidiary and contribute a pool of mortgage loans to the subsidiary. An inability to securitize our mortgage loans successfully could limit our ability to grow our business or fully execute our business strategies and could decrease our earnings. In addition, the successful securitization of our mortgage loans might expose us to losses as the portfolios of the securitizations that we choose to keep will tend to be those that are riskier and more likely to generate credit losses.

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**Risks Related to Seneca**

***Seneca might fail to comply with the terms of the Amended Agreement, manage our Spread portfolio poorly, or lose key personnel that are important to our Spread portfolio, which could adversely impact our results of operations or financial condition.***

In March 2005, we executed an Amended Agreement with Seneca. Seneca has dedicated key personnel to our Spread portfolio business, including the investment and financing decisions related to that portfolio. If Seneca fails to comply with the terms of the Amended Agreement, Seneca can be terminated for cause, which could adversely impact our results of operations. If Seneca manages our Spread portfolio poorly, or loses key personnel that are important to the ongoing management of our Spread portfolio, it could adversely impact our results of operations or financial condition. Seneca might be subject to business continuity risk, due to its recently announced change in ownership. This could adversely affect the management of our Spread portfolio.

***Because Seneca is entitled to a fee that may be significant if we terminate the Amended Agreement without cause, economic considerations might preclude us from terminating the Amended Agreement in the event that Seneca's performance fails to meet our expectations but does not constitute cause.***

If we terminate the Amended Agreement without cause or because we decide to manage our company internally, then we have to pay a fee to Seneca that may be significant. Under the amended agreement, the amount of the termination fee shall be equal to two times the amount of the highest annual base management compensation and the highest annual incentive management compensation, for a particular year, earned by Seneca during any of the three years (or on an annualized basis if a lesser period) preceding the effective date of the termination, multiplied by a fraction, where the numerator is the positive difference, resulting from thirty-six (36) minus the number of months between the effective date of the Amended Agreement and the termination date, and the denominator is thirty-six (36). After March 2008, there would be no termination or internalization fees.

The actual amount of such fee cannot be known at this time. Paying this fee would reduce significantly the cash available for distribution to our stockholders and might cause us to suffer a net operating loss. Consequently, terminating the Amended Agreement might not be advisable even if we determine that it would be more efficient to operate with an internal management structure or if we are otherwise dissatisfied with Seneca's performance. ***Seneca's liability is limited under the Amended Agreement and we have agreed to indemnify Seneca against certain liabilities.***

Seneca has not assumed any responsibility to us other than to render the services described in the Amended Agreement, and Seneca is not responsible for any action of our board of directors in declining to follow Seneca's advice or recommendations. Seneca and its directors, officers and employees are not liable to us for acts performed by its officers, directors or employees in accordance with and pursuant to the Amended Agreement, except for acts constituting gross negligence, recklessness, willful misconduct or active fraud in connection with their duties under the Amended Agreement. We have agreed to indemnify Seneca and its directors, officers and employees with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from acts of Seneca not constituting gross negligence, recklessness, willful misconduct or active fraud.

**Legal and Tax Risks**

***If we are disqualified as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability.***

Qualification as a REIT involves the application of highly technical and complex U.S. federal income tax code provisions for which only a limited number of judicial or administrative interpretations exist. Accordingly, there can be no assurances that we will be able to remain qualified as a REIT for U.S. federal income tax purposes. Even a technical or inadvertent mistake could jeopardize our REIT status. Furthermore, Congress or the IRS might change tax laws or regulations and the courts might issue new rulings, in each case potentially having retroactive effect that

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could make it more difficult or impossible for us to qualify as a REIT in a particular tax year. If we fail to qualify as a REIT in any tax year, then:

we would be taxed as a regular domestic corporation, which, among other things, means that we would be unable to deduct distributions to our stockholders in computing taxable income and we would be subject to U.S. federal income tax on our taxable income at regular corporate rates;

any resulting tax liability could be substantial, would reduce the amount of cash available for distribution to our stockholders and could force us to liquidate assets at inopportune times, causing lower income or higher losses than would result if these assets were not liquidated; and

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

Even if we remain qualified as a REIT, we might face other tax liabilities that reduce our cash flow. Further, we might be subject to federal, state and local taxes on our income and property. Any of these taxes would decrease cash available for distribution to our stockholders.

***Complying with REIT requirements might cause us to forego otherwise attractive opportunities.***

In order to qualify as a REIT for U.S. federal income tax purposes, we must satisfy tests concerning, among other things, our sources of income, the nature and diversification of our mortgage-backed securities, the amounts we distribute to our stockholders and the ownership of our stock. We may also be required to make distributions to our stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may cause us to forego opportunities we would otherwise pursue.

In addition, the REIT provisions of the Internal Revenue Code, or Code, impose a 100% tax on income from prohibited transactions. Prohibited transactions generally include sales of assets that constitute inventory or other property held for sale in the ordinary course of a business, other than foreclosure property. This 100% tax could impact our desire to sell mortgage-backed securities at otherwise opportune times if we believe such sales could be considered a prohibited transaction.

***Complying with REIT requirements may limit our ability to hedge effectively.***

The REIT provisions of the Code substantially limit our ability to hedge mortgage-backed securities and related borrowings. Under these provisions, our annual income from qualified hedges, together with any other income not generated from qualified REIT real estate assets, is limited to less than 25% of our gross income. In addition, we must limit our aggregate income from hedging and services from all sources, other than from qualified REIT real estate assets or qualified hedges, to less than 5% of our annual gross income. As a result, we might in the future have to limit our use of advantageous hedging techniques, which could leave us exposed to greater risks associated with changes in interest rates than we would otherwise want to bear. If we fail to satisfy the 25% or 5% limitations, unless our failure was due to reasonable cause and we meet certain other technical requirements, we could lose our REIT status for federal income tax purposes. Even if our failure were due to reasonable cause, we might have to pay a penalty tax equal to the amount of our income in excess of certain thresholds, multiplied by a fraction intended to reflect our profitability.

***Complying with the REIT requirements may force us to borrow to make distributions to our stockholders.***

As a REIT, we must distribute at least 90% of our annual taxable income, subject to certain adjustments, to our stockholders. From time to time, we might generate taxable income greater than our net income for financial reporting purposes from, among other things, amortization of capitalized purchase premiums, or our taxable income might be greater than our cash flow available for distribution to our stockholders. If we do not have other funds available in these situations, we might be unable to distribute 90% of our taxable income as required by the REIT

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rules. In that case, we would need to borrow funds, sell a portion of our mortgage loans or mortgage-backed securities potentially at disadvantageous prices or find another alternative source of funds. These alternatives could increase our costs or reduce our equity and reduce amounts available to invest in mortgage loans or mortgage-backed securities.

***Complying with the REIT requirements may force us to liquidate otherwise attractive investments.***

In order to qualify as a REIT, we must ensure that at the end of each calendar quarter at least 75% of the value of our assets consists of cash, cash items, government securities, certain temporary investments and qualified REIT real estate assets. The remainder of our investment in securities generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, generally, no more than 5% of the value of our assets can consist of the securities of any one issuer. If we fail to comply with these requirements, we could lose our REIT status unless we are able to avail ourselves of certain relief provisions. Under certain relief provisions, we would be subject to penalty taxes.

***Failure to maintain an exemption from the Investment Company Act would harm our results of operations.***

We intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act of 1940, as amended. Because we conduct some of our business through wholly owned subsidiaries, we must ensure not only that we qualify for an exclusion or exemption from regulation under the Investment Company Act, but also that each of our subsidiaries so qualifies.

The Investment Company Act exempts entities that are primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Under the current interpretation of the SEC, based on a series of no-action letters issued by the Division of Investment Management (Division), in order to qualify for this exemption, at least 55% of our assets must consist of mortgage loans and other assets that are considered the functional equivalent of mortgage loans for purposes of the Investment Company Act (collectively, qualifying real estate assets ), and an additional 25% of our assets must consist of real estate-related assets.

Based on the no-action letters issued by the Division, we classify our investment in residential mortgage loans as qualifying real estate assets, provided the loans are fully secured by an interest in real estate. That is, if the loan-to-value ratio of the loan is equal to or less than 100%, then we consider the mortgage loan a qualifying real estate asset. We do not consider loans with loan-to-value ratios in excess of 100% to be qualifying real estate assets for the 55% test, but only real estate-related assets for the 25% test. We also consider agency whole pool certificates to be qualifying real estate assets. Most non-agency mortgage-backed securities do not constitute qualifying real estate assets for purposes of the 55% test, because they represent less than the entire beneficial interest in the related pool of mortgage loans.

If we acquire securities that, collectively, are expected to receive all of the principal and interest paid on the related pool of underlying loans (less fees, such as servicing and trustee fees, and expenses of the securitization), then we will consider those securities, collectively, to be qualifying real estate assets.

Mortgage-backed securities that do not represent all of the certificates issued with respect to an underlying pool of mortgages may be treated as separate from the underlying mortgage loans and, thus, may not qualify for purposes of the 55% requirement. Therefore, our ownership of these mortgage-backed securities is limited by the provisions of the Investment Company Act. One exception relates to the most subordinate class of securities issued in a securitization if to the holder has the right to decide whether to foreclose upon defaulted loans.

In addition to monitoring our assets to qualify for exclusion from regulation as an investment company, we also must ensure that each of our subsidiaries qualifies for its own exclusion or exemption. To the extent that we form subsidiaries in the future, we must ensure that they qualify for their own separate exclusion from regulation as an investment company.

We have not received, nor have we sought, a no-action letter from the Division regarding how our investment strategy fits within the exclusion from regulation under the Investment Company Act that we are using. In satisfying

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the 55% requirement under the Investment Company Act, we treat as qualifying real estate assets mortgage loans that we own and mortgage-backed securities issued with respect to an underlying pool as to which we hold all issued certificates, or subordinate classes with foreclosure rights with respect to the underlying mortgage loans. If the SEC adopts a contrary interpretation of such treatment, we could be required to sell a substantial amount of our mortgage-backed securities under potentially adverse market conditions. Further, we might be precluded from acquiring higher-yielding mortgage-backed securities and instead buy a lower yielding security in our attempts to ensure that we at all times qualify for the exemption under the Investment Company Act. These factors may lower or eliminate our net income.

We plan to continue to satisfy the tests with respect to our assets, measured on an unconsolidated basis. It is not completely settled, however, that the tests are to be measured on an unconsolidated basis. To the extent the SEC provides further guidance on how to measure assets for these tests, we will adjust our measurement techniques.

If we fail to qualify for this exemption, our ability to use leverage would be substantially reduced, and we would be unable to conduct our business as described in our operating policies and programs discussed in our business strategy in our 2004 Annual Report on Form 10-K filed with the Securities and Exchange Commission.

***Misplaced reliance on legal opinions or statements by issuers of mortgage-backed securities could result in a failure to comply with REIT income or assets tests.***

When purchasing mortgage-backed securities, we may rely on opinions of counsel for the issuer or sponsor of such securities, or statements made in related offering documents, for purposes of determining whether and to what extent those securities constitute REIT real estate assets for purposes of the REIT asset tests and produce income that qualifies under the REIT gross income tests. The inaccuracy of any such opinions or statements may adversely affect our REIT qualification and result in significant corporate-level tax.

***One-action rules may harm the value of the underlying property.***

Several states have laws that prohibit more than one action to enforce a mortgage obligation, and some courts have construed the term "action" broadly. In such jurisdictions, if the judicial action is not conducted according to law, there may be no other recourse in enforcing a mortgage obligation, thereby decreasing the value of the underlying property.

***We may be harmed by changes in various laws and regulations.***

Changes in the laws or regulations governing Seneca may impair Seneca's ability to perform services in accordance with the Amended Agreement. Our business may be harmed by changes to the laws and regulations affecting our manager, Seneca, or us, including changes to securities laws and changes to the Code applicable to the taxation of REITs. New legislation may be enacted into law or new interpretations, rulings or regulations could be adopted, any of which could harm us, Seneca and our stockholders, potentially with retroactive effect.

***We may incur excess inclusion income that would increase the tax liability of our stockholders.***

In general, dividend income that a tax-exempt entity receives from us should not constitute unrelated business taxable income as defined in Section 512 of the Code. If we realize excess inclusion income and allocate it to our stockholders, this income cannot be offset by net operating losses. If the stockholder is a tax-exempt entity, then this income would be fully taxable as unrelated business taxable income under Section 512 of the Code. If the stockholder is foreign, it would be subject to U.S. federal income tax withholding on this income without reduction pursuant to any otherwise applicable income-tax treaty.

Excess inclusion income could result if we held a residual interest in a real estate mortgage investment conduit, or REMIC. Excess inclusion income also would be generated if we were to issue debt obligations with two or more maturities and the terms of the payments on these obligations bore a relationship to the payments that we received on our mortgage-backed securities securing those debt obligations. We generally structure our borrowing arrangements in a manner designed to avoid generating significant amounts of excess inclusion income. We do,



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however, enter into various repurchase agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities if we default on our obligations. The IRS may determine that these borrowings give rise to excess inclusion income that should be allocated among our stockholders. Furthermore, some types of tax-exempt entities, including voluntary employee benefit associations and entities that have borrowed funds to acquire our common stock, may be required to treat a portion of or all of the distributions they may receive from us as unrelated business taxable income. Finally, we may invest in equity securities of other REITs, and it is possible that we might receive excess inclusion income from those investments.

**Risks Related to Investing in Our Securities*****The timing and amount of our cash distributions may be volatile over time.***

Our policy is to make quarterly distributions to our stockholders in amounts such that we distribute all or substantially all of our taxable income in each year, subject to certain adjustments, which, along with other factors, should enable us to qualify for the tax benefits accorded to a REIT under the Code. We do not intend to establish a minimum distribution payment level for the foreseeable future. Our ability to make distributions might be harmed by the risk factors described herein. All distributions will be made at the discretion of our board of directors and will depend on our earnings, our financial condition, maintenance of our REIT status and such other factors as our board of directors may deem relevant from time to time. We cannot assure you that we will have the ability to make distributions to our stockholders in the future.

***Our declared cash distributions may force us to liquidate mortgage loans or mortgage-backed securities or borrow additional funds.***

From time to time, our board of directors will declare cash distributions. These distribution declarations are irrevocable. If we do not have sufficient cash to fund distributions, we will need to liquidate mortgage loans or mortgage-backed securities or borrow funds by entering into repurchase agreements or otherwise borrowing funds under our margin lending facility to pay the distribution. If required, the sale of mortgage loans or mortgage-backed securities at prices lower than the carrying value of such assets would result in losses. Also, if we were to borrow funds on a regular basis to make distributions, it is likely that our results of operations and our stock price would be harmed.

***Future offerings of debt securities by us, which would be senior to our common stock upon liquidation, or equity securities, which would dilute our existing stockholders and may be senior to our common stock for the purposes of distributions, may harm the value of our common stock.***

In the future, we may attempt to increase our capital resources by making additional offerings of debt or equity securities, including commercial paper, medium-term notes, senior or subordinated notes and classes of preferred stock or common stock. Upon our liquidation, holders of our debt securities and shares of preferred stock and lenders with respect to other borrowings will receive a distribution of our available assets prior to the holders of our common stock. Additional equity offerings by us may dilute the holdings of our existing stockholders or reduce the value of our common stock, or both. Our preferred stock, if issued, would have a preference on distributions that could limit our ability to make distributions to the holders of our common stock. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus, our stockholders bear the risk of our future offerings reducing the market price of our common stock and diluting their stock holdings in us.

***Changes in yields may harm the market price of our common stock.***

Our earnings are derived from the expected positive spread between the yield on our assets and the cost of our borrowings. This spread will not necessarily be larger in high interest rate environments than in low interest rate environments and may also be negative. In addition, during periods of high interest rates, our net income and, therefore, the amount of any distributions on our common stock, might be less attractive compared to alternative investments of equal or lower risk. Each of these factors could harm the market price of our common stock.

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***The market price and trading volume of our common stock may be volatile; broad market fluctuations could harm the market price of our common stock.***

The market price of our common stock may be volatile and be subject to wide fluctuations. In addition, the trading volume in our common stock may fluctuate and cause significant price variations to occur. If the market price of our common stock declines significantly, you may be unable to resell your shares at or above your purchase price. We cannot assure you that the market price of our common stock will not fluctuate or decline significantly in the future.

The stock market has experienced price and volume fluctuations that have affected the market price of many companies in industries similar or related to ours and that have been unrelated to these companies' operating performances. These broad market fluctuations could reduce the market price of our common stock. Furthermore, our operating results and prospects may be below the expectations of public market analysts and investors or may be lower than those of companies with comparable market capitalizations, which could harm the market price of our common stock.

***The market price of our common stock may be adversely affected by future sales of a substantial number of shares of our common stock in the public market or the availability of such shares for sale.***

We cannot predict the effect, if any, of future sales of our common stock, or the availability of shares for future sales, on the market price of our common stock. Sales of substantial amounts of shares of our common stock, or the perception that these sales could occur, may harm prevailing market prices for our common stock.

Subject to Rule 144 volume limitations applicable to our officers and directors, substantially all of our shares of common stock outstanding are eligible for immediate resale by their holders. If any of our stockholders were to sell a large number of shares in the public market, the sale could reduce the market price of our common stock and could impede our ability to raise future capital through a sale of additional equity securities.

***Issuance of large amounts of our stock could cause our price to decline.***

We may issue additional shares of common stock or shares of preferred stock that are convertible into common stock. If we were to issue a significant number of shares of our common stock or convertible preferred stock in a short period of time, our outstanding shares of common stock could be diluted and the market price of our common stock could decline.

***Restrictions on ownership of a controlling percentage of our capital stock might limit your opportunity to receive a premium on our stock.***

For the purpose of preserving our REIT qualification and for other reasons, our charter prohibits direct or constructive ownership by any person of more than 9.8% of the lesser of the total number or value of the outstanding shares of our common stock or more than 9.8% of the outstanding shares of our preferred stock. The constructive ownership rules in our charter are complex and may cause our outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of less than 9.8% of our outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of 9.8% of our outstanding stock, and thus be subject to the ownership limit in our charter. Any attempt to own or transfer shares of our common or preferred stock in excess of the ownership limit without the consent of our board of directors is void, and will result in the shares being transferred by operation of law to a charitable trust. These provisions might inhibit market activity and the resulting opportunity for our stockholders to receive a premium for their shares that might otherwise exist if any person were to attempt to assemble a block of our stock in excess of the number of shares permitted under our charter and that may be in the best interests of our stockholders.

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***Certain provisions of Maryland law and our charter and bylaws could hinder, delay or prevent a change in control of our company.***

Certain provisions of Maryland Business Corporations Act (MBCA), our charter and our bylaws have the effect of discouraging, delaying or preventing transactions that involve an actual or threatened change in control of our company. These provisions include the following:

*Classified Board of Directors.* Our board of directors is divided into three classes with staggered terms of office of three years each. The classification and staggered terms of office of our directors make it more difficult for a third party to gain control of our board of directors. At least two annual meetings of stockholders, instead of one, generally would be required to effect a change in a majority of our board of directors.

*Removal of Directors.* Under our charter, subject to the rights of one or more classes or series of preferred stock to elect one or more directors, a director may be removed only for cause and only by the affirmative vote of at least two-thirds of all votes entitled to be cast by our stockholders generally in the election of directors.

*Number of Directors, Board Vacancies, Term of Office.* We have elected to be subject to certain provisions of Maryland law that vest in our board of directors the exclusive right to determine the number of directors and the exclusive right, by the affirmative vote of a majority of the remaining directors, to fill vacancies on the board even if the remaining directors do not constitute a quorum. These provisions of Maryland law, which are applicable even if other provisions of Maryland law or our charter or bylaws provide to the contrary, also provide that any director elected to fill a vacancy shall hold office for the remainder of the full term of the class of directors in which the vacancy occurred, rather than the next annual meeting of stockholders as would otherwise be the case, and until his or her successor is elected and qualifies.

*Preferred Stock.* Under our charter, our board of directors has authority to issue preferred stock from time to time in one or more series and to establish the terms, preferences and rights of any such series of preferred stock, all without approval of our stockholders.

*Duties of Directors with Respect to Unsolicited Takeovers.* Maryland law provides protection for Maryland corporations against unsolicited takeovers by limiting, among other things, the duties of the directors in unsolicited takeover situations. The duties of directors of Maryland corporations do not require them to (1) accept, recommend or respond to any proposal by a person seeking to acquire control of the corporation, (2) authorize the corporation to redeem any rights under, or modify or render inapplicable, any stockholder rights plan, (3) make a determination under the Maryland Business Combination Act or the Maryland Control Share Acquisition Act, or (4) act or fail to act solely because of the effect the act or failure to act may have on an acquisition or potential acquisition of control of the corporation or the amount or type of consideration that may be offered or paid to the stockholders in an acquisition. Moreover, under Maryland law, the act of the directors of a Maryland corporation relating to or affecting an acquisition or potential acquisition of control is not subject to any higher duty or greater scrutiny than is applied to any other act of a director. Maryland law also contains a statutory presumption that an act of a director of a Maryland corporation satisfies the applicable standards of conduct for directors under Maryland law.

*Ownership Limit.* In order to preserve our status as a REIT under the Internal Revenue Code, our charter generally prohibits any single stockholder, or any group of affiliated stockholders, from beneficially owning more than 9.8% of our outstanding common and preferred stock unless our board of directors waives or modifies this ownership limit.

*Maryland Business Combination Act.* The Maryland Business Combination Act provides that, unless exempted, a Maryland corporation may not engage in business combinations, including mergers, dispositions of 10% or more of its assets, certain issuances of shares of stock and other specified transactions, with an

interested stockholder or an affiliate of an interested stockholder for five years after the most recent date on which the interested stockholder became an interested stockholder, and thereafter unless specified criteria are

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met. An interested stockholder is generally a person owning or controlling, directly or indirectly, 10% or more of the voting power of the outstanding stock of a Maryland corporation. Our board of directors has adopted a resolution exempting our company from this statute. However, our board of directors may repeal or modify this resolution in the future, in which case the provisions of the Maryland Business Combination Act would be applicable to business combinations between our company and interested stockholders.

*Maryland Control Share Acquisition Act.* Maryland law provides that control shares of a corporation acquired in a control share acquisition shall have no voting rights except to the extent approved by a vote of two-thirds of the votes eligible to be cast on the matter under the Maryland Control Share Acquisition Act. Control shares means shares of stock that, if aggregated with all other shares of stock previously acquired by the acquirer, would entitle the acquirer to exercise voting power in electing directors within one of the following ranges of the voting power: one-tenth or more but less than one-third, one-third or more but less than a majority or a majority or more of all voting power. A control share acquisition means the acquisition of control shares, subject to certain exceptions. If voting rights of control shares acquired in a control share acquisition are not approved at a stockholders meeting, then, subject to certain conditions and limitations, the corporation may redeem any or all of the control shares for fair value. If voting rights of such control shares are approved at a stockholders meeting and the acquirer becomes entitled to vote a majority of the shares of stock entitled to vote, all other stockholders may exercise appraisal rights. Our bylaws contain a provision exempting acquisitions of our shares from the Maryland Control Share Acquisition Act. However, our board of directors may amend our bylaws in the future to repeal or modify this exemption, in which case any control shares of our company acquired in a control share acquisition will be subject to the Maryland Control Share Acquisition Act.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

The primary component of our market risk is interest rate risk as described below. While we do not seek to avoid risk completely, we do seek to assume risk that can be quantified from historical experience, to manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake or to which we are exposed.

**Interest Rate Risk**

We are subject to interest rate risk in connection with our investments in fixed-rate, adjustable-rate and hybrid adjustable-rate mortgage-backed securities, residential mortgage loans and our related debt obligations, which are generally repurchase agreements of limited duration that are periodically refinanced at current market rates and warehouse lending facilities, and our derivative contracts.

**Effect on Net Interest Income**

We primarily fund our investments in hybrid adjustable-rate mortgage-backed securities with short-term borrowings under repurchase agreements. During periods of rising interest rates, the borrowing costs associated with those hybrid-adjustable rate mortgage-backed securities tend to increase while the income earned on such hybrid adjustable-rate mortgage-backed securities (during the fixed-rate component of such securities) may remain substantially unchanged. This effect results in a narrowing of the net interest spread between the related assets and borrowings and may even result in losses.

As a means to mitigate the negative impact of a rising interest rate environment, we have entered into derivative transactions, specifically Eurodollar futures contracts, interest rate swap contracts and swaption contracts. Hedging techniques are based, in part, on assumed levels of prepayments of our hybrid adjustable-rate mortgage-backed securities. If prepayments are slower or faster than assumed, the life of the mortgage-backed securities will be longer or shorter, which would reduce the effectiveness of any hedging strategies we may utilize and may result in losses on such transactions. Hedging strategies involving the use of derivative securities are highly complex and may produce volatile returns. Our hedging activity is also limited by the asset and sources-of-income requirements applicable to us as a REIT.

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We invest in hybrid adjustable-rate mortgage-backed securities. Hybrid adjustable-rate mortgage-backed securities have interest rates that are fixed for the first few years of the loan typically three, five, seven or 10 years and thereafter their interest rates reset periodically on the same basis as adjustable-rate mortgage-backed securities. At September 30, 2005, 93.2% of our investment portfolio was comprised of hybrid adjustable-rate mortgage-backed securities. We compute the projected weighted-average life of our hybrid adjustable-rate mortgage-backed securities based on the market's assumptions regarding the rate at which the borrowers will prepay the underlying mortgages. In general, when a hybrid adjustable-rate mortgage-backed 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 mortgage-backed security. 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 mortgage-backed security. However, if prepayment rates decrease in a rising interest rate environment, the life of the fixed-rate portion of the related mortgage-backed security could extend beyond the term of the swap agreement or other hedging instrument. This situation could negatively impact us as our borrowing costs would no longer be fixed after the end of the hedging instrument while the income earned on the hybrid adjustable-rate mortgage-backed security would remain fixed. This situation may also cause the market value of our hybrid adjustable-rate mortgage-backed securities to decline with little or no offsetting gain from the related hedging transactions. In extreme situations, we may be forced to sell assets and incur losses to maintain adequate liquidity.

***Interest Rate Cap Risk***

We also invest in residential mortgage loans and adjustable-rate and hybrid adjustable-rate mortgage-backed securities that are based on mortgages that are typically subject to periodic and lifetime interest rate caps. These caps limit the amount by which these investments' interest yield may change during any given period. However, our borrowing costs pursuant to our repurchase agreements are not subject to similar restrictions. Therefore, in a period of increasing interest rates, interest rate costs on our borrowings could increase without limitation by caps, while the interest-rate yields on our investments in residential mortgage loans and adjustable-rate and hybrid adjustable-rate mortgage-backed securities would effectively be limited by caps. This problem will be magnified to the extent we acquire adjustable-rate and hybrid adjustable-rate mortgage-backed securities that are not based on mortgages that are fully-indexed. In addition, the underlying mortgages may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. The presence of caps could result in our receipt of less cash income on our residential mortgage loans adjustable-rate and hybrid adjustable-rate mortgage-backed securities than we need in order to pay the interest cost on our related borrowings. These factors could lower our net interest income or cause a net loss during periods of rising interest rates, which would negatively impact our financial condition, cash flows and results of operations.

***Interest Rate Mismatch Risk***

We fund a substantial portion of our acquisitions of adjustable-rate and hybrid adjustable-rate mortgage-backed securities with borrowings that have interest rates based on indices and repricing terms similar to, but of somewhat shorter maturities than, the interest rate indices and repricing terms of the mortgage-backed securities. Thus, we anticipate that in most cases the interest rate indices and repricing terms of our mortgage assets and our funding sources will not be identical, thereby creating an interest rate mismatch between our mortgage assets and liabilities. Therefore, our cost of funds would likely rise or fall more quickly than would our earnings rate on assets. During periods of changing interest rates, such interest rate mismatches could negatively impact our financial condition, cash flows and results of operations. To mitigate interest rate mismatches, we may utilize hedging strategies discussed above and in Note 10 to our financial statements included in Item 1 of this Quarterly Report on Form 10-Q.

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Our analysis of risks is based on management's experience, estimates, models and assumptions. These analyses rely on models that utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of investment decisions by our manager may produce results that differ significantly from our expectations.

***Prepayment Risk***

Prepayments are the full or partial repayment of principal prior to the original term to maturity of a mortgage loan and typically occur due to refinancing of mortgage loans. Prepayment rates for mortgage-backed securities generally increase when prevailing interest rates fall below the market rate existing when the underlying mortgages were originated. In addition, prepayment rates on adjustable-rate and hybrid adjustable-rate mortgage-backed securities generally increase when the difference between long-term and short-term interest rates declines or becomes negative. Prepayments of mortgage-backed securities could harm our results of operations in several ways. Some adjustable-rate mortgages underlying our adjustable-rate mortgage-backed securities may bear initial teaser interest rates that are lower than their fully-indexed rate, which refers to the applicable index rates plus a margin. In the event that such an adjustable-rate mortgage is prepaid prior to or soon after the time of adjustment to a fully-indexed rate, the holder of the related mortgage-backed security would have held such security while it was less profitable and lost the opportunity to receive interest at the fully-indexed rate over the expected life of the adjustable-rate mortgage-backed security. Although we currently do not own any adjustable-rate mortgage-backed securities with teaser rates, we may obtain some in the future that would expose us to this prepayment risk. In addition, we currently own mortgage-backed securities that were purchased at a premium. The prepayment of such mortgage-backed securities at a rate faster than anticipated would result in a write-off of any remaining capitalized premium amount and a consequent reduction of our net interest income by such amount. Finally, in the event that we are unable to acquire new mortgage-backed securities to replace the prepaid mortgage-backed securities, our financial condition, cash flow and results of operations could be negatively impacted.

***Effect on Fair Value***

Another component of interest rate risk is the effect changes in interest rates will have on the market value of our investments, liabilities and our interest-rate hedge instruments. We are exposed to the risk that the market value of our investments will increase or decrease at different rates from those of our liabilities and our interest-rate hedge instruments.

We primarily assess our interest rate risk by estimating the duration of our investments, liabilities and interest-rate hedge instruments. Duration essentially 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 financial instruments.

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The following sensitivity analysis table shows the estimated impact on the fair value of our interest rate-sensitive investments, repurchase agreement liabilities, warehouse lending facility, junior subordinated notes and hedge instruments at September 30, 2005, assuming rates instantaneously fall 100 basis points, rise 100 basis points and rise 200 basis points:

|  | <b>Interest Rates<br/>Fall 100<br/>Basis Points</b> | <b>Unchanged</b> | <b>Interest Rates<br/>Rise 100<br/>Basis Points</b> | <b>Interest Rates<br/>Rise 200<br/>Basis Points</b> |
|--|---|------------------|---|---|
| <b>(in millions)</b>                                     |   |                  |   |   |
| <b>Adjustable-Rate Mortgage-Backed Securities</b>        |   |                  |   |   |
| Fair value   | \$ 80.5   | \$ 80.1          | \$ 79.7   | \$ 79.3   |
| Change in fair value                                     | \$ 0.4  |                  | \$ (0.4)  | \$ (0.8)  |
| Change as a percent of fair value                        | 0.5%  |                  | (0.5)%  | (1.0)%  |
| <b>Hybrid Adjustable-Rate Mortgage-Backed Securities</b> |   |                  |   |   |
| Fair value   | \$4,414.7   | \$4,334.8        | \$4,255.0   | \$4,177.4   |
| Change in fair value                                     | \$ 79.9   |                  | \$ (79.8)   | \$ (157.4)  |
| Change as a percent of fair value                        | 1.8%  |                  | (1.8)%  | (3.6)%  |
| <b>Balloon Mortgage-Backed Securities</b>                |   |                  |   |   |
| Fair value   | \$ 53.8   | \$ 53.0          | \$ 52.2   | \$ 51.4   |
| Change in fair value                                     | \$ 0.8  |                  | \$ (0.8)  | \$ (1.6)  |
| Change as a percent of fair value                        | 1.5%  |                  | (1.5)%  | (3.0)%  |
| <b>Other Mortgage-Backed Securities</b>                  |   |                  |   |   |
| Fair value   | \$ 184.0  | \$ 183.7         | \$ 183.4  | \$ 183.1  |
| Change in fair value                                     | \$ 0.3  |                  | \$ (0.3)  | \$ (0.6)  |
| Change as a percent of fair value                        | 0.2%  |                  | (0.2)%  | (0.3)%  |
| <b>Total Mortgage-Backed Securities</b>                  |   |                  |   |   |
| Fair value   | \$4,733.0   | \$4,651.6        | \$4,570.3   | \$4,491.2   |
| Change in fair value                                     | \$ 81.4   |                  | \$ (81.3)   | \$ (160.4)  |
| Change as a percent of fair value                        | 1.7%  |                  | (1.7)%  | (3.4)%  |
| <b>Mortgage Loans Held-for-Investment</b>                |   |                  |   |   |
| Fair value   | \$ 145.4  | \$ 143.0         | \$ 140.6  | \$ 138.2  |
| Change in fair value                                     | \$ 2.4  |                  | \$ (2.4)  | \$ (4.8)  |
| Change as a percent of fair value                        | 1.7%  |                  | (1.7)%  | (3.4)%  |
| <b>Repurchase Agreements (1)</b>                         |   |                  |   |   |
| Fair value   | \$4,239.0   | \$4,239.0        | \$4,239.0   | \$4,239.0   |
| Change in fair value                                     |   |                  |   |   |
| Change as a percent of fair value                        |   |                  |   |   |
| <b>Warehouse Lending Facility (1)</b>                    |   |                  |   |   |



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|                                   |          |          |          |          |
|-----------------------------------|----------|----------|----------|----------|
| Fair value                        | \$ 140.4 | \$ 140.4 | \$ 140.4 | \$ 140.4 |
| Change in fair value              |          |          |          |          |
| Change as a percent of fair value |          |          |          |          |

**Junior Subordinated Notes**

|                                   |         |         |          |          |
|-----------------------------------|---------|---------|----------|----------|
| Fair value                        | \$ 53.2 | \$ 51.0 | \$ 49.0  | \$ 47.0  |
| Change in fair value              | \$ 2.2  | \$      | \$ (2.0) | \$ (4.0) |
| Change as a percent of fair value | 4.3%    |         | (3.9)%   | (7.8)%   |

**Hedge Instruments**

|                                   |           |        |         |         |
|-----------------------------------|-----------|--------|---------|---------|
| Fair value                        | \$ (9.3)  | \$ 9.5 | \$ 30.9 | \$ 51.8 |
| Change in fair value              | \$ (18.8) |        | \$ 21.4 | \$ 42.3 |
| Change as a percent of fair value | nm        |        | nm      | nm      |

(1) The fair value of the repurchase agreements and warehouse lending facility would not change materially due to the short-term nature of these instruments.

nm = not meaningful

It is important to note that the impact of changing interest rates on fair value can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the fair value of our

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assets could increase significantly when interest rates change beyond 100 basis points. 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, in the event of changes in actual interest rates, the change in the fair value of our assets would likely differ from that shown above and such difference might be material and adverse to our stockholders.

***Risk Management***

To the extent consistent with maintaining our status as a REIT, we seek to manage our interest rate risk exposure to protect our portfolio of mortgage-backed securities and related debt against the effects of major interest rate changes.

We generally seek to manage our interest rate risk by:

monitoring and adjusting, if necessary, the reset index and interest rate related to our mortgage-backed securities and our borrowings;

attempting to structure our borrowing agreements to have a range of different maturities, terms, amortizations and interest rate adjustment periods;

using derivatives, financial futures, swaps, options, caps, floors and forward sales to adjust the interest rate sensitivity of our mortgage-backed securities and our borrowings; and

actively managing, on an aggregate basis, the interest rate indices, interest rate adjustment periods and gross reset margins of our mortgage-backed securities and the interest rate indices and adjustment periods of our borrowings.

Item 4. Controls and Procedures.

**Conclusion Regarding Disclosure Controls and Procedures**

At September 30, 2005, our principal executive officer and our principal financial officer have performed an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934, or Exchange Act) and concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC rules and forms.

**Changes in Internal Control Over Financial Reporting**

There were no material changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the third quarter of our fiscal year ending December 31, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II  
OTHER INFORMATION

Item 1. Legal Proceedings.

At September 30, 2005, no legal proceedings were pending to which we were party or of which any of our properties were subject.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None

Item 3. Defaults Upon Senior Notes.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None

Item 5. Other Information.

None.

Item 6. Exhibits.

The exhibits listed on the Exhibit Index (following the Signatures section of this report) are included, or incorporated by reference, in this Quarterly Report on Form 10-Q.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

LUMINENT MORTGAGE CAPITAL, INC.  
(Registrant)

By: /s/ GAIL P. SENECA

Gail P. Seneca  
Chief Executive Officer  
(Principal Executive Officer)

Date: November 9, 2005

By: /s/ CHRISTOPHER J. ZYDA

Christopher J. Zyda  
Chief Financial Officer  
(Principal Financial and Accounting  
Officer)

Date: November 9, 2005

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Pursuant to Item 601(a) (2) of Regulation S-K, this exhibit index immediately precedes any exhibits filed herewith.

The following exhibits are included, or incorporated by reference, in this Quarterly Report on Form 10-Q and are numbered in accordance with Item 601 of Regulation S-K.

| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 3.1                   | Second Articles of Amendment and Restatement (4)   |
| 3.2                   | Third Amended and Restated Bylaws (9)  |
| 4.1                   | Form of Common Stock Certificate (1)   |
| 4.2                   | Registration Rights Agreement, dated as of June 11, 2003, by and between the Registrant and Friedman, Billings, Ramsey & Co., Inc. (for itself and for the benefit of the holders from time to time of registrable securities issued in the Registrant's June 2003 private offering) (1) |
| 10.1                  | Amended and Restated Management Agreement, dated as of March 1, 2005, by and between the Registrant and Seneca Capital Management LLC (7)  |
| 10.2                  | Cost-Sharing Agreement, dated as of June 11, 2003, by and between the Registrant and Seneca (1)  |
| 10.3                  | 2003 Stock Incentive Plan, as amended (10)   |
| 10.4                  | Form of Incentive Stock Option under the 2003 Stock Incentive Plan (1)   |
| 10.5                  | Form of Non Qualified Stock Option under the 2003 Stock Incentive Plan (1)   |
| 10.6                  | 2003 Outside Advisors Stock Incentive Plan, as amended (10)  |
| 10.7                  | Form of Non-Qualified Stock Option under the 2003 Outside Advisors Stock Incentive Plan (1)  |
| 10.8                  | Form of Indemnity Agreement (1)  |
| 10.9                  | Employment Agreement dated as of August 4, 2003 by and between the Registrant and Christopher J. Zyda (1)  |
| 10.10                 | Form of Restricted Stock Award Agreement for Christopher J. Zyda (1)   |
| 10.11                 | Form of Restricted Stock Award Agreement for Seneca (3)  |
| 10.12                 | Controlled Equity Offering Sales Agreement dated February 7, 2005 between Luminent Mortgage Capital, Inc. and Cantor Fitzgerald & Co. (6)  |
| 10.13                 | Letter Agreement dated March 8, 2005 between Luminent Mortgage Capital, Inc. and S. Trezevant Moore, Jr. (8)   |
| 31.1*                 |  |

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Certification of Gail P. Seneca, Chairman of the Board of Directors and Chief Executive Officer of the Registrant, pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

- 31.2\* Certification of Christopher J. Zyda, Chief Financial Officer of the Registrant, pursuant to Rule 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32.1\* Certification of Gail P. Seneca, Chairman of the Board of Directors and Chief Executive Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2\* Certification of Christopher J. Zyda, Chief Financial Officer of the Registrant, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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- (1) Incorporated by reference to our Registration Statement on Form S-11 (Registration No. 333-107984) which became effective under the Securities Act of 1933, as amended, on December 18, 2003.
- (2) Incorporated by reference to our Current Report on Form 8-K filed on December 23, 2003.
- (3) Incorporated by reference to our Registration Statement on Form S-11 (Registration No. 333-107981), which became effective under the Securities Act of 1933, as amended, on February 13, 2004.
- (4) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended September 30, 2004.
- (5) Incorporated by reference to our registration

statement on  
Form S-11  
(Registration  
No. 333-113493)  
which became  
effective under  
the Securities Act  
of 1933, as  
amended, on  
March 30, 2004.

- (6) Incorporated by reference to our Current Report on Form 8-K filed on February 8, 2005.
- (7) Incorporated by reference to our Current Report on Form 8-K filed on April 1, 2005.
- (8) Incorporated by reference to our Current Report on Form 8-K filed on March 14, 2005.
- (9) Incorporated by reference to our Current Report on Form 8-K filed on August 9, 2005.
- (10) Incorporated by reference to our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005.

\* Filed herewith.

Denotes a  
management  
contract or  
compensatory  
plan.