

Western Asset Mortgage Capital Corp  
Form 424B5  
October 02, 2012

Use these links to rapidly review the document

[Table of contents](#)

[Index to the financial statements of Western Asset Mortgage Capital Corporation](#)

[Table of Contents](#)

Filed Pursuant to 424(b)(5)  
Registration Number 333-183840

## PROSPECTUS

# 12,000,000 Shares

## Common Stock

Western Asset Mortgage Capital Corporation is a Delaware corporation focused on investing in, financing and managing primarily Agency RMBS, which are residential mortgage-backed securities for which the principal and interest payments are guaranteed by a U.S. Government agency, such as the Government National Mortgage Association, or a U.S. Government-sponsored entity, such as the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation. Although our core investment strategy is focused on Agency RMBS, we may opportunistically supplement our portfolio with residential mortgage-backed securities that are not guaranteed by a U.S. Government agency or sponsored entity, commercial mortgage-backed securities and other asset-backed securities. We are externally managed and advised by Western Asset Management Company, or our Manager, an investment advisor registered with the Securities and Exchange Commission and a wholly-owned subsidiary of Legg Mason, Inc. (NYSE: LM). We are offering 12,000,000 shares of our common stock, par value \$0.01 per share, as described in this prospectus. Our common stock is listed on the New York Stock Exchange under the symbol "WMC." On September 26, 2012, the last reported price of our common stock was \$23.90 per share.

We intend to elect and qualify to be taxed as a real estate investment trust for U.S. federal income tax purposes, commencing with our taxable year ending December 31, 2012. To assist us in qualifying as a real estate investment trust, stockholders are generally restricted from owning more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding shares of common or capital stock. Our amended and restated certificate of incorporation contains various other restrictions on the ownership and transfer of our common stock. See "Description of capital stock Restrictions on ownership and transfer of our capital stock."

We are an "emerging growth company" as that term is used in the Jumpstart Our Business Startups Act of 2012, or the JOBS Act.

**Investing in our common stock involves risks. See "Risk factors" beginning on page 24 of this prospectus for a discussion of the following and other risks.**

	Per Share	Total
Public offering	\$22.20	\$266,400,000
Underwriting discount	\$0.35	\$4,200,000
Proceeds, before expenses, to us	\$21.85	\$262,200,000

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

The underwriters may also purchase up to an additional 1,800,000 shares of our common stock from us at the initial public offering price, less the underwriting discount, within 30 days after the date of this prospectus.

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.**

The shares will be ready for delivery on or about October 3, 2012.

**Deutsche Bank Securities**

**Citigroup**

**J.P. Morgan**

**Jefferies**

The date of this prospectus is September 28, 2012.

---

Table of Contents

**Table of contents**

<u>Summary</u>	<u>1</u>
<u>The offering</u>	<u>22</u>
<u>Risk factors</u>	<u>24</u>
<u>Forward-looking statements</u>	<u>57</u>
<u>Use of proceeds</u>	<u>59</u>
<u>Market prices and distribution policy</u>	<u>60</u>
<u>Capitalization</u>	<u>62</u>
<u>Selected financial information</u>	<u>63</u>
<u>Management's discussion and analysis of financial condition and results of operations</u>	<u>65</u>
<u>Quantitative and qualitative disclosures about market risk</u>	<u>88</u>
<u>Business</u>	<u>92</u>
<u>Management</u>	<u>112</u>
<u>Our Manager and the Management Agreement</u>	<u>126</u>
<u>Principal stockholders</u>	<u>136</u>
<u>Certain relationships and related transactions</u>	<u>138</u>
<u>Description of capital stock</u>	<u>141</u>
<u>Shares eligible for future sale</u>	<u>150</u>
<u>U.S. federal income tax considerations</u>	<u>153</u>
<u>Underwriting</u>	<u>175</u>
<u>Legal matters</u>	<u>179</u>
<u>Experts</u>	<u>179</u>
<u>Where you can find more information</u>	<u>179</u>
<u>Index to financial statements of Western Asset Mortgage Capital Corporation</u>	<u>F-1</u>

You should rely only on the information contained in this prospectus or in any free writing prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different or additional information. If anyone provides you with different or additional information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus and any free writing prospectus prepared by us is accurate only as of their respective dates or on the date or dates which are specified in these documents. Our business, financial condition, liquidity, results of operations and prospects may have changed since those dates.

---

Table of Contents

**Summary**

*This summary highlights some of the information in this prospectus. It does not contain all of the information that you should consider before investing in our common stock. You should read carefully the more detailed information set forth under "Risk Factors" and the other information included in this prospectus. Except where the context suggests otherwise, the terms "company," "we," "us," and "our" refer to Western Asset Mortgage Capital Corporation, a Delaware corporation, and "our Manager" refers to Western Asset Management Company, a California corporation, our external manager. Unless indicated otherwise, the information in this prospectus assumes no exercise by the underwriters of their option to purchase up to an additional 1,800,000 shares of our common stock.*

**Our Company**

We are organized as a Delaware corporation focused on investing in, financing and managing primarily residential mortgage-backed securities, or RMBS, for which the principal and interest payments are guaranteed by a U.S. Government agency, such as the Government National Mortgage Association, or GNMA, or a U.S. Government-sponsored entity, including the Federal National Mortgage Association, or FNMA, and the Federal Home Loan Mortgage Corporation, or FHLMC. We refer to these types of securities as Agency RMBS. Although our core investment strategy is focused on Agency RMBS, we may opportunistically supplement our portfolio with RMBS that are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, or non-Agency RMBS, commercial mortgage-backed securities, or CMBS, and other asset-backed securities, or ABS. We refer to these assets as our potential target assets. We finance our investments in Agency RMBS and intend to finance our potential target assets primarily through the use of repurchase agreements.

Our objective is to provide attractive risk-adjusted returns to our investors over the long term, primarily through dividends and secondarily through capital appreciation without sacrificing capital preservation. In pursuing this objective, we rely on our Manager's expertise to construct and manage a diversified mortgage investment portfolio by identifying asset classes that, when properly financed and hedged, are designed to produce attractive returns across a variety of market conditions and economic cycles, while considering the risks associated with owning such investments.

We are externally managed and advised by our Manager, an investment advisor registered with the U.S. Securities and Exchange Commission, or the SEC, and a wholly-owned subsidiary of Legg Mason, Inc., or Legg Mason (NYSE: LM). Our Manager is responsible for administering our business activities and day-to-day operations, subject to the supervision and oversight of our board of directors.

We were organized as a Delaware corporation on June 3, 2009. We commenced operations on May 15, 2012 following the completion of our initial public offering, or IPO, and the two concurrent private placements, as further described under " Our IPO and concurrent private placements".

We intend to elect and qualify to be taxed as a real estate investment trust, or REIT, for U.S. federal income tax purposes, commencing with our taxable year ending December 31, 2012. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute all of our net taxable income to stockholders and maintain our intended qualification as a REIT. We also operate our business in a manner that permits us to maintain our exemption from registration under the Investment Company Act of 1940, or the 1940 Act.

**Current market opportunities**

Since the height of the financial crisis in 2008, there have been a number of proposals put forward regarding the reform of the housing finance market. We believe the most important theme of these proposals, as highlighted in the U.S. Department of Treasury and Department of Housing and Urban Development report to Congress on February 11, 2011, is the reduction of the government's role in,

Table of Contents

and the return of private capital to, the housing finance market. Several tools intended to encourage investment of private capital were recommended in the U.S. Department of Treasury and Department of Housing and Urban Development report including increasing guarantee fees, decreasing loan limits and tightening underwriting criteria for conforming loans. We believe these recommended changes, some of which have begun to be implemented, such as the tightening of conforming loan limits in October 2011 and the announcement in August 2012 that FNMA and FHLMC would increase guarantee fees by the end of 2012, will reduce the future supply of Agency RMBS, limit mortgage refinancing and associated prepayment risk, and reduce the future volatility of the Agency RMBS market, which we view as positive developments for existing Agency RMBS.

We believe investors continue to seek incremental spreads relative to U.S. Treasury Notes in a low yield environment and financial institutions continue to prefer high quality, liquid Agency RMBS. In addition, our Manager has observed that the long-standing correlation between the prepayment rates of borrowers and their ability to refinance mortgage loans (as defined by the difference between available rates in the market and the legacy rates being paid by borrowers) has become partially de-linked in the past several years. Our Manager believes this is primarily a result of the inability of many borrowers to refinance their existing mortgages because of the significant decrease in the equity value of those borrowers' homes and more stringent underwriting standards. With yield spreads on Agency RMBS at what our Manager views as attractive levels, our Manager believes there will continue to be strong demand for Agency RMBS.

Although our core investment strategy is focused on Agency RMBS, we may opportunistically supplement our portfolio with non-Agency RMBS, which are collateralized by non-conforming residential mortgages. While we anticipate mortgage loan delinquencies and credit losses may continue to rise and housing conditions may continue to deteriorate, we believe that current prices for certain non-Agency RMBS offer the potential for attractive risk-adjusted returns. Over time, we believe reform of U.S. Government-sponsored entities will accelerate the demand for private capital into the housing finance sector, and we expect that we will be well positioned to make attractive risk-adjusted investments in new residential-mortgage assets.

The current interest rate environment is characterized by a steep yield curve with the spread between two-year U.S. Treasury Notes and 10-year U.S. Treasury Notes well above the average spread over the last three decades. The Federal Reserve Board has maintained a near-zero target for the federal funds rate. On August 1, 2012, the Federal Open Market Committee released a statement indicating that it would maintain the target range for the federal funds rate at 0% to 0.25% and that it continues to anticipate that economic conditions, including low rates of resource utilization and a subdued outlook for inflation over the medium term, are likely to warrant exceptionally low levels for the federal funds rate at least through late 2014, reiterating previous statements by the Federal Open Market Committee from January and April 2012. Our Manager believes recent economic data suggest an improvement in U.S. economic growth. However, certain indicators such as high unemployment, low levels of capacity utilization, the current large shadow inventory of non-performing loans, declining or stagnant home prices in most markets and continued stress in the housing and construction markets all point to a muted recovery. We believe this slow growth environment should keep the yield curve relatively steep and promote continued demand for Agency and non-Agency RMBS.

As the capital markets have recovered, commercial banks have re-entered the secured lending market which has quickened the pace of the recovery of asset values in the credit markets. Financing of Agency and non-Agency RMBS is currently widely available through, among other vehicles, repurchase agreements. Haircuts, or the discount attributed to the value of securities sold under repurchase agreements, average between 3% and 10% for Agency RMBS and average between 10% and 50% for non-Agency RMBS, depending on the specific security used as collateral for such repurchase agreements. We use leverage to seek to increase potential returns to our stockholders by borrowing

Table of Contents

against existing assets through repurchase agreements and using the proceeds to acquire additional assets.

Our Manager's views of the current market opportunities are based on its own assessments. There can be no assurance that our investment and financing strategies based on our Manager's views will be able to generate attractive returns for our stockholders. For additional information regarding recent developments impacting the RMBS market, see "Recent developments".

**Our Manager**

We are externally managed and advised by Western Asset Management Company. Established in 1971 and acquired by Legg Mason in 1986, our Manager is a registered investment advisor headquartered in Pasadena, California, that specializes in fixed-income asset management. From offices in Pasadena, Dubai, Hong Kong, London, Melbourne, New York, São Paulo, Singapore and Tokyo, our Manager's 889 employees provide investment services for a wide variety of global clients, including mutual funds, corporate, public, insurance, health care, union organizations and charitable foundations. Client portfolios range across an equally wide variety of mandates, from money markets to emerging markets. As of June 30, 2012, our Manager had 516 clients, representing 40 countries and 1,057 accounts. By concentrating resources on fixed-income, our Manager is able to fully commit to serving clients of all types within the fixed-income sector.

As of June 30, 2012, our Manager and its investment advisory affiliates over which our Manager has operational responsibility, or its supervised affiliates, had approximately \$446 billion in assets under management. As of June 30, 2012, our Manager had approximately \$65.8 billion in assets under management in the asset classes corresponding to Agency RMBS and our potential target assets, of which approximately \$40.5 billion was invested in Agency RMBS, approximately \$13.2 billion in non-Agency RMBS, approximately \$2.6 billion in CMBS and approximately \$9.5 billion in ABS. Our Manager manages these assets using a range of specific strategies and investment vehicles, including mutual and private funds, private commingled vehicles and separately managed accounts. Our Manager's investment professionals and other staff have extensive experience in managing fixed-income assets, including Agency RMBS, non-Agency RMBS, CMBS, ABS and other such instruments.

Our chief investment officer, Stephen P. Fulton, who also serves as the head of our Manager's Agency RMBS team, is, along with two senior portfolio managers from the Agency RMBS team, primarily responsible for overseeing the management of our assets. The Agency RMBS team works alongside and is able to utilize the resources of our Manager's structured products team, which focuses on managing and evaluating our potential target assets, including non-Agency RMBS, CMBS and ABS. The Agency RMBS team is also able to call on the experience of a number of our Manager's other investment professionals, not specifically dedicated to managing our assets, but with expertise that covers certain aspects of our potential target assets as well as on specialists in derivatives and liquidity who are part of our Manager's broader investment team. The collective team operates under the purview of our Manager's U.S. broad markets committee which sets overall sector allocations for broad market accounts. Our Manager seeks to unite groups of specialists dedicated to different market sectors. The daily interaction among the different teams is designed to develop a consensus approach that draws on the expertise of all team members. Our Manager's overall investment management team consists of 124 investment professionals.

**Our investment strategy**

Our Manager's investment philosophy, which developed from a singular focus in fixed-income asset management over a variety of credit cycles and conditions, is to provide clients with diversified, tightly controlled, long-term value-oriented portfolios. Through rigorous analysis of all sectors of the fixed-income market, our Manager seeks to identify assets with the greatest risk-adjusted total value

Table of Contents

potential. In making investment decisions on our behalf, our Manager incorporates its views on the economic environment and the outlook for the mortgage markets, including relative valuation, supply and demand trends, the level of interest rates, the shape of the yield curve, prepayment rates, financing and liquidity, commercial and residential real estate prices, delinquencies, default rates, recovery of various segments of the economy and vintage of collateral, subject to maintaining our REIT qualification and our exemption from registration under the 1940 Act. We benefit from the breadth and depth of our Manager's overall investment philosophy, which focuses on a macroeconomic analysis as well as an in-depth analysis of individual assets and their relative value.

We rely on our Manager's expertise in asset allocation and identifying attractive assets within our investment strategy. Although our core investment strategy is focused on Agency RMBS, our Manager's expertise in related investment disciplines such as non-Agency RMBS, CMBS and ABS provides our Manager with both (1) valuable investment insights to our RMBS investment selection and strategy and (2) flexibility to invest in assets other than Agency RMBS opportunistically as market conditions warrant.

We purchase and sell Agency RMBS and may, in the future, purchase and sell our potential target assets. Our Manager does not purchase securities on our behalf with a view to selling them shortly after purchase. However, in order to maximize returns and manage portfolio risk while remaining opportunistic, we may dispose of securities earlier than anticipated or hold securities longer than anticipated depending upon prevailing market conditions, credit performance, availability of leverage or other factors regarding a particular security or our capital position.

**Agency RMBS**

Agency RMBS, which are RMBS for which the principal and interest payments are guaranteed by a U.S. Government agency, such as the GNMA, or a U.S. Government-sponsored entity, such as the FNMA or the FHLMC. The Agency RMBS we acquire could be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages. Fixed-rate mortgages have interest rates that are fixed for the term of the loan and do not adjust. The interest rates on adjustable-rate mortgages generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. Hybrid adjustable-rate mortgages have interest rates that are fixed for a specified period of time (typically three, five, seven or ten years) and, thereafter, adjust to an increment over a specified interest rate index. Adjustable-rate mortgages and hybrid adjustable-rate mortgages generally have periodic and lifetime constraints on how much the loan interest rate can change on any predetermined interest rate reset date. As of June 30, 2012, all of our Agency RMBS were secured by fixed-rate mortgages.

We have invested the proceeds of our IPO and concurrent private placements and expect to continue to focus on investing in the following types of securities:

*Mortgage pass-through certificates.* Mortgage pass-through certificates are securities representing interests in "pools" of mortgage loans secured by residential real property where payments of both interest and principal, plus pre-paid principal, on the securities are made monthly to holders of the securities, in effect "passing through" monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer/guarantor and servicers of the securities.

*Agency Derivatives*

We refer to Agency Interest-Only Strips and Agency Inverse Interest-Only Strips as Agency Derivatives. Both of these are Agency RMBS that represent a type of Collateralized Mortgage Obligation.

Table of Contents

*Agency Interest-Only Strips.* This type of security only entitles the holder to interest payments. The yield to maturity of Agency Interest-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of particularly attractive prepayment-related or structural opportunities in the Agency RMBS markets, as well as to help manage the duration of our overall portfolio.

*Agency Inverse Interest-Only RMBS.* This type of security has a coupon with an inverse relationship to its index and is subject to caps and floors. Agency Inverse Interest-Only RMBS entitles the holder to interest only payments based on a notional principal balance, which is typically equal to a fixed rate of interest on the notional principal balance less a floating rate of interest on the notional principal balance that adjusts according to an index subject to set minimum and maximum rates. The value of Agency Inverse Interest-Only RMBS will generally decrease when its related index rate increases and increase when its related index rate decreases.

*Collateralized Mortgage Obligations, or CMOs.* CMOs are securities that are structured from residential pass-through certificates, which receive monthly payments of principal and interest. CMOs divide the cash flows which come from the underlying mortgage pass-through certificates into different classes of securities that may have different maturities and different weighted average lives than the underlying pass-through certificates.

Other Agency RMBS we intend to invest in, but have not yet done so, are described below.

*TBAs.* We may utilize "to-be-announced" forward contracts, or TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we would agree to purchase, for future delivery, Agency RMBS with certain principal and interest terms and certain types of underlying collateral, but the particular Agency RMBS to be delivered would not be identified until shortly before the TBA settlement date. Our ability to purchase Agency RMBS through TBAs may be limited by the 75% income and asset tests applicable to REITs. See "U.S. federal income tax considerations Taxation of Western Asset Mortgage Capital Corporation."



## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

### Table of Contents

The following table presents certain information about our investment portfolio at June 30, 2012:

	Principal Balance <sup>(1)</sup>	Unamortized Premium (Discount)	Amortized Cost <sup>(1)</sup>	Unrealized Gain (Loss)	Estimated Fair Value <sup>(1)</sup>	Net Weighted Average Coupon <sup>(2)</sup>	Weighted Average Yield <sup>(3)</sup>
<b>30-Year Mortgage</b>							
Coupon Rate:							
3.00%	\$ 159,816	\$ 3,034	\$ 162,850	\$ 1,189	\$ 164,039	3.0%	2.8%
3.50%	784,902	40,643	825,545	2,639	828,184	3.5%	3.0%
4.00%	419,065	31,108	450,173	(77)	450,096	4.0%	3.0%
7.00%	77,035	12,449	89,484	179	89,663	7.0%	0.9%
	1,440,818	87,234	1,528,052	3,930	1,531,982	3.8%	2.8%
<b>20-Year Mortgage</b>							
Coupon Rate:							
3.50%	186,074	11,062	197,136	(252)	196,884	3.5%	2.4%
4.00%	24,916	2,008	26,924	(88)	26,836	4.0%	2.3%
	210,990	13,070	224,060	(340)	223,720	3.6%	2.4%
CMO Fixed Rate IOs and IIOs <sup>(4)</sup>	66,000	11,124	77,124	(316)	76,808	6.5%	4.9%
Agency interest-only strips accounted for as derivatives <sup>(4)</sup>					26,844	4.2% <sup>(5)</sup>	1.6%
					86,322	4.3%	6.4%
<b>Total</b>			<b>\$ 1,888,063</b>	<b>\$ 3,925</b>	<b>\$ 1,918,832</b>	<b>4.0%</b>	<b>3.0%</b>

- (1) Includes unsettled purchases with an aggregate cost of \$105,912 and estimated fair value of \$106,019 at June 30, 2012.
- (2) Net weighted average coupon as of June 30, 2012 is presented net of servicing and other fees.
- (3) Weighted average yield as of June 30, 2012 incorporates estimates for future prepayment and loss assumptions.
- (4) IOs and IIOs and Agency Interest-Only Strips accounted for as derivatives have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities.
- (5) Interest on these securities is reported as a component of Loss on derivative instruments.

Since June 30, 2012, we have made certain acquisitions and dispositions of Agency RMBS that have resulted in adjustments to our investment portfolio's allocation of the subcategories of Agency RMBS described above; however, these adjustments have not been material.

### Potential target assets

Although our core investment strategy is focused on Agency RMBS, we may opportunistically supplement our portfolio with the types of assets described below.

*Non-Agency RMBS.* RMBS that are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

The mortgage loan collateral for non-Agency RMBS consists of residential mortgage loans that do not generally conform to underwriting guidelines issued by a U.S. Government agency or U.S. Government-sponsored entity due to certain factors, including mortgage balances in excess of agency underwriting guidelines, borrower characteristics, loan characteristics and level of documentation, and therefore are not issued or guaranteed by an agency. The mortgage loan collateral may be classified as subprime, Alternative-A or prime depending on the borrower's credit rating. The non-Agency RMBS

Table of Contents

we may acquire could be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages.

**CMBS.** Fixed and floating rate CMBS, with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. We have not established a minimum current rating requirement.

**ABS.** Debt and equity tranches of securitizations backed by various asset classes including, but not limited to, small balance commercial mortgages, aircrafts, automobiles, credit cards, equipment, manufactured housing, franchises, recreational vehicles and student loans with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. Investments in ABS generally are not qualifying assets for purposes of the 75% asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets. See "U.S. federal income tax considerations Taxation of Western Asset Mortgage Capital Corporation.

**Other Agency MBS.** We may also invest in mortgage-backed securities, or MBS, for which the principal and interest payments are guaranteed by a U.S. Government-sponsored entity, but for which the underlying mortgage loans are secured by real property other than single family residences. These may include, but are not limited to the FNMA's DUS (Delegated Underwriting and Servicing) MBS, the FHLMC's Multifamily Mortgage Participation Certificates and the GNMA's project loan pools, or CMOs structured from such collateral.

**Our competitive advantages**

We believe that our competitive advantages include the following:

***Significant experience of our Manager***

Our Manager has utilized Agency RMBS as a vital component within its investment strategy since its inception in 1971 and has managed through several interest rate, housing, and credit cycles. Our Manager has extensive experience managing Agency RMBS strategies as separately-managed accounts, commingled vehicles, and mutual funds. These strategies include Agency RMBS only, the GNMA's RMBS only and several Agency RMBS strategies with varying degrees of non-Agency RMBS exposure. Agency RMBS has also been a significant portion of our Manager's broad market strategies since 1971. Moreover, our Manager has been an active investor in non-Agency RMBS, CMBS and ABS for over 20 years as those markets have developed. Our Manager manages these assets in broad market accounts as well as non-Agency RMBS specific strategies, including commingled funds and mutual funds. We have access to our Manager's dedicated Agency RMBS team, which is led by our chief investment officer. In addition, we utilize the resources of our Manager's structured products team, which focuses on our potential target assets, including non-Agency RMBS, CMBS and ABS. We also call on the experience of specialists in derivatives and liquidity who are part of our Manager's broader investment team. In addition, we believe that our Manager's senior management team, which has a long track record and broad experience in managing mortgage-related assets through a variety of credit and interest rate environments, has demonstrated the ability to generate attractive risk-adjusted returns under different market conditions and cycles and provides us with a competitive advantage.

***Extensive strategic relationships***

Our Manager and its supervised affiliates maintain extensive long-term relationships with other financial intermediaries, including primary dealers, leading investment banks, brokerage firms, leading mortgage originators and commercial banks. As one of the largest fixed-income investment managers in

Table of Contents

the world, our Manager has access to deal flow and secondary trading opportunities to which smaller firms do not have access. Additionally, our Manager's size and broad market access are valuable in developing and implementing our investment strategy. We believe these relationships enhance our ability to source, finance and hedge investment opportunities and, thus, will enable us to grow in various credit and interest rate environments. In addition, we believe the contacts our Manager and its supervised affiliates have with numerous investment grade derivative and lending counterparties assist us in implementing our financing and hedging strategies.

***Disciplined investment approach***

Our Manager takes a value-oriented approach to managing Agency RMBS. Using that approach, our Manager seeks to optimize yield while adjusting for prepayment and interest rate risk.

From a macroeconomic perspective, our Manager examines current and forward interest rates, the shape of the yield curve, gross domestic product, or GDP, growth and inflation expectations, regional and local property trends, local employment conditions, national loan modification initiatives and mortgage servicer timelines and techniques. At the security level, our Manager examines borrower and collateral characteristics such as the incentives a homeowner might have to refinance and the level of equity in the home.

***Access to our Manager's analytical tools and infrastructure***

Our Manager uses its analytical and portfolio management modeling tools and processes to seek to generate positive net interest margins for our assets. We employ a combination of proprietary and third-party tools in an effort to identify investments in the Agency RMBS sector with the most attractive risk-adjusted returns.

Our Manager analyzes macroeconomic factors to seek to determine the appropriate sector mix and strategy for us that best capitalizes on the market knowledge, experience and relationships within our Manager's existing platform. We capitalize on the market knowledge and ready access to data across our target markets that our Manager obtains through these tools and processes and believe that our Manager's sophisticated analysis of both macro and micro economic factors positions us to manage cash flows from Agency RMBS and our potential target assets and make distributions to our stockholders while preserving capital. We believe we also benefit from our Manager's comprehensive finance and administrative infrastructure, including its risk management and financial reporting operations, as well as its business development, legal and compliance teams.

***Alignment of our Manager's interests***

We have taken steps to structure our relationship with our Manager so that our interests and those of our Manager are closely aligned. Concurrently with the closing of our IPO, we issued and sold in a private placement 46,043 shares of our common stock at \$20.00 per share to our Manager's deferred compensation plan, which made such investment on behalf of the beneficiaries of the plan, which includes certain executives and other employees of our Manager and its affiliates. These shares are subject to a two year lock-up agreement from the date of our IPO with the underwriters of that offering.

In addition, our equity incentive plans allow us to grant common stock-based awards to our Manager and its employees, including our executive officers, representing up to 3.0% of the total number of issued and outstanding shares of our common stock (on a fully diluted basis) at the time of each award (other than any shares issued or subject to awards made pursuant to one of our equity incentive plans). Upon the consummation of our IPO, we granted 51,159 shares of our restricted common stock to our Manager under one of our equity incentive plans. One-third of these shares vest on each of the first, second and third anniversaries of the grant date.

Table of Contents

**Investment guidelines**

Our board of directors has adopted a set of investment guidelines that sets forth our target asset classes and other criteria to be used by our Manager to evaluate specific assets as well as our overall portfolio composition. Our Manager makes determinations as to the percentage of our assets that will be invested in each of our target asset classes, consistent with the investment guidelines adopted by our board of directors and the limits necessary to maintain compliance with REIT tax rules and our exemption under the 1940 Act. Our Manager's investment decisions depend on prevailing market conditions and may change over time in response to opportunities available in different interest rate, economic and credit environments. As a result, we cannot predict the percentage of our assets that will be invested in any of our target asset classes at any given time, although we are focused on investing in Agency RMBS, and to date have invested almost exclusively in Agency RMBS. We believe that the diversification of our portfolio of assets, our Manager's extensive experience in investing in Agency RMBS and our potential target assets and the flexibility of our strategy, combined with our Manager's and its supervised affiliates' general investment and advisory expertise and comprehensive finance and administrative infrastructure, will enable us to achieve attractive risk-adjusted returns under a variety of market conditions and economic cycles.

Our investment guidelines may be changed from time to time by our board of directors without the approval of our stockholders. Changes to our investment guidelines may include, without limitation, modification or expansion of the types of assets in which we may invest.

**Our financing strategy and leverage**

We fund the acquisition of our assets through the use of leverage from a number of financing sources, subject to maintaining our qualification as a REIT. We finance purchases of Agency RMBS and intend to finance future purchases of our potential target assets primarily through the use of repurchase agreements.

We use leverage to increase potential returns to our stockholders. We accomplish this by borrowing against existing assets through repurchase agreements and using the proceeds to acquire additional assets. There are no limits on the maximum amount of leverage that we may use, and we are not required to maintain any particular debt-to-equity leverage ratio. We may also change our financing strategy and leverage without the consent of our stockholders.

We currently borrow between seven to eleven times the amount of our stockholders' equity (calculated in accordance with accounting principles generally accepted in the United States, or U.S. GAAP), although there is no minimum or maximum leverage that our investment policies explicitly require. Depending on the different cost of borrowing funds at different maturities, we vary the maturities of our borrowed funds to attempt to produce lower borrowing costs and reduce interest rate risk. We have entered into repurchase agreements only with institutions that are rated investment grade by at least one nationally-recognized statistical rating organization. As of June 30, 2012, we had entered into repurchase agreements with nine counterparties and had borrowings of approximately \$1.7 billion as of that date with those counterparties.

The leverage that we employ is specific to each asset class and is determined based on several factors, including potential asset price volatility, margin requirements, the current cycle for interest rates, the shape of the yield curve, the outlook for interest rates and our ability to use and the effectiveness of interest rate hedges. We analyze both historical volatility and market-driven implied volatility for each asset class in order to determine potential asset price volatility. Our leverage targets attempt to risk-adjust asset classes based on each asset class's potential price volatility. The goal of our leverage strategy is to ensure that, at all times, our investment portfolio's overall leverage ratio is appropriate for the level of risk inherent in the investment portfolio, and that each asset class has individual leverage targets that are appropriate for its potential price volatility.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

### Table of Contents

The following table presents information about our repurchase agreements as of June 30, 2012:

(dollars in thousands) Repurchase Agreement Counterparties	Amount Outstanding	Percent of Total Amount Outstanding	Company MBS Held as Collateral <sup>(1)</sup>
Merrill Lynch Pierce Fenner & Smith Inc.	\$ 271,316	15.6%	\$ 281,668
Barclays Capital Inc.	160,818	9.3%	169,684
BNP Paribas Securities Corporation	70,904	4.1%	75,678
Credit Suisse Securities (USA) LLC	255,720	14.7%	267,024
Deutsche Bank Securities LLC	246,903	14.2%	260,938
Goldman Sachs Bank USA	97,064	5.6%	102,477
JP Morgan Securities LLC	299,274	17.2%	308,641
Morgan Stanley & Co. LLC	192,469	11.1%	203,063
RBC Capital Markets LLC	142,025	8.2%	149,916
<b>Total</b>	<b>\$ 1,736,493</b>	<b>100.0%</b>	<b>\$ 1,819,089</b>

(1) At fair value.

Since June 30, 2012, we have entered into repurchase agreements with an additional four counterparties.

### Risk management

As part of our risk management strategy, our Manager may seek to actively manage the financing, interest rate, credit, prepayment and convexity risks associated with holding a portfolio of Agency RMBS and our potential target assets. We rely on our Manager's expertise to manage these risks on our behalf and our Manager may incorporate various hedging, asset/liability risk management and credit risk mitigation techniques in order to facilitate our risk management. We may engage in a variety of interest rate management techniques that seek on one hand to mitigate the influence of interest rate changes on the values of some of our assets, and on the other hand help us achieve our risk management objectives. Subject to maintaining our qualification as a REIT and exemption from registration under the 1940 Act, we have utilized or may utilize derivative financial instruments, including, among others, puts and calls on securities or indices of securities, interest rate swaps, interest rate caps, interest rate swaptions (options on interest rate swaps), exchange-traded derivatives, U.S. Treasury securities and options on U.S. Treasury securities and interest rate floors to hedge all or a portion of the interest rate risk associated with the financing of our investment portfolio. We have also purchased or may purchase interest rate swaps, interest rate swaptions, interest cancellable swaps, interest rate caps, interest rate corridors (long interest rate cap positions combined with short interest rate cap positions; a buyer of a corridor purchases a cap position with a lower strike price while selling a cap position with a higher strike price), Eurodollar futures contracts and options on such contracts, and other interest rate and non-interest rate derivatives, including, but not limited to, total return swaps. As of June 30, 2012, we had entered into interest rate swap contracts for a total notional amount of approximately \$1 billion.

The following table presents information about our interest rate swaps as of June 30, 2012 (dollars in thousands):

Remaining Interest Rate interest rate swap Term	Notional Amount	Average Fixed Pay Rate	Average Maturity (Years)
Greater than 1 year and less than 3 years	\$ 320,000	0.7%	2.4
Greater than 3 years and less than 5 years	165,000	1.1	4.6
Greater than 5 years	530,500	1.8	10.0
<b>Total</b>	<b>\$ 1,015,500</b>	<b>1.3%</b>	<b>6.7</b>

Table of Contents

In utilizing leverage and interest rate hedges, our objective is to improve risk-adjusted returns and, where possible, to lock in, on a long-term basis, a favorable spread between the yield on our assets and the cost of our financing. However, through the employment of financial leverage in funding our portfolio, mismatches in the maturities of our assets and liabilities can create the risk that we will need to continually renew or otherwise refinance our liabilities. We also retain the risk of potential credit losses on the loans underlying the non-Agency RMBS, CMBS and ABS we may hold. We may seek to manage this risk through our pre-acquisition due diligence process, through the use of non-recourse financing that limits our credit loss exposure to the specific assets that are subject to the non-recourse financing and through the use of derivative financial instruments.

Our Manager actively employs portfolio-wide and security-specific risk measurement and management processes in our daily operations through tools which include software and services licensed or purchased from third parties, in addition to proprietary systems and analytical methods developed internally. There can be no assurance, however, that these tools and the other risk management techniques described above will protect us from these risks.

In addition, our Manager has appointed an investment oversight committee made up of senior investment personnel from our Manager, which is tasked with reviewing, considering and approving our interest rate, hedging and leverage strategies. The investment oversight committee meets as frequently as necessary in order for us to make rapid investment decisions. The investment oversight committee also periodically reviews our investment portfolio and is available to provide updates to our board of directors in connection with its reviews of our investment performance.

**Summary risk factors**

An investment in shares of our common stock involves various risks. You should consider carefully the risks discussed below and under the heading "Risk factors" beginning on page 23 of this prospectus before purchasing our common stock. If any of the following risks occurs, our business, financial condition or results of operations could be materially and adversely affected. In that case, the trading price of our common stock could decline and you may lose some or all of your investment.

We have a limited operating history and may not be able to successfully operate our business or generate sufficient revenue to make or sustain distributions to our stockholders.

We are dependent on our Manager and its key personnel for our success.

There are conflicts of interest in our relationship with our Manager that could result in decisions that are not in the best interests of our stockholders.

Our Manager's management fee is payable regardless of our performance.

We may change any of our strategies, policies or procedures without stockholder consent.

We have not yet identified any specific investments we may make with the net proceeds of this offering.

We may pay distributions from offering proceeds, borrowings or the sale of assets to the extent that distributions exceed earnings or cash flow from our operations.

We operate in a highly competitive market for investment opportunities and competition may limit our ability to acquire desirable investments in Agency RMBS and our potential target assets and could also affect the pricing of these securities.

A lack of liquidity in our investments may adversely affect our business.

Adverse developments in the broader residential mortgage market may adversely affect the value of the assets in which we invest.



## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

### Table of Contents

The mortgage loans underlying the non-Agency RMBS and the CMBS we may acquire will be subject to defaults, foreclosure, timeline extension, fraud and residential/commercial price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, which could result in losses to us.

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

Most of our investments are recorded at fair value, and quoted prices or observable inputs may not be available to determine such value, resulting in the use of significant unobservable inputs to determine value.

Declines in value of the assets in which we invest will adversely affect our financial position and results of operations, and make it more costly to finance these assets.

Changes in prepayment rates may adversely affect our profitability.

Loss of our exemption from regulation pursuant to the 1940 Act would adversely affect us.

We use leverage in executing our business strategy, which may adversely affect the return on our assets and may reduce cash available for distribution to our stockholders, as well as increase losses when economic conditions are unfavorable.

The federal conservatorship of the FNMA and the FHLMC and related efforts, along with any changes in laws and regulations affecting the relationship between these agencies and the U.S. Government, may adversely affect our business.

Mortgage loan modification and refinancing programs and future legislative action may adversely affect the value of, and our returns on, Agency RMBS and our potential target assets.

Actions of the U.S. Government, including the U.S. Congress, Federal Reserve, U.S. Treasury and other governmental and regulatory bodies, to stabilize or reform the financial markets may not achieve their intended effect and may adversely affect our business.

We are subject to the risk that U.S. Government agencies and/or U.S. Government-sponsored entities may not be able to fully satisfy their guarantees of Agency RMBS or that these guarantee obligations may be repudiated, which may adversely affect the value of our assets and our ability to sell or finance these securities.

If a counterparty to our repurchase transactions defaults on its obligation to resell the underlying security back to us at the end of the transaction term, or if the value of the underlying security has declined as of the end of that term, or if we default on our obligations under the repurchase agreement, we will lose money on our repurchase transactions.

Failure to procure adequate repurchase agreement financing, which generally have short terms, or to renew or replace repurchase agreement financing as it matures, would adversely affect our results of operations.

An increase in our borrowing costs relative to the interest we receive on our assets may adversely affect our profitability and cash available for distribution to our stockholders.

Hedging against interest rate exposure may adversely affect our earnings, which could reduce our cash available for distribution to our stockholders.

Our Manager has limited experience operating a REIT and we cannot assure you that our Manager's past experience will be sufficient to successfully manage our business as a REIT.

Our board of directors has approved very broad investment guidelines for our Manager and does not approve each investment and financing decision made by our Manager.

Table of Contents

The Management Agreement with our Manager was not negotiated on an arm's-length basis and may not be as favorable to us as if it had been negotiated with an unaffiliated third party and may be costly and difficult to terminate.

The dilutive effect of our outstanding warrants, including in certain circumstances, upon the issuance of common stock in this offering as well as future issuances of our common stock, could have an adverse effect on the future market price of our common stock or otherwise adversely affect the interests of our common stockholders.

If we do not qualify as a REIT or if we fail to remain qualified as a REIT, we will be subject to tax as a regular corporation and could face a substantial tax liability, which would reduce the amount of cash available for distribution to our stockholders.

Complying with REIT requirements may cause us to forgo otherwise attractive opportunities.

**Management agreement**

We are externally managed and advised by our Manager, which is our promoter with respect to this offering. Our Manager's parent company, Legg Mason, is also our promoter with respect to this offering. We benefit from the personnel, infrastructure, relationships and experience of our Manager to enhance the growth of our business. All of our officers, apart from our chief financial officer, Steven M. Sherwyn, are employees of our Manager. In addition two, of our directors, James W. Hirschmann III and Gavin L. James, are also employees of our Manager. We do not have any employees other than our chief financial officer. Our Manager does not serve us exclusively and is not obligated to dedicate any of its personnel to us, nor is our Manager or its personnel obligated to dedicate any specific portion of its or their time to our business.

On May 9, 2012, we entered into a management agreement, or the Management Agreement, with our Manager. Pursuant to the Management Agreement, our Manager is responsible for the implementation of our business strategy and performs certain services for us, subject to oversight by our board of directors. Our Manager is responsible for, among other duties, (1) performing all of our day-to-day functions, (2) determining investment criteria in conjunction with our board of directors, (3) sourcing, analyzing and executing investments, asset sales and financings, (4) performing asset management duties and (5) performing financial and accounting management.

The initial term of the Management Agreement ends three years after the closing of our IPO, May 15, 2015, with automatic one-year renewal terms that end on the anniversary of the closing of our IPO. Our independent directors review our Manager's performance annually and, following the initial three-year term, the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds of our independent directors based upon: (1) our Manager's unsatisfactory performance that is materially detrimental to us or (2) our determination that any fees payable to our Manager are not fair, subject to our Manager's right to prevent termination based on unfair fees by accepting a reduction of management fees agreed to by at least two-thirds of our independent directors. We are required to provide our Manager with 180 days prior notice of such termination. Upon such a termination, we are required to pay our Manager a termination fee as described in the table below. We may also terminate the Management Agreement at any time, including during the initial term, with 30 days prior notice from our board of directors, without payment of a termination fee, for cause, as defined in the Management Agreement. Our Manager may terminate the Management Agreement if we become required to register as an investment company under the 1940 Act, with such termination deemed to occur immediately before such event, in which case we are not required to pay a termination fee. Our Manager may also decline to renew the Management Agreement by providing us with 180 days written notice, in which case we are not required to pay a termination fee.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

### Table of Contents

The following table summarizes the fees and expense reimbursements that we pay to our Manager:

<b>Type</b>	<b>Description</b>	<b>Payment</b>
Management fee	<p>Our Manager is entitled to a management fee equal to 1.5% per annum, calculated and payable quarterly in arrears, of our stockholders' equity.</p> <p>For purposes of calculating the management fee, our "stockholders' equity" means the sum of the net proceeds from any issuances of our equity securities since inception (allocated on a pro rata daily basis for such issuances during the fiscal quarter of any such issuance), plus our retained earnings, calculated in accordance with U.S. GAAP, at the end of the most recently completed fiscal quarter (without taking into account any non-cash equity compensation expense incurred in current or prior periods), less any amount that we pay for repurchases of our shares of common stock, excluding any unrealized gains, losses or other non-cash items that have impacted stockholders' equity as reported in our financial statements prepared in accordance with U.S. GAAP, regardless of whether such items are included in other comprehensive income or loss, or in net income, and excluding one-time events pursuant to changes in U.S. GAAP and certain other non-cash charges after discussions between our Manager and our independent directors and after approval by a majority of our independent directors. However, if our stockholders' equity for any given quarter is negative based on the calculation described above, our Manager will not be entitled to receive any management fee for that quarter.</p> <p>Assuming that we sell 12,000,000 shares of common stock in this offering (which assumes no exercise of the underwriters' option to purchase up to an additional 1,800,000 shares), the management fee payable to our Manager for the 12-month period beginning on October 1, 2012 (assuming no additional equity is issued within this 12-month period) would be approximately \$7 million. The management fee that was payable for the period from May 15, 2012 (commencement of operations) through June 30, 2012 was approximately \$0.4 million.</p>	Quarterly in cash.
Expense reimbursement	<p>Reimbursement of operating expenses related to us incurred by our Manager, including legal, accounting, due diligence and other services. We do not reimburse our Manager or its affiliates for the salaries and other compensation of their personnel.</p>	Monthly in cash.

Table of Contents

Type	Description	Payment
Termination fee	Termination fee equal to three times the average annual management fee earned by our Manager during the prior 24-month period prior to such termination, calculated as of the end of the most recently completed fiscal quarter prior to such termination. See "Our Manager and the Management Agreement Management agreement Term and termination."	Upon termination of the Management Agreement by us without cause or by our Manager if we materially breach the Management Agreement.
Equity incentive plans	Our equity incentive plans include provisions for grants of restricted common stock and other equity based awards to our Manager and its employees and to our directors and officers. The total number of shares that may be made subject to awards under our equity incentive plans will be equal to an aggregate of 3.0% of the total number of issued and outstanding shares of our common stock (on a fully diluted basis) at the time of each award (other than any shares issued or subject to awards made pursuant to one of our equity incentive plans). As of the date of this prospectus, we have granted 66,114 shares of our restricted common stock under our equity incentive plans. See "Management Equity incentive plans" for a further description of the vesting terms of these grants of restricted common stock.	Administered by the compensation committee of our board of directors.

**Our IPO and the concurrent private placements**

On May 15, 2012, we completed our IPO in which we sold a total of 8.0 million shares of our common stock for \$20.00 per share. Concurrently with the completion of our IPO, on May 15, 2012, we completed an institutional private placement in which we sold 2,231,787 of our units (as further described below) to certain "qualified institutional buyers" (as defined in Rule 144A under the Securities Act) for \$20.00 per unit. On May 15, 2012, we also completed a private placement in which we sold 46,043 shares of our common stock to our Manager's deferred compensation plan for \$20.00 per share. Our Manager's deferred compensation plan made this investment on behalf of the beneficiaries of the plan, which includes certain executives and other employees of our Manager and its affiliates. Our aggregate net proceeds from our IPO and these two private placements was approximately \$204.4 million, after deducting estimated organizational and offering expenses payable by us.

Each of the 2,231,787 units sold in the institutional private placement described above consisted of one share of our common stock and a warrant to purchase 0.5 of a share of our common stock, which immediately separated upon issuance. As of the date of this prospectus, the qualified institutional buyers that purchased our units in the institutional private placement described above hold an aggregate of 2,231,787 shares of our common stock and warrants entitling them to purchase an aggregate of 1,115,893 shares of our common stock. Each of these warrants has an initial exercise price of \$20.50 per share, subject to adjustment upon the occurrence of customary events triggering an anti-dilution adjustment and certain sales of our common stock and subject to certain limitations on exercise. The warrants expire on May 15, 2019. This offering will trigger an adjustment to the exercise price of the warrants.

Table of Contents

We have entered into a registration rights agreement with the purchasers of our units in the institutional private placement described above, the trustee of our Manager's deferred compensation plan and our Manager pursuant to which we have agreed to register the resale of the 2,231,787 shares of common stock originally comprising a part of the units, the 1,115,893 shares of common stock issuable upon exercise of the warrants, the 46,043 shares of common stock sold to our Manager's deferred compensation plan, and any shares of common stock that we have granted or may grant to our Manager under the Manager Equity Plan, which we collectively refer to as the registrable shares. Pursuant to the registration rights agreement, all holders of the registrable shares (other than our Manager) and their direct and indirect transferees have the right to demand that we cause their registrable shares to be registered for resale on a registration statement; however, we will not be required to file such registration statement until November 11, 2012. The registration rights agreement also requires us to file a "shelf registration statement" for the remaining registerable shares as soon as practicable after we become eligible to use Form S-3 and we must maintain the effectiveness of this shelf registration statement until all the registerable shares have been sold under the shelf registration statement or sold pursuant to Rule 144 under the Securities Act. At any time prior to the filing of this shelf registration statement, if we file a registration statement providing for a public offering (such as the registration statement that includes this prospectus), we must notify the holders of registerable shares of the proposed offering within five business days of the initial filing of the registration statement and the holders of registerable shares have 20 days to request to have their shares included on this registration statement subject to customary exceptions pursuant to the registration rights agreement. All holders of registrable shares have waived their rights to sell shares of our common stock in this offering. See "Shares eligible for future sale Registration rights."

**Conflicts of interest**

*Dependence on our Manager and its personnel*

We are dependent on our Manager for our day-to-day management. All of our officers, apart from our chief financial officer, Steven M. Sherwyn, are employees of our Manager. In addition two, of our directors, James W. Hirschmann III and Gavin L. James, are also employees of our Manager. We do not have any employees other than our chief financial officer. Our Manager does not serve us exclusively and is not obligated to dedicate any of its personnel to us. Because our Manager serves other clients in addition to us, it is difficult to estimate the amount of time our Manager or its personnel will allocate to our business. The obligations of our Manager and its officers and personnel to engage in other business activities may reduce the time our Manager and its officers and personnel spend managing us.

*Management agreement and fees*

Our Management Agreement with our Manager was negotiated between related parties and its terms, including fees and other amounts payable, may not be as favorable to us as if it had been negotiated at arm's length with an unaffiliated third party.

We pay our Manager a management fee that is not tied to our performance. The management fee may not sufficiently incentivize our Manager to generate attractive risk-adjusted returns for us. This could hurt both our ability to make distributions to our stockholders and the market price of our common stock.

*Investment allocation policies*

Our Manager has an investment allocation policy in place that is designed to treat all of its client accounts fairly and equitably with the goal of providing all clients with the best execution under the circumstances for transactions in fixed-income securities. Our Manager's investment allocation policy

Table of Contents

provides that no single client is intentionally favored over another and the procedures associated with this policy require our Manager's investment management department to allocate trades in a fair and equitable manner. When possible, in order to minimize transaction costs and seek best execution for all client accounts, transactions may be bunched or blocked together, with securities generally allocated to client accounts on a pro rata basis. According to our Manager's investment allocation policy, investments may be allocated by taking into account factors, including but not limited to investment goals or guidelines, available cash, liquidity requirements, odd lot positions, minimum allocations, existing portfolio holdings compared to target weightings, regulatory and legal restrictions and the tax implications of an investment. Our Manager's investment allocation policy requires that these bunched or blocked trades be allocated on the same day they are executed and requires that all clients receive the same average cost for the transaction.

Our Manager periodically reviews its client accounts to identify situations where a potential conflict may exist, and when appropriate, may design specific procedures to address these situations. The investment allocation policy may be amended by our Manager at any time without our consent. To the extent that our Manager's or our business changes in such a way as to give rise to conflicts not currently addressed by our Manager's investment allocation policy, our Manager may need to refine its investment allocation policy to address such situation. Our independent directors review our Manager's compliance with its investment allocation policy and the conflicts or potential conflicts of interest surrounding our Manager. In addition, to avoid any actual or perceived conflicts of interest with our Manager, prior to an acquisition of any security structured or issued by an entity managed by our Manager or any of its affiliates or the purchase or sale of any asset from or to an entity managed by our Manager or any of its affiliates, such transaction must be approved by our board of directors, including a majority of our independent directors.

*Other clients of our Manager*

We do not have any agreement or understanding with our Manager that would give us any priority over any other client of our Manager in opportunities to invest in Agency RMBS or any class of our potential target assets. Accordingly, we may compete for investment opportunities in these asset classes directly with other investment portfolios managed by our Manager. As discussed further below, several investment portfolios managed by our Manager invest primarily in real estate or real estate-related assets, including Agency RMBS and our potential target assets and a substantial number of investment portfolios managed by our Manager have exposure to Agency RMBS and our potential target assets. In addition, our Manager may in the future have additional clients that may compete with us for investment opportunities in Agency RMBS and our potential target assets.

As of June 30, 2012, our Manager had approximately \$446 billion in assets under management. Of this total, approximately \$65.8 billion was invested in Agency RMBS and our potential target assets, of which approximately \$40.5 billion was invested in Agency RMBS, approximately \$13.2 billion in non-Agency RMBS, approximately \$2.6 billion in CMBS and \$9.5 billion in ABS. Our Manager manages a number of portfolios in strategies that invest primarily in real estate or real estate-related assets, including Agency RMBS and our potential target assets. These portfolios include mutual funds, private commingled investment vehicles and separate accounts. As of June 30, 2012, our Manager managed approximately \$3.1 billion in 15 separate accounts and \$5.9 billion in six commingled investment vehicles, which include mutual funds and private commingled investment vehicles, that invest primarily in Agency RMBS and our potential target assets. For additional information, see "Management Conflicts of interest Other clients of our manager."

Our Manager also manages broad market portfolios that may have a material allocation to real estate or real estate-related assets, including Agency RMBS and our potential target assets, but have not invested primarily in real estate or real estate-related assets. Our Manager's broad market strategies that have exposure to Agency RMBS and our potential target assets but do not invest

Table of Contents

primarily in real estate or real estate-related assets are described in "Management Conflicts of interest Other clients of our manager."

*Other business activities of our affiliates*

We do not have a policy that expressly prohibits our directors, officers, security holders or affiliates from engaging for their own account in business activities of the types conducted by us. However, subject to our Manager's investment allocation policy, our code of conduct contains a conflicts of interest policy that prohibits our directors, officers and personnel, as well as employees of our Manager who provide services to us, from engaging in any transaction that involves an actual conflict of interest with us.

**REIT qualification**

We intend to elect and qualify as a REIT commencing with our taxable year ending December 31, 2012. Our qualification as a REIT depends upon our ability to meet on a continuing basis, through actual investment and operating results, various complex requirements under the Internal Revenue Code of 1986, as amended, or the Internal Revenue Code, relating to, among other things, the sources of our gross income, the composition and values of our assets, our distribution levels and the diversity of ownership of our shares. We believe that we have been organized in conformity with the requirements for qualification and taxation as a REIT under the Internal Revenue Code and that our intended manner of operation will enable us to meet the requirements for qualification and taxation as a REIT.

So long as we qualify as a REIT, we generally will not be subject to U.S. federal income tax on our net taxable income we distribute currently to our stockholders. If we fail to qualify as a REIT in any taxable year and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal income tax at regular corporate rates and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year during which we lost our REIT qualification. Even if we qualify for taxation as a REIT, we may be subject to certain U.S. federal, state and local taxes on our income or property.

**1940 Act exemption**

We conduct our business so as not to become regulated as an investment company under the 1940 Act in reliance on the exemption provided by Section 3(c)(5)(C) of the 1940 Act. Section 3(c)(5)(C), as interpreted by the staff of the SEC, requires us to invest at least 55% of our assets in "mortgages and other liens on and interest in real estate," or "qualifying real estate interests," and at least 80% of our assets in qualifying real estate interests plus "real estate-related assets." In satisfying this 55% requirement, based on pronouncements of the SEC staff, we may treat Agency RMBS issued with respect to an underlying pool of mortgage loans in which we hold all of the certificates issued by the pool as qualifying real estate interests. The SEC staff has not issued guidance with respect to whole pool Non-Agency RMBS. Accordingly, based on our own judgment and analysis of the SEC's pronouncements with respect to whole pool Agency RMBS, we may also treat Non-Agency RMBS issued with respect to an underlying pool of mortgage loans in which we hold all of the certificates issued by the pool as qualifying real estate interests. We may also treat whole mortgage loans that we acquire directly as qualifying real estate interests provided that 100% of the loan is secured by real estate when we acquire it and we have the unilateral right to foreclose on the mortgage. We currently treat partial pool Agency and, to the extent we acquire such assets, will treat Non-Agency RMBS and partial pool CMBS as real estate-related assets. We treat any interest rate swaps or other derivative hedging transactions we enter into as miscellaneous assets that will not exceed 20% of our total assets. We rely on guidance published by the SEC staff or on our analyses of guidance published with respect



Table of Contents

to other types of assets to determine which assets are qualifying real estate assets and real estate-related assets.

The SEC recently solicited public comment on a wide range of issues relating to Section 3(c)(5)(C), including the nature of the assets that qualify for purposes of the exemption and whether mortgage REITs should be regulated in a manner similar to investment companies. There can be no assurance that the laws and regulations governing the 1940 Act status of REITs, including the guidance of the Division of Investment Management of the SEC regarding this exemption, will not change in a manner that adversely affects our operations. To the extent that the SEC staff publishes new or different guidance with respect to these matters, we may be required to adjust our strategy accordingly. In addition, we may be limited in our ability to make certain investments and these limitations could require us to hold assets we might wish to sell or to sell assets we might wish to hold. To the extent that the SEC staff provides more specific guidance regarding any of the matters bearing upon the exemption we rely on from the 1940 Act, we may be required to adjust our strategy accordingly. Any additional guidance from the SEC staff could provide additional flexibility to us, or it could further inhibit our ability to pursue the strategies we have chosen.

See "Business Operating and regulatory structure 1940 Act exemption" for a further discussion of the exemption from registration under the 1940 Act that we rely on and the treatment of certain of our targeted asset classes for purposes of such exemptions.

Qualification for exemption from registration under the 1940 Act will limit our ability to make certain investments. See "Risk factors Risks related to our business Loss of our exemption from regulation pursuant to the 1940 Act would adversely affect us."

**Restrictions on ownership of our common stock**

To assist us in complying with the limitations on the concentration of ownership of a REIT imposed by the Internal Revenue Code, among other purposes, our amended and restated certificate of incorporation prohibits, with certain exceptions, any stockholder from beneficially or constructively owning, applying certain attribution rules under the Internal Revenue Code, more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding shares of common stock, or 9.8% by value or number of shares, whichever is more restrictive, of our outstanding capital stock. Our board of directors may, in its sole discretion, waive the 9.8% ownership limit with respect to a particular stockholder; provided, however, that our board of directors may only waive the 9.8% ownership limit after it is presented with evidence satisfactory to it that such ownership will not then or in the future jeopardize our qualification as a REIT. Our board of directors has granted waivers of the 9.8% ownership limit to Pine River Fixed Income Master Fund Ltd., Pine River Financial Services Master Fund Ltd. and Southern California Edison Company Retirement Plan Trust, with ownership limits set at 15% for Pine River Fixed Income Master Fund Ltd. and Pine River Master Fund Ltd., and Southern California Edison Company Retirement Plan Trust, respectively.

Our amended and restated certificate of incorporation also prohibits any person from, among other things:

beneficially or constructively owning shares of our capital stock that would result in our being "closely held" under Section 856(h) of the Internal Revenue Code, or otherwise cause us to fail to qualify as a REIT; and

transferring shares of our capital stock if such transfer would result in our capital stock being owned by fewer than 100 persons.

In addition, our amended and restated certificate of incorporation provides that any ownership or purported transfer of our capital stock in violation of the foregoing restrictions will result in the shares so owned or transferred being automatically transferred to a charitable trust for the benefit of a

Table of Contents

charitable beneficiary and the purported owner or transferee acquiring no rights in such shares. If a transfer to a charitable trust would be ineffective for any reason to prevent a violation of the restriction, the transfer resulting in such violation will be void from the time of such purported transfer.

**Emerging growth company status**

We are an "emerging growth company," as defined in the JOBS Act, and we are eligible to take advantage of certain exemptions from various reporting requirements that are applicable to other public companies that are not "emerging growth companies" including, but not limited to, not being required to comply with the auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act, reduced disclosure obligations regarding executive compensation in our periodic reports and proxy statements, and exemptions from the requirements of holding a nonbinding advisory vote on executive compensation and shareholder approval of any golden parachute payments not previously approved. We have not made a decision whether to take advantage of all of these exemptions. If we do take advantage of any of these exemptions, we do not know if some investors will find our common stock less attractive as a result. The result may be a less active trading market for our common stock and our stock price may be more volatile.

In addition, Section 107 of the JOBS Act also provides that an "emerging growth company" can take advantage of the extended transition period provided in Section 7(a)(2)(B) of the Securities Act for complying with new or revised accounting standards. In other words, an "emerging growth company" can delay the adoption of certain accounting standards until those standards would otherwise apply to private companies. We currently take advantage of such an extended transition period. Since we are not required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, our financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If we were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

We could remain an "emerging growth company" for up to five years from the completion of our IPO, or until the earliest of: (i) the last day of the first fiscal year in which our annual gross revenues exceed \$1 billion, (ii) December 31 of the fiscal year that we become a "large accelerated filer" as defined in Rule 12b-2 under the Exchange Act, which would occur if the market value of our common stock that is held by non-affiliates exceeds \$700 million as of the last business day of our most recently completed second fiscal quarter and we have been publicly reporting for at least 12 months or (iii) the date on which we have issued more than \$1 billion in non-convertible debt during the preceding three-year period.

**Recent developments**

On September 20, 2012, we declared a dividend of \$0.85 per share for the period from July 1, 2012 to September 30, 2012, to be paid October 25, 2012 to holders of record as of October 1, 2012, with an ex-dividend date of September 27, 2012.

On September 20, 2012, we also announced that our estimated book value per share, as of September 14, 2012, was \$22.68. The estimate of our book value per share as of September 14, 2012 may differ from the book value per share that is ultimately reflected in our third quarter financial statements. Please see "Forward-looking statements" in this prospectus for important information regarding estimates and other forward-looking statements.

On September 13, 2012, the U.S. Federal Reserve announced an open-ended program to expand its holdings of long-term securities by purchasing an additional \$40 billion of Agency RMBS per month until key economic indicators, such as the unemployment rate, showed signs of improvement. This program, which we refer to as QE3, when combined with existing programs to extend the average

Table of Contents

maturity of the Federal Reserve's holdings of securities and reinvest principal payments from the Federal Reserve's holdings of agency debt and Agency RMBS into Agency RMBS, is expected to increase the Federal Reserve's holdings of long-term securities by \$85 billion each month through the end of 2012. The Federal Reserve also announced that it will keep the federal funds range between zero and 0.25% through at least mid-2015, which is six months longer than previously expected. The Federal Reserve expects these measures to put downward pressure on long-term interest rates. While the Federal Reserve hopes that QE3 will expedite an economic recovery, stabilize prices, reduce unemployment and restart business and household spending, there is no way of knowing what impact QE3 or any future actions by the Federal Reserve will have on the prices and liquidity of Agency RMBS or other securities in which we invest.

**Our corporate information**

Our principal executive offices are located at 385 East Colorado Boulevard, Pasadena, California 91101. Our telephone number is (626) 844-9400. Our website is [www.westernassetmcc.com](http://www.westernassetmcc.com). The contents of our website are not a part of this prospectus. The information on our website is not intended to form a part of or be incorporated by reference into this prospectus.

Table of Contents

**The offering**

Common stock offered by us	12,000,000 shares (plus up to an additional 1,800,000 shares of our common stock that we may issue and sell upon the exercise of the underwriters' option to purchase up to an additional 1,800,000 shares).
Common stock to be outstanding after this offering	22,343,944 shares. <sup>(1)</sup>
Use of proceeds	<p>In this offering, we are offering 12,000,000 shares of our common stock at \$22.20 per share. Assuming no shares are issued pursuant to the underwriters' option to purchase up to an additional 1,800,000 shares, this offering would result in gross proceeds of \$262.2 million to us. We currently estimate the expenses attributable to this offering to be \$0.5 million. Therefore, we estimate that our aggregate net proceeds from this offering will be \$261.7 million, after deducting our estimated offering expenses (or \$301 million, if the underwriters exercise their option to purchase up to an additional 1,800,000 shares in full).</p> <p>We plan to use the net proceeds from this offering to purchase Agency RMBS and our potential target assets, focusing predominantly on Agency RMBS.</p> <p>Until appropriate investments can be identified, our Manager may invest these proceeds in interest-bearing short-term investments, including money market accounts and/or funds, that are consistent with our intention to qualify as a REIT and maintain exemption from registration under the 1940 Act. These initial investments, if any, are expected to provide a lower net return than we seek to achieve from investments in Agency RMBS and our potential target assets. We anticipate that we will be able to identify a sufficient amount of Agency RMBS and our potential target assets within approximately one month after the closing of this offering. However, depending on the availability of appropriate investment opportunities and subject to prevailing market conditions, there can be no assurance that we will be able to identify a sufficient amount of investments within this timeframe. See "Use of proceeds."</p>

Table of Contents

Distribution policy

We intend to make regular quarterly distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its net taxable income and that it pay tax at regular corporate rates to the extent that it annually distributes less than 100% of its net taxable income. We generally intend to make total annual distributions equal to all or substantially all of our taxable income for that year. On July 26, 2012, we declared a dividend of \$0.38 per share for the period from May 15, 2012 to June 30, 2012, which was paid August 14, 2012 to holders of record as of August 6, 2012. On September 20, 2012, we declared a dividend of \$0.85 per share for the period from July 1, 2012 to September 30, 2012, to be paid October 25, 2012 to holders of record as of October 1, 2012.

We cannot assure you that we will make any distributions to our stockholders. Any distributions that we make will be at the discretion of our board of directors and will depend upon, among other things, our actual results of operations. These results and our ability to pay distributions will be affected by various factors, including the net interest and other income from our portfolio, our operating expenses and any other expenditures. For more information, see "Distribution policy."

New York Stock Exchange symbol  
Ownership and transfer restrictions

"WMC"

To assist us in complying with limitations on the concentration of ownership of a REIT imposed by the Internal Revenue Code, among other purposes, our amended and restated certificate of incorporation generally prohibits, among other prohibitions, any stockholder from beneficially or constructively owning more than 9.8% by value or number of shares, whichever is more restrictive, of our outstanding shares of common stock, or 9.8% by value or number of shares, whichever is more restrictive, of our outstanding capital stock. See "Description of Capital Stock Restrictions on ownership and transfer of our capital stock."

Risk factors

Investing in our common stock involves a high degree of risk. You should carefully read and consider the information set forth under the heading "Risk factors" beginning on page 23 of this prospectus and all other information in this prospectus before investing in our common stock.

---

(1) Does not include the 1,115,893 shares of our common stock initially issuable upon the exercise of the warrants and the shares of our common stock that may be granted under our Equity Plan or Manager Equity Plan.

Table of Contents

**Risk factors**

*Investing in our common stock involves a high degree of risk. You should carefully consider the following risk factors and all other information contained in this prospectus before purchasing our common stock. If any of the following risks occur, our business, financial condition or results of operations could be materially and adversely affected. In that case, the trading price of our common stock could decline, and you may lose some or all of your investment.*

**Risks related to our business**

*We have a limited operating history and may not be able to successfully operate our business or generate sufficient revenue to make or sustain distributions to our stockholders.*

We were organized as a Delaware corporation on June 3, 2009, but did not commence operations until the completion of our IPO on May 15, 2012. We cannot assure you that we will be able to operate our business successfully or implement our operating policies and strategies as described in this prospectus. The results of our operations depend on several factors, including the availability of opportunities for the acquisition of assets, the level and volatility of interest rates, the availability of adequate short and long-term financing, conditions in the financial markets and economic conditions.

*We may change any of our strategies, policies or procedures without stockholder consent.*

We may change any of our strategies, policies or procedures with respect to investments, acquisitions, growth, operations, indebtedness, capitalization, distributions, financing strategy and leverage at any time without the consent of our stockholders, which could result in an investment portfolio with a different risk profile. A change in our investment strategy may increase our exposure to interest rate risk, default risk and real estate market fluctuations. Furthermore, a change in our asset allocation could result in our making investments in asset categories different from those described in this prospectus. These changes could adversely affect our financial condition, results of operations, the market price of our common stock and our ability to make distributions to our stockholders.

*We have not yet identified any specific investments we may make with the net proceeds of this offering.*

We have not yet identified any specific investments we may make with the net proceeds of this offering and as a result, you will only be able to evaluate our existing investments as of June 30, 2012 before purchasing shares of our common stock. Additionally, our investments will be selected by our Manager and our stockholders will not have input into such investment decisions. Both of these factors will increase the uncertainty, and thus the risk, of investing in shares of our common stock.

Until appropriate investments can be identified, our Manager may invest the net proceeds of this offering in interest-bearing short-term investments, including money market accounts and/or funds, that are consistent with our intention to qualify as a REIT. These investments, if any, are expected to provide a lower net return than we will seek to achieve from investments in Agency RMBS. We anticipate that we will be able to identify a sufficient amount of investments in Agency RMBS within approximately one to two months after the closing of this offering. However, depending on the availability of appropriate investment opportunities and subject to prevailing market conditions, there can be no assurance that we will be able to identify a sufficient amount of investments within this timeframe. See "Use of proceeds." Our Manager intends to conduct due diligence with respect to each investment and suitable investment opportunities may not be immediately available. Even if opportunities are available, there can be no assurance that our Manager's due diligence processes will uncover all relevant facts or that any investment will be successful.

Furthermore, you will be unable to evaluate the manner in which the net proceeds of this offering will be invested or the economic merit of our expected investments and, as a result, we may use the net

Table of Contents

proceeds from these offerings to make investments with which you may not agree. The failure of our management to apply these proceeds effectively or find investments that meet our investment criteria in sufficient time or on acceptable terms could result in unfavorable returns, could cause a material adverse effect on our business, financial condition, liquidity, results of operations and ability to make distributions to our stockholders, and could cause the value of our common stock to decline.

*There is no certainty what effect "QE3" will have on the price and liquidity of Agency RMBS and other securities in which we invest, although the Federal Reserve's actions could increase the prices of our target assets and reduce the spread on our investments.*

On November 25, 2008, the Federal Reserve announced a program to purchase Agency RMBS in the open market. The stated goal of this program was to provide support to mortgage and housing markets and to foster improved conditions in financial markets more generally. On March 18, 2009, this program was expanded to a target size of \$1.25 trillion. The Federal Reserve completed this purchase program in March 2010. In October 2010, the Federal Reserve announced plans for a second round of quantitative easing, and on November 3, 2010, announced that it intended to purchase a further \$600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about \$75 billion per month. On September 13, 2012, the U.S. Federal Reserve announced QE3 to expand its holdings of long-term securities by purchasing an additional \$40 billion of Agency RMBS per month until key economic indicators, such as the unemployment rate, showed signs of improvement. This program when combined with existing programs to extend the average maturity of the Federal Reserve's holdings of securities and reinvest principal payments from the Federal Reserve's holdings of agency debt and Agency RMBS into Agency RMBS, is expected to increase the Federal Reserve's holdings of long-term securities by \$85 billion each month through the end of 2012. The Federal Reserve also announced that it will keep the target federal funds range between zero and 0.25% through at least mid-2015, which is six months longer than previously expected. The Federal Reserve expects these measures to put downward pressure on long-term interest rates. While the Federal Reserve hopes that QE3 will expedite an economic recovery, stabilize prices, reduce unemployment and restart business and household spending, there is no way of knowing what impact QE3 or any future actions by the Federal Reserve will have on the prices and liquidity of Agency RMBS or other securities in which we invest, although the Federal Reserve's actions could increase the prices of our target assets and reduce the spread on our investments.

**Risks related to our investing strategy**

*Mortgage loan modification and refinancing programs and future legislative action may adversely affect the value of, and our returns on, Agency RMBS and our potential target assets.*

The U.S. Government, through the U.S. Federal Reserve, the Federal Housing Administration, or the FHA, and the Federal Deposit Insurance Corporation, has implemented a number of federal programs designed to assist homeowners, including the Home Affordable Modification Program, or HAMP, which provides homeowners with assistance in avoiding residential mortgage loan foreclosures, the Hope for Homeowners Program, or H4H Program, which allows certain distressed borrowers to refinance their mortgages into FHA-insured loans in order to avoid residential mortgage loan foreclosures, and the Home Affordable Refinance Program, or HARP, which allows borrowers who are current on their mortgage payments to refinance and reduce their monthly mortgage payments at loan-to-value ratios up to 125% (and, in some cases, above 125%) without new mortgage insurance. HAMP, the H4H Program and other loss mitigation programs may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans (through forbearance and/or forgiveness) and/or the rate of interest payable on the loans, or the extension of payment terms of the loans.

Table of Contents

In September 2011, the White House announced they are working on a major plan to allow certain homeowners who owe more on their mortgages than their homes are worth to refinance. In October 2011, the FHFA announced changes to the HARP to expand access to refinancing for qualified individuals and families whose homes have lost value, including increasing the HARP loan-to-value ratio above 125%. However, this would only apply to mortgages guaranteed by the U.S. government-sponsored entities. There are many challenging issues to this proposal, notably the question as to whether a loan with a loan-to-value ratio of 125% qualifies as a mortgage or an unsecured consumer loan. The chances of this initiative's success have created additional uncertainty in the Agency RMBS market, particularly with respect to possible increases in prepayment rates. On January 4, 2012, the U.S. Federal Reserve issued a white paper outlining additional ideas with regard to refinancings and loan modifications. On July 31, 2012, the FHLMC announced plans to expand its Relief Refinance Mortgage Program, which includes HARP, by aligning requirements for mortgages with loan-to-value ratios that are equal to or less than 80% with those for mortgages with loan-to-value ratios greater than 80%. It is likely that loan modifications would result in increased prepayments on some Agency RMBS.

Especially with non-Agency RMBS, a significant number of loan modifications with respect to a given security, including, but not limited to, those related to principal forgiveness and coupon reduction, resulting in increased prepayment rates, could negatively impact the realized yields and cash flows on such security. These loan modification programs, future legislative or regulatory actions, including possible amendments to the bankruptcy laws, which result in the modification of outstanding residential mortgage loans, as well as changes in the requirements necessary to qualify for refinancing mortgage loans with the FNMA, the FHLMC or the GNMA may adversely affect the value of, and the returns on, Agency RMBS and our potential target assets that we may purchase.

***Actions of the U.S. Government, including the U.S. Congress, Federal Reserve, U.S. Treasury and other governmental and regulatory bodies, to stabilize or reform the financial markets, or market responses to those actions, may not achieve the intended effect and may adversely affect our business.***

In response to the financial issues affecting the banking system and financial markets and going concern threats to commercial banks, investment banks and other financial institutions, the Emergency Economic Stabilization Act, or EESA, was enacted by the U.S. Congress in 2008. There can be no assurance that the EESA or any other U.S. government actions will have a beneficial impact on the financial markets. To the extent the markets do not respond favorably to any such actions by the U.S. government or such actions do not function as intended, our business may not receive the anticipated positive impact from the legislation and such result may have broad adverse market implications.

In July 2010, the U.S. Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act, or the Dodd-Frank Act, in part to impose significant investment restrictions and capital requirements on banking entities and other organizations that are significant to U.S. financial markets. For instance, the Dodd-Frank Act will impose significant restrictions on the proprietary trading activities of certain banking entities and subject other systemically significant organizations regulated by the U.S. Federal Reserve to increased capital requirements and quantitative limits for engaging in such activities. The Dodd-Frank Act also seeks to reform the asset-backed securitization market (including the mortgage-backed securities market) by requiring the retention of a portion of the credit risk inherent in the pool of securitized assets and by imposing additional registration and disclosure requirements. Certain of the new requirements and restrictions exempt Agency RMBS, other government issued or guaranteed securities, or other securities. Nonetheless, the Dodd-Frank Act also imposes significant regulatory restrictions on the origination of residential mortgage loans. While the full impact of the Dodd-Frank Act cannot be assessed until all implementing regulations are released, the Dodd-Frank Act's extensive requirements may have a significant effect on the financial markets, and may affect the availability or terms of financing from our lender counterparties and the availability



Table of Contents

or terms of mortgage-backed securities, both of which may have an adverse effect on our financial condition and results of operations.

In addition, the U.S. Government, Federal Reserve, U.S. Treasury and other governmental and regulatory bodies have taken or are considering taking other actions to address the financial crisis. We cannot predict whether or when such actions may occur or what effect, if any, such actions could have on our business, results of operations and financial condition.

***The federal conservatorship of FNMA and FHLMC and related efforts, along with any changes in laws and regulations affecting the relationship between these agencies and the U.S. Government, may adversely affect our business.***

The payments of principal and interest we receive on our Agency RMBS, which depend directly upon payments on the mortgages underlying such securities, are guaranteed by FNMA, FHLMC and GNMA. FNMA and FHLMC are U.S. Government-sponsored entities, or GSEs, but their guarantees are not backed by the full faith and credit of the United States. GNMA is part of a U.S. Government agency and its guarantees are backed by the full faith and credit of the United States.

In response to general market instability and, more specifically, the financial conditions of FNMA and FHLMC, in July 2008, the Housing and Economic Recovery Act of 2008, or HERA, established a new regulator for FNMA and FHLMC, the U.S. Federal Housing Finance Agency, or the FHFA. In September 2008, the U.S. Treasury, the FHFA and the U.S. Federal Reserve announced a comprehensive action plan to help stabilize the financial markets, support the availability of mortgage financing and protect taxpayers. Under this plan, among other things, the FHFA was appointed as conservator of both FNMA and FHLMC, allowing the FHFA to control the actions of the two GSEs, without forcing them to liquidate, which would be the case under receivership. Importantly, the primary focus of the plan was to increase the availability of mortgage financing by allowing these GSEs to continue to grow their guarantee business without limit, while limiting the size of their retained mortgage and agency security portfolios and requiring that these portfolios be reduced over time.

Although the U.S. Government has committed to support the positive net worth of FNMA and FHLMC through 2012, there can be no assurance that these actions will be adequate for their needs. These uncertainties lead to questions about the availability of, and trading market for, Agency RMBS. Despite the steps taken by the U.S. Government, FNMA and FHLMC could default on their guarantee obligations which would materially and adversely affect the value of our Agency RMBS. Accordingly, if these government actions are inadequate and the GSEs continue to suffer losses or cease to exist, our business, operations and financial condition could be materially and adversely affected.

In addition, the problems faced by FNMA and FHLMC resulting in their being placed into federal conservatorship and receiving significant U.S. Government support have sparked serious debate among federal policy makers regarding the continued role of the U.S. Government in providing liquidity for mortgage loans. The future roles of FNMA and FHLMC could be significantly reduced and the nature of their guarantee obligations could be considerably limited relative to historical measurements. Any such changes to the nature of their guarantee obligations could redefine what constitutes an agency security and could have broad adverse implications for the market and our business, operations and financial condition. If FNMA or FHLMC were eliminated, or their structures were to change radically (*i.e.*, limitation or removal of the guarantee obligation), or their market share reduced because of required price increases or lower limits on the loans they can guarantee, we could be unable to acquire additional Agency RMBS and our existing Agency RMBS could be materially and adversely impacted.

We could be negatively affected in a number of ways depending on the manner in which related events unfold for FNMA and FHLMC. We currently rely on our Agency RMBS as collateral for our financings under our repurchase agreements. Any decline in their value, or perceived market uncertainty about their value, would make it more difficult for us to obtain financing on our Agency

Table of Contents

RMBS on acceptable terms or at all, or to maintain our compliance with the terms of any financing transactions. Further, the current support provided by the U.S. Treasury to FNMA and FHLMC, and any additional support it may provide in the future, could have the effect of lowering the interest rates we expect to receive from Agency RMBS, thereby tightening the spread between the interest we earn on our Agency RMBS and the cost of financing those assets. A reduction in the supply of Agency RMBS could also negatively affect the pricing of Agency RMBS by reducing the spread between the interest we earn on our investment portfolio of Agency RMBS and our cost of financing that portfolio.

As indicated above, recent legislation has changed the relationship between FNMA and FHLMC and the U.S. Government. Future legislation could further change the relationship between FNMA and FHLMC and the U.S. Government, and could also nationalize, privatize, or eliminate such entities entirely. Any law affecting these GSEs may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by FNMA or FHLMC. As a result, such laws could increase the risk of loss on our investments in Agency RMBS guaranteed by FNMA and/or FHLMC. It also is possible that such laws could adversely impact the market for such securities and spreads at which they trade. All of the foregoing could materially and adversely affect our financial condition and results of operations.

***We are subject to the risk that U.S. Government agencies and/or GSEs may not be able to fully satisfy their guarantees of Agency RMBS or that these guarantee obligations may be repudiated, which may adversely affect the value of our assets and our ability to sell or finance these securities.***

The interest and principal payments we receive on the Agency RMBS in which we invest are guaranteed by FNMA, FHLMC or the GNMA. Unlike the GNMA securities in which we may invest, the principal and interest on securities issued by FNMA and FHLMC are not guaranteed by the U.S. government. All the Agency RMBS in which we invest depend on a steady stream of payments on the mortgages underlying the securities.

As conservator of FNMA and FHLMC, the FHFA may disaffirm or repudiate contracts (subject to certain limitations for qualified financial contracts) that FHLMC or FNMA entered into prior to the FHFA's appointment as conservator if it determines, in its sole discretion, that performance of the contract is burdensome and that disaffirmation or repudiation of the contract promotes the orderly administration of its affairs. The HERA requires the FHFA to exercise its right to disaffirm or repudiate most contracts within a reasonable period of time after its appointment as conservator. FNMA and FHLMC have disclosed that the FHFA has disaffirmed certain consulting and other contracts that these entities entered into prior to the FHFA's appointment as conservator. FHLMC and FNMA have also disclosed that the FHFA has advised that it does not intend to repudiate any guarantee obligation relating to FNMA and FHLMC's mortgage-related securities, because the FHFA views repudiation as incompatible with the goals of the conservatorship. In addition, the HERA provides that mortgage loans and mortgage-related assets that have been transferred to a FHLMC or FNMA securitization trust must be held for the beneficial owners of the related mortgage-related securities, and cannot be used to satisfy the general creditors of FHLMC or FNMA.

If the guarantee obligations of FHLMC or FNMA were repudiated by FHFA, payments of principal and/or interest to holders of Agency RMBS issued by FHLMC or FNMA would be reduced in the event of any borrowers' late payments or failure to pay or a servicer's failure to remit borrower payments to the trust. In that case, trust administration and servicing fees could be paid from mortgage payments prior to distributions to holders of Agency RMBS. Any actual direct compensatory damages owed due to the repudiation of FHLMC or FNMA's guarantee obligations may not be sufficient to offset any shortfalls experienced by holders of Agency RMBS. FHFA also has the right to transfer or sell any asset or liability of FHLMC or FNMA, including its guarantee obligation, without any approval, assignment or consent. If FHFA were to transfer FHLMC or FNMA's guarantee obligations

Table of Contents

to another party, holders of Agency RMBS would have to rely on that party for satisfaction of the guarantee obligation and would be exposed to the credit risk of that party.

***We operate in a highly competitive market for investment opportunities and competition may limit our ability to acquire desirable investments in Agency RMBS and our potential target assets and could also affect the pricing of these securities.***

We operate in a highly competitive market for investment opportunities. Currently, our profitability depends, in large part, on our ability to acquire Agency RMBS and our potential target assets at attractive prices. In acquiring these assets, we compete with a variety of institutional investors, including other REITs, specialty finance companies, public and private funds (including other funds managed by our Manager), commercial and investment banks, commercial finance and insurance companies and other financial institutions. Many of our competitors are substantially larger and have considerably greater financial, technical, marketing and other resources than we do. Several other REITs have recently raised, or are expected to raise, significant amounts of capital, and may have investment objectives that overlap with ours, which may create additional competition for investment opportunities. Some competitors may have a lower cost of funds and access to funding sources that may not be available to us, such as funding from the U.S. Government. Many of our competitors are not subject to the operating constraints associated with REIT tax compliance or maintenance of an exemption from the 1940 Act. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships than us. Furthermore, competition for investments in Agency RMBS and our potential target assets may lead to the price of such assets increasing, which may further limit our ability to generate desired returns. We cannot assure you that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. Also, as a result of this competition, desirable investments in these assets may be limited in the future and we may not be able to take advantage of attractive investment opportunities from time to time, as we can provide no assurance that we will be able to identify and make investments that are consistent with our investment objectives.

***A lack of liquidity in our investments may adversely affect our business.***

The assets we acquire are not publicly traded. A lack of liquidity may result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale or the unavailability of financing for these assets. In addition, mortgage-related assets generally experience periods of illiquidity, including the recent period of delinquencies and defaults with respect to residential and commercial mortgage loans. The illiquidity of our investments may make it difficult for us to sell such investments if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded our investments. Further, we may face other restrictions on our ability to liquidate an investment in a business entity to the extent that we or our Manager has or could be attributed with material, non-public information regarding such business entity. As a result, our ability to vary our portfolio in response to changes in economic and other conditions may be relatively limited, which could adversely affect our results of operations and financial condition.

***Adverse developments in the broader residential mortgage market may adversely affect the value of the assets in which we invest.***

Since 2007, the residential mortgage market in the United States has experienced a variety of unprecedented difficulties and changed economic conditions, including defaults, credit losses and liquidity concerns. Certain commercial banks, investment banks and insurance companies announced extensive losses from exposure to the residential mortgage market. These losses reduced financial

Table of Contents

industry capital, leading to reduced liquidity for some institutions. These factors have impacted investor perception of the risk associated with real estate-related assets, including Agency RMBS and other high-quality RMBS assets. As a result, values for RMBS assets, including some Agency RMBS and other AAA-rated RMBS assets, have experienced a certain amount of volatility. Further increased volatility and deterioration in the broader residential mortgage and RMBS markets may adversely affect the performance and market value of the Agency RMBS in which we invest and the non-Agency RMBS in which we may invest.

We invest in Agency RMBS and may invest in non-Agency RMBS. We need to rely on our securities as collateral for our financings. Any decline in their value, or perceived market uncertainty about their value, would likely make it difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements already in place. The securities we acquire are classified for accounting purposes as available-for-sale. All assets classified as available-for-sale are reported at fair value, based on market prices from third-party sources. We have elected to include any unrealized gains and losses in our earnings. If market conditions result in a decline in the fair value of our assets, our financial position and results of operations could be adversely affected.

***A prolonged economic recession and further declining real estate values could impair our assets and harm our operations.***

The risks associated with our business are more severe during economic recessions and are compounded by declining real estate values. The non-Agency RMBS in which we may invest a part of our capital will be particularly sensitive to these risks. Declining real estate values will likely reduce the level of new mortgage loan originations since borrowers often use appreciation in the value of their existing properties to support the purchase of additional properties. Borrowers will also be less able to pay principal and interest on loans underlying the securities in which we invest if the value of residential real estate weakens further. Further, declining real estate values significantly increase the likelihood that we will incur losses on non-Agency RMBS, which we may acquire in the future, in the event of default because the value of collateral on the mortgages underlying such securities may be insufficient to cover the outstanding principal amount of the loan. Any sustained period of increased payment delinquencies, foreclosures or losses could adversely affect both our net interest income from non-Agency RMBS, if any, in our portfolio, which could have an adverse effect on our financial condition, results of operations and our ability to make distributions to our stockholders.

***Our investments in non-Agency RMBS are generally subject to losses.***

We may acquire non-Agency RMBS. In general, losses on a mortgaged property securing a mortgage loan included in a securitization will be borne first by the equity holder of the property, then by a cash reserve fund or letter of credit, if any, then by the holder of a mezzanine loan or B-Note, if any, then by the "first loss" subordinated security holder and then by the holder of a higher-rated security. In the event of default and the exhaustion of any equity support, reserve fund, letter of credit, mezzanine loans or B-Notes, and any classes of securities junior to those in which we invest, we will not be able to recover all of our investment in the securities we purchase. In addition, if the underlying mortgage portfolio has been overvalued by the originator, or if the values subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related non-Agency RMBS. The prices of lower credit quality securities are generally less sensitive to interest rate changes than more highly rated investments, but more sensitive to adverse economic downturns or individual issuer developments.

Table of Contents

***The mortgage loans underlying the non-Agency RMBS that we may acquire will be subject to defaults, foreclosure timeline extension, fraud and residential price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, which could result in losses to us.***

Our potential investments in non-Agency RMBS will be subject to the risks of defaults, foreclosure timeline extension, fraud and home price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, accompanying the underlying residential mortgage loans. The ability of a borrower to repay a mortgage loan secured by a residential property is dependent upon the income or assets of the borrower. A number of factors may impair borrowers' abilities to repay their loans, including:

adverse changes in national and local economic and market conditions;

changes in governmental laws and regulations, fiscal policies and zoning ordinances and the related costs of compliance with laws and regulations, fiscal policies and ordinances;

costs of remediation and liabilities associated with environmental conditions such as indoor mold;

the potential for uninsured or under-insured property losses;

acts of God, including earthquakes, floods and other natural disasters, which may result in uninsured losses; and

acts of war or terrorism, including the consequences of terrorist attacks, such as those that occurred on September 11, 2001.

In the event of defaults on the residential mortgage loans that underlie our investments in non-Agency RMBS, if any, and the exhaustion of any underlying or any additional credit support, we may not realize our anticipated return on our investments and we may incur a loss on these investments. In addition, to the extent we elect to invest in such assets, our investments in non-Agency RMBS will be backed by residential real property but, in contrast to Agency RMBS, their principal and interest will not be guaranteed by a U.S. Government agency or a GSE. The ability of a borrower to repay these loans or other financial assets is dependent upon the income or assets of these borrowers.

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

Allegations of deficiencies in servicing and foreclosure practices among several large sellers and servicers of residential mortgage loans that surfaced in 2010 raised various concerns relating to such practices, including the improper execution of the documents used in foreclosure proceedings (so-called "robo signing"), inadequate documentation of transfers and registrations of mortgages and assignments of loans, improper modifications of loans, violations of representations and warranties at the date of securitization and failure to enforce put-backs.

As a result of alleged deficiencies in foreclosure practices, a number of servicers temporarily suspended foreclosure proceedings beginning in the second half of 2010 while they evaluated their foreclosure practices. In late 2010, a group of state attorneys general and state bank and mortgage regulators representing nearly all 50 states and the District of Columbia, along with the U.S. Justice Department and the Department of Housing and Urban Development, began an investigation into foreclosure practices of banks and servicers. The investigations and lawsuits by several state attorneys general led to a proposed settlement agreement in early February 2012 with five of the nation's largest banks, pursuant to which the banks agreed to pay more than \$25 billion to settle claims relating to improper foreclosure practices. The proposed settlement does not prohibit the states, the federal government, individuals or investors in RMBS from pursuing additional actions against the banks and servicers in the future.

Table of Contents

The integrity of the servicing and foreclosure processes are critical to the value of the mortgage loan portfolios underlying the RMBS in which we invest, and our financial results could be adversely affected by deficiencies in the conduct of those processes. For example, delays in the foreclosure process that have resulted from investigations into improper servicing practices may adversely affect the values of, and our losses on, the non-Agency RMBS we may acquire. Foreclosure delays may also increase the administrative expenses of the securitization trusts for the non-Agency RMBS, thereby reducing the amount of funds available for distribution to investors. In addition, the subordinate classes of securities issued by the securitization trusts may continue to receive interest payments while the defaulted loans remain in the trusts, rather than absorbing the default losses. This may reduce the amount of credit support available for the senior classes we may own, thus possibly adversely affecting these securities. Additionally, a substantial portion of the proposed \$25 billion settlement is intended to be a "credit" to the banks and servicers for principal write-downs or reductions they may make to certain mortgages underlying RMBS. There remains considerable uncertainty as to how these principal reductions will work and what effect they will have on the value of related RMBS; as a result, there can be no assurance that any such principal reductions will not adversely affect the value of certain of the RMBS in which we invest.

While we believe that the sellers and servicers would be in violation of their servicing contracts to the extent that they have improperly serviced mortgage loans or improperly executed documents in foreclosure or bankruptcy proceedings, or do not comply with the terms of servicing contracts when deciding whether to apply principal reductions, it may be difficult, expensive, and time consuming for us to enforce our contractual rights. We continue to monitor and review the issues raised by the alleged improper foreclosure practices. While we cannot predict exactly how the servicing and foreclosure matters or the resulting litigation or settlement agreements will affect our business, there can be no assurance that these matters will not have an adverse impact on our results of operations and financial condition.

***The commercial mortgage loans underlying the CMBS we may acquire will be subject to defaults, foreclosure timeline extension, fraud and commercial price depreciation and unfavorable modification of loan principal amount, interest rate and amortization of principal, which could result in losses to us.***

CMBS are secured by a single commercial mortgage loan or a pool of commercial mortgage loans. Commercial mortgage loans are secured by multifamily or commercial property and are subject to risks of delinquency and foreclosure, and risks of loss that may be greater than similar risks associated with loans made on the security of residential property. The ability of a borrower to repay a loan secured by an income-producing property typically is dependent primarily upon the successful operation of such property rather than upon the existence of independent income or assets of the borrower. If the net operating income of the property is reduced, the borrower's ability or willingness to repay the loan may be impaired. Net operating income of an income-producing property can be affected by, among other things,

tenant mix;

success of tenant businesses;

property management decisions;

property location and condition;

competition from comparable types of properties;

changes in laws that increase operating expenses or limit rents that may be charged;

any need to address environmental contamination at the property or the occurrence of any uninsured casualty at the property;

Table of Contents

changes in national, regional or local economic conditions and/or specific industry segments;

declines in regional or local real estate values;

declines in regional or local rental or occupancy rates;

increases in interest rates;

real estate tax rates and other operating expenses;

changes in governmental rules, regulations and fiscal policies, including environmental legislation; and

acts of God, terrorist attacks, social unrest and civil disturbances.

***If our Manager overestimates the loss-adjusted yields of our CMBS investments, we may experience losses.***

Our Manager will value any CMBS investments we may acquire based on loss-adjusted yields, taking into account estimated future losses on the mortgage loans included in the securitization's pool of loans, and the estimated impact of these losses on expected future cash flows. Our Manager's loss estimates may not prove accurate, as actual results may vary from estimates. In the event that our Manager underestimates the pool level losses relative to the price we pay for a particular CMBS investment, we may experience losses with respect to such investment.

***We may not control the special servicing of the mortgage loans included in the CMBS in which we invest and, in such cases, the special servicer may take actions that could adversely affect our interests.***

With respect to CMBS in which we invest, overall control over the special servicing of the related underlying mortgage loans will be held by a "directing certificateholder" or a "controlling class representative," which is appointed by the holders of the most subordinate class of CMBS in such series. We may not have the right to appoint the directing certificateholder. In connection with the servicing of the specially serviced mortgage loans, the related special servicer may, at the direction of the directing certificateholder, take actions with respect to the specially serviced mortgage loans that could adversely affect our interests.

***The receivables underlying the ABS we may acquire are subject to credit exposure, which could result in losses to us.***

ABS are securities backed by various asset classes including auto loans, student loans, credit card loans, equipment loans, floor plan loans and small business loans fully guaranteed as to principal and interest by the U.S. Small Business Administration, or the SBA. ABS remain subject to the credit exposure of the underlying receivables. In the event of increased rates of delinquency with respect to any receivables underlying our ABS, we may not realize our anticipated return on these investments.

***Most of our investments are recorded at fair value, and quoted prices or observable inputs may not be available to determine such value, resulting in the use of significant unobservable inputs to determine value.***

We expect that the values of some of our investments may not be readily determinable. We measure the fair value of these investments on at least a monthly basis. The fair value at which our assets are recorded may not be an indication of their realizable value. Ultimate realization of the value of an asset depends to a great extent on economic and other conditions that are beyond the control of our Manager, our Company or our board of directors. Further, fair value is only an estimate based on good faith judgment of the price at which an investment can be sold since market prices of investments can only be determined by negotiation between a willing buyer and seller. If we were to liquidate a particular asset, the realized value may be more than or less than the amount at which such asset is valued. Accordingly, the value of our common stock could be adversely affected by our determinations





Table of Contents

regarding the fair value of our investments, whether in the applicable period or in the future. Additionally, such valuations may fluctuate over short periods of time.

Our determination of the fair value of our investments include inputs provided by third-party dealers and pricing services. Valuations of certain investments in which we invest are often difficult to obtain. In general, dealers and pricing services heavily disclaim their valuations. Dealers may claim to furnish valuations only as an accommodation and without special compensation, and so they may disclaim any and all liability for any direct, incidental, or consequential damages arising out of any inaccuracy or incompleteness in valuations, including any act of negligence or breach of any warranty. Depending on the complexity and illiquidity of a security, valuations of the same security can vary substantially from one dealer or pricing service to another. Therefore, our results of operations for a given period could be adversely affected if our determinations regarding the fair market value of these investments are materially different than the values that we ultimately realize upon their disposal. The valuation process has been particularly challenging recently as market events have made valuations of certain assets more difficult, unpredictable and volatile.

***Declines in value of the assets in which we invest will adversely affect our financial position and results of operations, and make it more costly to finance these assets.***

We use our investments as collateral for our financings. Any decline in their value, or perceived market uncertainty about their value, would likely make it difficult for us to obtain financing on favorable terms or at all, or maintain our compliance with terms of any financing arrangements already in place. Our investments in mortgage-backed securities are recorded at fair value under a fair value option election at the time of purchase with changes in fair value reported in earnings. As a result, a decline in fair values of our mortgage-backed securities could reduce both our earnings and stockholders' equity. If market conditions result in a decline in the fair value of our assets, our financial position and results of operations could be adversely affected.

***An increase in interest rates may cause a decrease in the volume of certain of our assets, which could adversely affect our ability to acquire assets that satisfy our investment objectives and to generate income and make distributions.***

Rising interest rates generally reduce the demand for mortgage loans due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of Agency RMBS and our potential target assets available to us, which could adversely affect our ability to acquire assets that satisfy our investment objectives. Rising interest rates may also cause our assets that were issued prior to an interest rate increase to provide yields that are below prevailing market interest rates. If rising interest rates cause us to be unable to acquire a sufficient volume of Agency RMBS and our potential target assets with a yield that is above our borrowing cost, our ability to satisfy our investment objectives and to generate income and make distributions may be materially and adversely affected.

The relationship between short-term and longer-term interest rates is often referred to as the "yield curve." Ordinarily, short-term interest rates are lower than longer-term interest rates. If short-term interest rates rise disproportionately relative to longer-term interest rates (a flattening of the yield curve), our borrowing costs may increase more rapidly than the interest income earned on our assets. Because our investments, on average, generally bear interest based on longer-term rates than our borrowings, a flattening of the yield curve would tend to decrease our net income and the market value of our net assets. Additionally, to the extent cash flows from investments that return scheduled and unscheduled principal are reinvested, the spread between the yields on the new investments and available borrowing rates may decline, which would likely decrease our net income. It is also possible that short-term interest rates may exceed longer-term interest rates (a yield curve inversion), in which event our borrowing costs may exceed our interest income and we could incur operating losses.

Table of Contents

***Increases in interest rates could adversely affect the value of our investments and cause our interest expense to increase, which could result in reduced earnings or losses and negatively affect our profitability as well as the cash available for distribution to our stockholders.***

We invest in Agency RMBS, and may also invest in non-Agency RMBS, CMBS and ABS. In a normal yield curve environment, an investment in such assets will generally decline in value if long-term interest rates increase. Declines in market value may ultimately reduce earnings or result in losses to us, which may negatively affect cash available for distribution to our stockholders.

A significant risk associated with Agency RMBS and our potential target assets is the risk that both long-term and short-term interest rates will increase significantly. If long-term rates increased significantly, the market value of these investments would decline, and the duration and weighted average life of the investments would increase. We could realize a loss if the securities were sold. At the same time, an increase in short-term interest rates would increase the amount of interest owed on any repurchase agreements we may enter into.

Market values of our investments may decline without any general increase in interest rates for a number of reasons, such as increases or expected increases in defaults, or increases or expected increases in voluntary prepayments for those investments that are subject to prepayment risk or widening of credit spreads.

In addition, in a period of rising interest rates, our operating results will depend in large part on the difference between the income from our assets and our financing costs. We anticipate that, in most cases, the income from such assets will respond more slowly to interest rate fluctuations than the cost of our borrowings. Consequently, changes in interest rates, particularly short-term interest rates, may significantly influence our net income. Increases in these rates will tend to decrease our net income and market value of our assets.

***Interest rate mismatches between our RMBS backed by ARMs or hybrid ARMs and our borrowings used to fund our purchases of these assets may cause us to suffer losses.***

We may fund our RMBS with borrowings that have interest rates that adjust more frequently than the interest rate indices and repricing terms of RMBS backed by adjustable-rate mortgages, or ARMs, or hybrid ARMs. Accordingly, if short-term interest rates increase, our borrowing costs may increase faster than the interest rates on RMBS backed by ARMs or hybrid ARMs adjust. As a result, in a period of rising interest rates, we could experience a decrease in net income or a net loss.

In most cases, the interest rate indices and repricing terms of RMBS backed by ARMs or hybrid ARMs and our borrowings will not be identical, thereby potentially creating an interest rate mismatch between our investments and our borrowings. While the historical spread between relevant short-term interest rate indices has been relatively stable, there have been periods when the spread between these indices was volatile. During periods of changing interest rates, these interest rate index mismatches could reduce our net income or produce a net loss, and adversely affect the level of our dividends and the market price of our common stock.

In addition, RMBS backed by ARMs or hybrid ARMs will typically be subject to lifetime interest rate caps that limit the amount an interest rate can increase through the maturity of the RMBS. However, our borrowings under repurchase agreements typically are not subject to similar restrictions. Accordingly, in a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while caps could limit the interest rates on these types of RMBS. This problem is magnified for RMBS backed by ARMs or hybrid ARMs that are not fully indexed. Further, some RMBS backed by ARMs or hybrid ARMs 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 these types of RMBS than we need to pay interest on our related

Table of Contents

borrowings. These factors could reduce our net interest income and cause us to suffer a loss during periods of rising interest rates.

***Interest rate fluctuations may adversely affect the level of our net income and the value of our assets and common stock.***

Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Interest rate fluctuations present a variety of risks, including the risk of a narrowing of the difference between asset yields and borrowing rates, flattening or inversion of the yield curve and fluctuating prepayment rates, and may adversely affect our income and the value of our assets and common stock.

Increases in interest rates may negatively affect the market value of the fixed-rate mortgages, or FRMs, and hybrid ARMs in which we invest. Our investments in these mortgage-backed securities are recorded at fair value under a fair value option election at the time of purchase with changes in fair value reported in earnings and any decrease in our earnings could cause the market value of our common stock to decline. In addition, rising interest rates generally reduce the demand for consumer credit, including mortgage loans, due to the higher cost of borrowing. A reduction in the volume of mortgage loans originated may affect the volume of RMBS available to us, which could affect our ability to acquire assets that satisfy our investment objectives.

***Changes in prepayment rates may adversely affect our profitability.***

The RMBS assets we acquire are backed by pools of residential mortgage loans. We receive payments, generally, from the payments that are made on these underlying residential mortgage loans. When borrowers prepay their residential mortgage loans at rates that are faster than expected, this results in prepayments that are faster than expected on the related RMBS. These faster than expected payments may adversely affect our profitability.

We may purchase RMBS assets that have a higher interest rate than the then prevailing market interest rate. In exchange for this higher interest rate, we may pay a premium to par value to acquire the asset. In accordance with accounting rules, we amortize this premium over the expected term of the asset based on our prepayment assumptions. If the asset is prepaid in whole or in part at a faster than expected rate, however, we must expense all or a part of the remaining unamortized portion of the premium that was paid at the time of the purchase, which will adversely affect our profitability.

Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. Prepayments can also occur when borrowers default on their residential mortgages and the mortgages are prepaid from the proceeds of a foreclosure sale of the property, or when borrowers sell the property and use the sale proceeds to prepay the mortgage as part of a physical relocation. Prepayment rates also may be affected by conditions in the housing and financial markets, increasing defaults on residential mortgage loans, which could lead to an acceleration of the payment of the related principal, general economic conditions and the relative interest rates on FRMs and ARMs. While we seek to manage prepayment risk, in selecting RMBS investments we must balance prepayment risk against other risks, the potential returns of each investment and the cost of hedging our risks. No strategy can completely insulate us from prepayment or other such risks, and we may deliberately retain exposure to prepayment or other risks.

In addition, a decrease in prepayment rates may adversely affect our profitability. When borrowers prepay their residential mortgage loans at slower than expected rates, prepayments on the RMBS may be slower than expected. These slower than expected payments may adversely affect our profitability. We may purchase RMBS assets that have a lower interest rate than the then prevailing market interest

Table of Contents

rate. In exchange for this lower interest rate, we may pay a discount to par value to acquire the asset. In accordance with accounting rules, we accrete this discount over the expected term of the asset based on our prepayment assumptions. If the asset is prepaid at a slower than expected rate, however, we must accrete the remaining portion of the discount at a slower than expected rate. This will extend the expected life of the asset and result in a lower than expected yield on assets purchased at a discount to par.

***We are highly dependent on information systems and systems failures could significantly disrupt our business, which may, in turn, negatively affect the market price of our common stock and our ability to make distributions to all stockholders.***

Our business is highly dependent on communications and information systems of our Manager. Any failure or interruption of our Manager's systems could cause delays or other problems in our securities trading activities, which could have a material adverse effect on our operating results and negatively affect the market price of our common stock and our ability to make distributions to our stockholders.

***Loss of our exemption from regulation pursuant to the 1940 Act would adversely affect us.***

We conduct our business so as not to become regulated as an investment company under the 1940 Act in reliance on the exemption provided by Section 3(c)(5)(C) of the 1940 Act. Section 3(c)(5)(C), as interpreted by the staff of the SEC, requires that: (i) at least 55% of our investment portfolio consist of "mortgages and other liens on and interest in real estate," or "qualifying real estate interests," and (ii) at least 80% of our investment portfolio consist of qualifying real estate interests plus "real estate-related assets." In satisfying this 55% requirement, based on pronouncements of the SEC staff, we may treat whole pool Agency RMBS as qualifying real estate interests. The SEC staff has not issued guidance with respect to whole pool Non-Agency RMBS. Accordingly, based on our own judgment and analysis of the SEC's pronouncements with respect to whole pool Agency RMBS, we may also treat Non-Agency RMBS issued with respect to an underlying pool of mortgage loans in which we hold all of the certificates issued by the pool as qualifying real estate interests. We may also treat whole mortgage loans that we acquire directly as qualifying real estate interests provided that 100% of the loan is secured by real estate when we acquire it and we have the unilateral right to foreclose on the mortgage. We currently treat partial pool Agency and, to the extent we acquire such assets, we treat Non-Agency RMBS and partial pool CMBS as real estate-related assets. We treat any interest rate swaps or other derivative hedging transactions we enter into as miscellaneous assets that will not exceed 20% of our total assets. We rely on guidance published by the SEC staff or on our analyses of guidance published with respect to other types of assets to determine which assets are qualifying real estate assets and real estate-related assets.

The SEC recently solicited public comment on a wide range of issues relating to Section 3(c)(5)(C), including the nature of the assets that qualify for purposes of the exemption and whether mortgage REITs should be regulated in a manner similar to investment companies. There can be no assurance that the laws and regulations governing the 1940 Act status of REITs, including the guidance of the Division of Investment Management of the SEC regarding this exemption, will not change in a manner that adversely affects our operations. To the extent that the SEC or its staff publishes new or different guidance with respect to these matters, we may be required to adjust our strategy accordingly. In addition, we may be limited in our ability to make certain investments and these limitations could require us to hold assets we might wish to sell or to sell assets we might wish to hold. To the extent that the SEC staff provides more specific guidance regarding any of the matters bearing upon the exemption we rely on from the 1940 Act, we may be required to adjust our strategy accordingly. Any additional guidance from the SEC staff could provide additional flexibility to us, or it could further inhibit our ability to pursue the strategies we have chosen.

Table of Contents

The mortgage related investments that we acquire are limited by the provisions of the 1940 Act and the rules and regulations promulgated thereunder. If the SEC determines that any of these securities are not qualifying interests in real estate or real estate-related assets, adopts a contrary interpretation with respect to these securities or otherwise believes we do not satisfy the above exceptions or changes its interpretation of the above exceptions, we could be required to restructure our activities or sell certain of our assets. We may be required at times to adopt less efficient methods of financing certain of our mortgage related investments and we may be precluded from acquiring certain types of higher yielding securities. The net effect of these factors would be to lower our net interest income. If we fail to qualify for an exemption from registration as an investment company or an exclusion from the definition of an investment company, our ability to use leverage would be substantially reduced. Our business will be materially and adversely affected if we fail to qualify for this exemption from regulation pursuant to the 1940 Act. In addition, the loss of our 1940 Act exemption would also permit our Manager to terminate the Management Agreement, which could result in material adverse effect on our business and results of operations.

***The downgrade of the U.S. government's or certain European countries' credit ratings and any future downgrades of the U.S. government's or certain European countries' credit ratings may materially adversely affect our business, financial condition and results of operations.***

On August 5, 2011, Standard & Poor's downgraded the U.S. government's credit rating for the first time in history. Because FNMA and FHLMC are in conservatorship of the U.S. government, downgrades to the U.S. government's credit rating could impact the credit risk associated with Agency RMBS and, therefore, decrease the value of the Agency RMBS in which we invest. In addition, the downgrade of the U.S. government's credit rating and the credit ratings of certain European countries has created broader financial turmoil and uncertainty, which has recently weighed heavily on the global banking system. Therefore, the downgrade of the U.S. government's credit rating and the credit ratings of certain European countries and any future downgrades of the U.S. government's credit rating or the credit ratings of certain European countries may materially adversely affect our business, financial condition and results of operations.

***Certain actions by the U.S. Federal Reserve could cause a flattening of the yield curve, which could materially adversely affect our business, financial condition and results of operations and our ability to pay distributions to our stockholders.***

On September 21, 2011, the U.S. Federal Reserve announced "Operation Twist," a program by which it purchased, by the end of June 2012, \$400 billion of U.S. Treasury securities with remaining maturities between six and 30 years and sold an equal amount of U.S. Treasury securities with remaining maturities of three years or less. On June 20, 2012, the U.S. Federal Reserve announced that it would extend "Operation Twist" through 2012 by purchasing and selling an additional \$267 billion of such securities. Further, in a statement issued at the conclusion of its August 1, 2012 meeting, the U.S. Federal Reserve Board acknowledged that despite some signs of improvement, the U.S. housing sector remains depressed. Based on the deceleration in economic and employment growth as well as the expectation for continued low inflation, the U.S. Federal Reserve Board announced that it would continue its highly accommodative fiscal policy and extend through the end of the year its program to extend the average maturity of its holdings of securities by continuing to reinvest principal payments received on its holdings of Agency debt and Agency RMBS in additional Agency RMBS. The effect of Operation Twist could be a flattening in the yield curve, which could result in increased prepayment rates due to lower long-term interest rates and a narrowing of our net interest margin. Consequently, Operation Twist and any other future securities purchase programs by the U.S. Federal Reserve could materially adversely affect our business, financial condition and results of operations and our ability to pay distributions to our stockholders.

Table of Contents

**Risks related to financing and hedging**

*Our strategy involves significant leverage, which may amplify losses.*

Our leverage currently ranges between seven to eleven times the amount of our stockholders' equity (calculated in accordance with U.S. GAAP). We incur this leverage by borrowing against a substantial portion of the market value of our assets. By incurring this leverage, we could enhance our returns. Nevertheless, this leverage, which is fundamental to our investment strategy, also creates significant risks.

As a result of our significant leverage, we may incur substantial losses if our borrowing costs increase. Our borrowing costs may increase for any of the following reasons:

short-term interest rates increase;

the market value of our securities decreases;

interest rate volatility increases; or

the availability of financing in the market decreases.

*There can be no assurance that our Manager will be able to prevent mismatches in the maturities of our assets and liabilities.*

Because we employ financial leverage in funding our portfolio, mismatches in the maturities of our assets and liabilities can create risk in the need to continually renew or otherwise refinance our liabilities. Our net interest margins are dependent upon a positive spread between the returns on our asset portfolio and our overall cost of funding. Our Manager actively employs portfolio-wide and security-specific risk measurement and management processes in our daily operations. Our Manager's risk management tools include software and services licensed or purchased from third parties, in addition to proprietary systems and analytical methods developed internally. There can be no assurance that these tools and the other risk management techniques described above will protect us from asset/liability risks.

*We may be subject to margin calls under our master repurchase agreements, which could result in defaults or force us to sell assets under adverse market conditions or through foreclosure.*

We have entered into master repurchase agreements with various financial institutions and borrow under these master repurchase agreements to finance the acquisition of assets for our investment portfolio. Pursuant to the terms of borrowings under our master repurchase agreements, a decline in the value of the subject assets may result in our lenders initiating margin calls. A margin call means that the lender requires us to pledge additional collateral to re-establish the ratio of the value of the collateral to the amount of the borrowing. The specific collateral value to borrowing ratio that would trigger a margin call is not set in the master repurchase agreements and will not be determined until we engage in a repurchase transaction under these agreements. Our fixed-rate securities generally are more susceptible to margin calls as increases in interest rates tend to more negatively affect the market value of fixed-rate securities. If we are unable to satisfy margin calls, our lenders may foreclose on our collateral. The threat of or occurrence of a margin call could force us to sell our assets, either directly or through a foreclosure, under adverse market conditions. Because of the significant leverage we have, we may incur substantial losses upon the threat or occurrence of a margin call.

Table of Contents

***If a counterparty to our repurchase transactions defaults on its obligation to resell the underlying security back to us at the end of the transaction term, or if the value of the underlying security has declined as of the end of that term, or if we default on our obligations under the repurchase agreement, we will lose money on our repurchase transactions.***

When we engage in repurchase transactions, we generally sell securities to lenders (repurchase agreement counterparties) and receive cash from these lenders. The lenders are obligated to resell the same securities back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the securities to the lender will be less than the value of those securities (this difference is the haircut), if the lender defaults on its obligation to resell the same securities back to us we may incur a loss on the transaction equal to the amount of the haircut (assuming there was no change in the value of the securities). We would also lose money on a repurchase transaction if the value of the underlying securities has declined as of the end of the transaction term, as we would have to repurchase the securities for their initial value but would receive securities worth less than that amount. Further, if we default on one of our obligations under a repurchase transaction, the lender can terminate the transaction and cease entering into any other repurchase transactions with us. Our repurchase agreements contain cross-default provisions, such that if a default occurs under an agreement with any specific lender, that lender could also declare a default under other repurchase agreements or other financing or derivative contracts, if any, with such lender. Any losses we incur on our repurchase transactions could adversely affect our earnings and thus our cash available for distribution to our stockholders.

***If a counterparty to one of our swap agreements or TBAs defaults on its obligations, we may incur losses.***

If a counterparty to one of the swap agreements that we enter into or TBAs that we may enter into defaults on its obligations under the agreement, we may not receive payments due under the agreement, and thus, we may lose any unrealized gain associated with the agreement. If any such swap agreement hedged a liability, such liability could cease to be hedged upon the default of a counterparty. Additionally, we may also risk the loss of any collateral we have pledged to secure our obligations under a swap agreement if the counterparty becomes insolvent or files for bankruptcy.

***Failure to procure adequate repurchase agreement financing, which generally have short terms, or to renew or replace repurchase agreement financing as it matures, would adversely affect our results of operations.***

We use repurchase agreement financing as a strategy to increase the return on our investment portfolio. However, we may not be able to achieve our desired leverage ratio for a number of reasons, including if the following events occur:

our lenders do not make repurchase agreement financing available to us at acceptable rates;

certain of our lenders exit the repurchase market;

our lenders require that we pledge additional collateral to cover our borrowings, which we may be unable to do; or

we determine that the leverage would expose us to excessive risk.

We cannot assure you that any, or sufficient, repurchase agreement financing will be available to us on terms that are acceptable to us. In recent years, investors and financial institutions that lend in the securities repurchase market, have tightened lending standards in response to the difficulties and changed economic conditions that have materially adversely affected the RMBS market. These market disruptions have been most pronounced in the non-Agency RMBS market, and the impact has also extended to Agency RMBS, which has made the value of these assets unstable and relatively illiquid compared to prior periods. Any decline in their value, or perceived market uncertainty about their value, would make it more difficult for us to obtain financing on favorable terms or at all, or maintain

Table of Contents

our compliance with terms of any financing arrangements then in place. Additionally, the lenders from which we seek to obtain repurchase agreement financing may have owned or financed RMBS that have declined in value and caused the lender to suffer losses as a result of the recent downturn in the residential mortgage market. If these conditions persist, these institutions may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of equity capital or haircut required to obtain financing, and in such event, could make it more difficult for us to obtain financing on favorable terms or at all. In the event that we cannot obtain sufficient funding on acceptable terms, there may be a negative impact on the value of our common stock and our ability to make distributions, and you may lose part or all of your investment.

Furthermore, because we rely primarily on short-term borrowings, our ability to achieve our investment objective will depend not only on our ability to borrow money in sufficient amounts and on favorable terms, but also on our ability to renew or replace on a continuous basis our maturing short-term borrowings. If we are not able to renew or replace maturing borrowings, we will have to sell some or all of our assets, possibly under adverse market conditions. In addition, if the regulatory capital requirements imposed on our lenders change, they may be required to significantly increase the cost of the financing that they provide to us. Our lenders also may revise their eligibility requirements for the types of assets they are willing to finance or the terms of such financings, based on, among other factors, the regulatory environment and their management of perceived risk, particularly with respect to assignee liability.

***Our repurchase agreement financing may require us to provide additional collateral and may restrict us from leveraging our assets as fully as desired.***

We use repurchase agreements to finance acquisitions of Agency RMBS and our potential target assets. If the market value of the asset pledged or sold by us to a financing institution pursuant to a repurchase agreement declines, we may be required by the financing institution to provide additional collateral or pay down a portion of the funds advanced, but we may not have the funds available to do so, which could result in defaults. Posting additional collateral to support our credit will reduce our liquidity and limit our ability to leverage our assets, which could adversely affect our business. In the event we do not have sufficient liquidity to meet such requirements, financing institutions can accelerate repayment of our indebtedness, increase interest rates, liquidate our collateral or terminate our ability to borrow. Such a situation would likely result in a rapid deterioration of our financial condition and possibly necessitate a filing for bankruptcy protection.

Further, financial institutions providing the repurchase facilities may require us to maintain a certain amount of cash uninvested or to set aside non-levered assets sufficient to maintain a specified liquidity position which would allow us to satisfy our collateral obligations. As a result, we may not be able to leverage our assets as fully as we would choose, which could reduce our return on equity. If we are unable to meet these collateral obligations, our financial condition could deteriorate rapidly.

***Lenders may require us to enter into restrictive covenants relating to our operations.***

When we obtain further financing, lenders could impose restrictions on us that would affect our ability to incur additional debt, our capability to make distributions to stockholders and our flexibility to determine our operating policies. Loan documents we execute may contain negative covenants that limit, among other things, our ability to repurchase stock, distribute more than a certain amount of our funds from operations, and employ leverage beyond certain amounts.



Table of Contents

***Our rights under repurchase agreements may be subject to the effects of the bankruptcy laws in the event of the bankruptcy or insolvency of us or our counterparties under the repurchase agreements.***

In the event of our insolvency or bankruptcy, certain repurchase agreements may qualify for special treatment under the U.S. Bankruptcy Code, the effect of which, among other things, would be to allow the lender under the applicable repurchase agreement to avoid the automatic stay provisions of the U.S. Bankruptcy Code and to take possession of and liquidate the assets that we have pledged under their repurchase agreements. In the event of the insolvency or bankruptcy of a lender during the term of a repurchase agreement, the lender may be permitted, under applicable insolvency laws, to repudiate the contract, and our claim against the lender for damages may be treated simply as an unsecured creditor. In addition, if the lender is a broker or dealer subject to the Securities Investor Protection Act of 1970, or an insured depository institution subject to the Federal Deposit Insurance Act, our ability to exercise our rights to recover our securities under a repurchase agreement or to be compensated for any damages resulting from the lender's insolvency may be further limited by those statutes. These claims would be subject to significant delay and, if and when received, may be substantially less than the damages we actually incur.

***An increase in our borrowing costs relative to the interest that we receive on investments in Agency RMBS and our potential target assets may adversely affect our profitability and cash available for distribution to our stockholders.***

As our financings mature, we will be required either to enter into new borrowings or to sell certain of our investments. An increase in short-term interest rates at the time that we seek to enter into new borrowings would reduce the spread between our returns on our assets and the cost of our borrowings. This would adversely affect our returns on our assets, which might reduce earnings and, in turn, cash available for distribution to our stockholders.

***We may enter into hedging transactions that could expose us to contingent liabilities in the future.***

Subject to maintaining our qualification as a REIT and exemption from registration under the 1940 Act, part of our investment strategy may involve entering into hedging transactions that could require us to fund cash payments in certain circumstances (such as the early termination of the hedging instrument caused by an event of default or other early termination event, or the decision by a counterparty to request margin securities it is contractually owed under the terms of the hedging instrument). The amount due would be equal to the unrealized loss of the open swap positions with the respective counterparty and could also include other fees and charges. These economic losses will be reflected in our results of operations, and our ability to fund these obligations will depend on the liquidity of our assets and access to capital at the time, and the need to fund these obligations could adversely impact our financial condition.

***Hedging against interest rate exposure may adversely affect our earnings, which could reduce our cash available for distribution to our stockholders.***

Subject to maintaining our qualification as a REIT and exemption from registration under the 1940 Act, we pursue various hedging strategies to seek to reduce our exposure to adverse changes in interest rates. Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. Interest rate hedging may fail to protect or could adversely affect us because, among other things:

interest rate hedging can be expensive, particularly during periods of rising and volatile interest rates;

available interest rate hedges may not correspond directly with the interest rate risk for which protection is sought;

Table of Contents

due to a credit loss, the duration of the hedge may not match the duration of the related liability;

the amount of income that a REIT may earn from hedging transactions (other than hedging transactions that satisfy certain requirements of the Internal Revenue Code or that are done through a taxable REIT subsidiary, or TRS) to offset interest rate losses is limited by U.S. federal tax provisions governing REITs;

the value of derivatives used for hedging may be adjusted from time to time in accordance with accounting rules to reflect changes in fair value. Downward adjustments or "mark-to-market losses," would reduce our stockholders' equity;

the credit quality of the hedging counterparty owing money on the hedge may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and

the hedging counterparty owing money in the hedging transaction may default on its obligation to pay.

Our hedging transactions, which are intended to limit losses, may actually adversely affect our earnings, which could reduce our cash available for distribution to our stockholders.

In addition, hedging instruments involve risk since they often are not traded on regulated exchanges, guaranteed by an exchange or its clearing house, or regulated by any U.S. or foreign governmental authorities. Consequently, there are no requirements with respect to record keeping, financial responsibility or segregation of customer funds and positions. Furthermore, the enforceability of agreements underlying hedging transactions may depend on compliance with applicable statutory and commodity and other regulatory requirements and, depending on the identity of the counterparty, applicable international requirements. The business failure of a hedging counterparty with whom we enter into a hedging transaction would most likely result in its default. Default by a party with whom we enter into a hedging transaction may result in the loss of unrealized profits and force us to cover our commitments, if any, at the then current market price. Although generally we seek to reserve the right to terminate our hedging positions, it may not always be possible to dispose of or close out a hedging position without the consent of the hedging counterparty and we may not be able to enter into an offsetting contract in order to cover our risk. We cannot assure you that a liquid secondary market will exist for any hedging instruments purchased or sold, and we may be required to maintain a position until exercise or expiration, which could result in losses.

**Risks associated with our relationship with our Manager**

*Our Manager has limited experience operating a REIT and we cannot assure you that our Manager's past experience will be sufficient to successfully manage our business as a REIT.*

Our Manager has limited experience operating a REIT. The REIT provisions of the Internal Revenue Code are complex, and any failure to comply with those provisions in a timely manner could prevent us from qualifying as a REIT or force us to pay unexpected taxes and penalties. In such event, our net income would be reduced and we could incur a loss.

*Our board of directors has approved very broad investment guidelines for our Manager and does not approve each investment and financing decision made by our Manager.*

Our Manager is authorized to follow very broad investment guidelines. Our board of directors periodically reviews our investment guidelines and our investment portfolio but does not, and is not required to, review all of our proposed investments, except that an investment in a security structured or issued by another entity managed by our Manager must be approved by a majority of our

Table of Contents

independent directors prior to such investment. In addition, in conducting periodic reviews, our board of directors may rely primarily on information provided to them by our Manager. Furthermore, our Manager may use complex strategies, and transactions entered into by our Manager may be costly, difficult or impossible to unwind by the time they are reviewed by our board of directors. Our Manager has great latitude within the broad parameters of our investment guidelines in determining the types and amounts of Agency RMBS, non-Agency RMBS, CMBS and ABS investments it may decide are attractive investments for us, which could result in investment returns that are substantially below expectations or that result in losses, which would materially and adversely affect our business operations and results. Further, decisions made and investments and financing arrangements entered into by our Manager may not fully reflect the best interests of our stockholders.

***There are conflicts of interest in our relationship with our Manager that could result in decisions that are not in the best interests of our stockholders.***

We are subject to conflicts of interest arising out of our relationship with our Manager. All of our officers apart from our chief financial officer, Steven M. Sherwyn, are employees of our Manager. In addition, two of our directors, James W. Hirschmann III and Gavin L. James, are also employees of our Manager. We do not have any employees other than our chief financial officer. Our Management Agreement with our Manager was negotiated between related parties and its terms, including fees and other amounts payable, may not be as favorable to us as if it had been negotiated at arm's length with an unaffiliated third party. In addition, the obligations of our Manager and its officers and personnel to engage in other business activities may reduce the time our Manager and its officers and personnel spend managing us.

We compete for investment opportunities directly with other client portfolios managed by our Manager. Clients of our Manager may have investment mandates and objectives that target the same assets as us. A substantial number of client accounts managed by our Manager have exposure to Agency RMBS and our potential target assets and may have similar investment mandates and objectives. In addition, our Manager may have additional clients that compete directly with us for investment opportunities in the future. Our Manager has an investment allocation policy in place that is intended to ensure that no single client is intentionally favored over another and that trades are allocated in a fair and equitable manner. We may compete with our Manager or its other clients for investment or financing opportunities sourced by our Manager; however, we may either not be presented with the opportunity or have to compete with our Manager to acquire these investments or have access to these sources of financing. Our Manager and our executive officers may choose to allocate favorable investments to itself or to its or other clients instead of to us. Further, at times when there are turbulent conditions in the mortgage markets or distress in the credit markets or other times when we will need focused support and assistance from our Manager, our Manager's other clients will likewise require greater focus and attention, placing our Manager's resources in high demand. In such situations, we may not receive the level of support and assistance that we may receive if we were internally managed or if our Manager did not act as a manager for other entities. There is no assurance that our Manager's allocation policies that address some of the conflicts relating to our access to investment and financing sources, which are described under "Management Conflicts of interest," will be adequate to address all of the conflicts that may arise.

We pay our Manager a management fee that is not tied to our performance. The management fee may not sufficiently incentivize our Manager to generate attractive risk-adjusted returns for us. This could hurt both our ability to make distributions to our stockholders and the market price of our common stock. Furthermore, the compensation payable to our Manager will increase as a result of future issuances of our equity securities, even if the issuances are dilutive to existing stockholders.

Concurrently with our IPO, we sold 46,043 shares of our common stock to our Manager's deferred compensation plan, which made such investment on behalf of the beneficiaries of the plan, including

Table of Contents

certain executives and other employees of our Manager and its affiliates. These shares are subject to a two-year lock-up agreement from the date of our IPO with the underwriters from that offering. To the extent these shares are sold, our Manager's interests may be less aligned with our interests.

***We are dependent on our Manager and its key personnel for our success.***

We have no separate facilities and are completely reliant on our Manager. All of our executive officers apart from our chief financial officer, and two of our directors are employees of our Manager. We do not have any employees other than our chief financial officer. Our Manager has significant discretion as to the implementation of our investment and operating policies and strategies. Accordingly, we believe that our success will depend to a significant extent upon the efforts, experience, diligence, skill and network of business contacts of the executive officers and key personnel of our Manager. The executive officers and key personnel of our Manager evaluate, negotiate, close and monitor our investments; therefore, our success depends on their continued service. The departure of any of the executive officers or key personnel of our Manager could have a material adverse effect on our performance. In addition, we offer no assurance that our Manager will remain our investment manager or that we will continue to have access to our Manager's principals and professionals. The initial term of our Management Agreement with our Manager only extends until the third anniversary of the closing of our IPO, May 15, 2015, with automatic one-year renewals thereafter. If the Management Agreement is terminated and no suitable replacement is found to manage us, we may not be able to execute our business plan. Moreover, our Manager is not obligated to dedicate any of its personnel exclusively to us nor is it obligated to dedicate any specific portion of its time to our business, and none of our Manager's personnel are contractually dedicated to us under our Management Agreement with our Manager.

***The Management Agreement with our Manager was not negotiated on an arm's-length basis and may not be as favorable to us as if it had been negotiated with an unaffiliated third party and may be costly and difficult to terminate.***

Our executive officers apart from our chief financial officer, and two of our directors are employees of our Manager. Our Management Agreement with our Manager was negotiated between related parties and its terms, including fees payable, may not be as favorable to us as if it had been negotiated with an unaffiliated third party.

Termination of the Management Agreement with our Manager without cause is difficult and costly. Our independent directors review our Manager's performance and any fees payable to our Manager annually and, following the initial three-year term, the Management Agreement may be terminated annually upon the affirmative vote of at least two-thirds of our independent directors based upon: (1) our Manager's unsatisfactory performance that is materially detrimental to us, or (2) our determination that any fees payable to our Manager are not fair, subject to our Manager's right to prevent termination based on unfair fees by accepting a reduction of management fees agreed to by at least two-thirds of our independent directors. We are required to provide our Manager 180 days prior notice of any such termination. Unless terminated for cause, we are required to pay our Manager a termination fee equal to three times the average annual management fee earned by our Manager during the prior 24-month period immediately preceding such termination, calculated as of the end of the most recently completed fiscal quarter before the date of termination. This provision increases the effective cost to us of electing not to renew, or defaulting in our obligations under, the Management Agreement, thereby adversely affecting our inclination to end our relationship with our Manager, even if we believe our Manager's performance is not satisfactory.

Our Manager is only contractually committed to serve us until the third anniversary of the closing of our IPO, May 15, 2015. Thereafter, the Management Agreement is automatically renewable for one-year terms; provided, however, that our Manager may terminate the Management Agreement annually

Table of Contents

upon 180 days prior notice. If the Management Agreement is terminated and no suitable replacement is found to manage us, we may not be able to execute our business plan.

Pursuant to the Management Agreement, our Manager does not assume any responsibility other than to render the services called for thereunder and is not responsible for any action of our board of directors in following or declining to follow its advice or recommendations. Our Manager maintains a contractual as opposed to a fiduciary relationship with us. Under the terms of the Management Agreement, our Manager, its officers, stockholders, members, managers, directors, personnel, any person controlling or controlled by our Manager and any person providing sub-advisory services to our Manager are not liable to us, our directors, our stockholders or any partners for acts or omissions performed in accordance with and pursuant to the Management Agreement, except because of acts constituting bad faith, willful misconduct, gross negligence, or reckless disregard of their duties under the Management Agreement. In addition, we indemnify our Manager, its officers, stockholders, members, managers, directors, personnel, any person controlling or controlled by our Manager and any person providing sub-advisory services to our Manager with respect to all expenses, losses, damages, liabilities, demands, charges and claims arising from acts of our Manager not constituting bad faith, willful misconduct, gross negligence, or reckless disregard of duties, performed in good faith in accordance with and pursuant to the Management Agreement.

***Our Manager's management fee is payable regardless of our performance.***

We pay our Manager a management fee regardless of the performance of our portfolio. Our Manager's entitlement to non-performance-based compensation might reduce its incentive to devote its time and effort to seeking assets that provide attractive risk-adjusted returns for our portfolio. This in turn could hurt both our ability to make distributions to our stockholders and the market price of our common stock.

***Our Manager is subject to extensive regulation as an investment advisor, which could adversely affect its ability to manage our business.***

Our Manager is subject to regulation as an investment advisor by various regulatory authorities that are charged with protecting the interests of its clients, including us. Instances of criminal activity and fraud by participants in the investment management industry and disclosures of trading and other abuses by participants in the financial services industry have led the U.S. government and regulators to consider increasing the rules and regulations governing, and oversight of, the U.S. financial system. This activity is expected to result in changes to the laws and regulations governing the investment management industry and more aggressive enforcement of the existing laws and regulations. Our Manager could be subject to civil liability, criminal liability, or sanction, including revocation of its registration as an investment adviser, revocation of the licenses of its employees, censures, fines, or temporary suspension or permanent bar from conducting business, if it is found to have violate any of these laws or regulations. Any such liability or sanction could adversely affect its ability to manage our business.

Our Manager must continually address conflicts between its interests and those of its clients, including us. In addition, the SEC and other regulators have increased their scrutiny of potential conflicts of interest. We believe our Manager has procedures and controls that are reasonably designed to address these issues. However, appropriately dealing with conflicts of interest is complex and difficult and if our Manager fails, or appears to fail, to deal appropriately with conflicts of interest, it could face litigation or regulatory proceedings or penalties, any of which could adversely affect its ability to manage our business.

Table of Contents

**Risks related to our common stock**

*The market price and trading volume of our common stock may vary substantially.*

Our common stock is listed on the NYSE under the symbol "WMC". The stock markets, including the NYSE, have experienced significant price and volume fluctuations over the past several years. As a result, the market price of our common stock is likely to be similarly volatile, and investors in our common stock may experience a decrease in the value of their shares. Accordingly, no assurance can be given as to the ability of our stockholders to sell their common stock or the price that our stockholders may obtain for their common stock.

Some of the factors that could negatively affect the market price of our common stock include:

actual or anticipated variations in our quarterly operating results;

changes in our earnings estimates or publication of research reports about us or the real estate industry;

changes in market valuations of similar companies;

adverse market reaction to any increased indebtedness we incur in the future;

additions to or departures of our Manager's key personnel;

actions by our stockholders; and

speculation in the press or investment community.

Market factors unrelated to our performance could also negatively impact the market price of our common stock. One of the factors that investors may consider in deciding whether to buy or sell our common stock is our distribution rate as a percentage of our stock price relative to market interest rates. If market interest rates increase, prospective investors may seek alternative investments paying higher dividends or interest. As a result, interest rate fluctuations and conditions in the capital markets can affect the market value of our common stock. For instance, if interest rates rise, it is likely that the market price of our common stock will decrease as market rates on interest-bearing securities increase.

***For as long as we are an emerging growth company, we will not be required to comply with certain reporting requirements, including those relating to accounting standards and disclosure about our executive compensation, that apply to other public companies.***

In April 2012, President Obama signed into law the Jumpstart Our Business Startups Act, or the JOBS Act. The JOBS Act contains provisions that, among other things, relax certain reporting requirements for "emerging growth companies," including certain requirements relating to accounting standards and compensation disclosure. We are classified as an emerging growth company. For as long as we are an emerging growth company, which may be up to five full fiscal years from the date of our IPO, unlike other public companies, we will not be required to (1) provide an auditor's attestation report on management's assessment of the effectiveness of our system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act, (2) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act, (3) comply with any new requirements adopted by the Public Company Accounting Oversight Board, or the PCAOB, requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer, (4) comply with any new audit rules adopted by the PCAOB after April 5, 2012 unless the SEC determines otherwise, (5) provide certain disclosure regarding executive compensation required of larger public companies or (6) hold shareholder advisory votes on executive compensation. We cannot predict if investors will find our common stock less attractive if we choose to rely on these exemptions. If some



Table of Contents

investors find our common stock less attractive as a result of any choices to reduce future disclosure, there may be a less active trading market for our common stock and our stock price may be more volatile.

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. We currently take advantage of such extended transition period. Since we are not required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, our financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If we were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

***Investing in our common stock may involve a high degree of risk.***

The investments that we make in accordance with our investment objectives may result in a high amount of risk when compared to alternative investment options and volatility or loss of principal. Our investments may be highly speculative and aggressive, and therefore an investment in our common stock may not be suitable for someone with lower risk tolerance.

***Common stock eligible for future sale may have adverse effects on our share price.***

We are offering 12,000,000 shares of our common stock as described in this prospectus. Immediately prior to this offering, we had 10,343,944 shares of our common stock issued and outstanding. Of those shares, 8,000,000 shares were sold in our IPO and are freely transferable. In addition, in connection with the concurrent private placements, we issued warrants entitling the holders to purchase up to an additional 1,115,893 shares of common stock, and under our equity incentive plans, we are able to issue a number of shares of common stock equivalent to 3.0% of our issued and outstanding common stock (on a fully diluted basis) at the time of the award (other than any shares subject to awards made under any of these plans).

We, our Manager, each of our directors and executive officers, and each of the executive officers of our Manager have entered into lock up agreements with the underwriters of this offering pursuant to which each of these persons or entities, with limited exceptions, for a period of 60 days after the date of this prospectus, may not, without the prior written consent of the representatives of the underwriters, sell or transfer any shares of our common stock or any securities convertible into or exercisable or exchangeable for our common stock. In addition, in connection with our IPO, our Manager, our directors and executive officers, and the executive officers of our Manager entered into similar lock up agreements with the representatives of the underwriters of that offering, except that these lock up agreements will apply for a period of 180 days from our IPO. Further, on May 15, 2012, we sold 46,043 shares of our common stock to our Manager's deferred compensation plan, which made such investment on behalf of the beneficiaries of this plan, including certain executives and other employees of our Manager and its affiliates. These shares are subject to a two-year lock-up agreement from the date of our IPO with the representatives of the underwriters of that offering. The terms of this two-year lock-up agreement are substantially similar to the 180-day lock up agreements described above except that it will apply until May 14, 2014.

The representatives of the underwriters of this offering or the IPO may, in their sole discretion, at any time from time to time, waive in writing the terms and conditions of the 60-day, 180-day or two-year lock-up agreements described above. However, each of our directors, our Manager and executive officers and each executive officer of our Manager may transfer or dispose of our shares during the applicable restricted period in the case of gifts or for distributions to their respective members or shareholders where the donee or transferee agrees to a similar lock-up agreement for the



Table of Contents

remainder of the restricted period. Assuming the underwriters do not exercise their option to purchase additional shares, approximately 0.9% of our shares of common stock (including our restricted common stock) will be subject to lock-up agreements. When the lock-up periods expire, these shares of common stock may become eligible for sale, in some cases subject to the requirements of Rule 144 under the Securities Act, which are described under "Shares eligible for future sale."

We cannot predict the effect, if any, of this offering, future sales of our common stock, or the availability of shares for future sales, on the market price of our common stock. The market price of our common stock may decline significantly when the restrictions on resale (or lock up agreements) by certain of our stockholders lapse. Sales of substantial amounts of common stock or the perception that such sales could occur may adversely affect the prevailing market price for our common stock.

Also, we may issue additional shares in subsequent public offerings or private placements to make new investments or for other purposes. We are not required to offer any such shares to existing stockholders on a preemptive basis. Therefore, it may not be possible for existing stockholders to participate in such future share issuances, which may dilute the existing stockholders' interests in us.

***We have not established a minimum distribution payment level and we cannot assure you of our ability to pay distributions in the future.***

We intend to pay quarterly distributions and to make distributions to our stockholders in an amount such that we distribute all or substantially all of our net taxable income in each year. We have not established a minimum distribution payment level and our ability to pay distributions may be adversely affected by a number of factors, including the risk factors described in this prospectus. All distributions will be made at the discretion of our board of directors and will depend on our earnings, our financial condition, debt covenants, maintenance of our REIT qualification and other factors as our board of directors may deem relevant from time to time. We believe that a change in any one of the following factors could adversely affect our results of operations and impair our ability to pay distributions to our stockholders:

the profitability of our existing investments and the investment of the net proceeds of this offering;

our ability to make profitable investments;

margin calls or other expenses that reduce our cash flow;

decreases in the value of our portfolio or defaults in our asset portfolio; and

the fact that anticipated operating expense levels may not prove accurate, as actual results may vary from estimates.

We cannot assure you that we will achieve investment results that will allow us to make a specified level of cash distributions or year-to-year increases in cash distributions in the future. In addition, some of our distributions may include a return in capital.

***Future offerings of debt or equity securities, which would rank senior to our common stock, may adversely affect the market price of our common stock.***

If we decide to issue debt or equity securities in the future, which would rank senior to our common stock, it is likely that they will be governed by an indenture or other instrument containing covenants restricting our operating flexibility. Additionally, any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock and may result in dilution to owners of our common stock. We and, indirectly, our stockholders, will bear the cost of issuing and servicing such securities. Because our decision to issue debt or equity securities in any future offering will depend on market conditions and other factors

Table of Contents

beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus holders of our common stock will bear the risk of our future offerings reducing the market price of our common stock and diluting the value of their stock holdings in us. Furthermore, the compensation payable to our Manager will increase as a result of future issuances of our equity securities, including issuances upon exercise of the warrants, even if the issuances are dilutive to existing stockholders.

***The dilutive effect of our outstanding warrants, including in certain circumstances, upon the issuance of common stock in this offering as well as future issuances of our common stock, could have an adverse effect on the future market price of our common stock or otherwise adversely affect the interests of our common stockholders.***

On May 15, 2012, we issued and sold to certain institutional investors a number of warrants entitling them to purchase up to an aggregate of 1,115,893 shares of our common stock. These warrants have an initial exercise price of \$20.50 per share (subject to adjustment and limitation on exercise in certain circumstances) and are exercisable for seven years after the date of the warrants' issuance, or earlier upon notice of redemption by us. The exercise of the warrants in the future would be dilutive to holders of our common stock if our book value per share or the market price of our common stock is higher than the exercise price at the time of exercise. The potential for dilution from the warrants could have an adverse effect on the future market price of our common stock.

Further, the exercise price of the warrants will be adjusted under certain circumstances, including, subject to certain exceptions, if we sell common stock (or other securities convertible into or exchangeable for our common stock) in a public offering or private placement such as this offering, for cash at a price per share (after deduction of underwriting discounts or placement fees and other expenses incurred by us that are attributable to the offering) that is less than the closing price of our common stock immediately prior to (a) the announcement of the proposed sale in the case of public offerings or (b) the execution of the purchase agreement in the case of private placements. Accordingly, the exercise price will be adjusted downward in connection with this offering and increase the dilutive effect of the warrants. Furthermore, any similar public offerings or private placements of our common stock we conduct in the future including this offering will likely increase the dilutive effect of the warrants.

**Risks related to our organization and structure**

***Our authorized but unissued shares of common and preferred stock may prevent a change in our control.***

Our amended and restated certificate of incorporation authorizes us to issue additional authorized but unissued shares of common or preferred stock. In addition, our board of directors may, without stockholder approval, amend our amended and restated certificate of incorporation to increase the aggregate number of our shares of stock or the number of shares of stock of any class or series that we have authority to issue and classify or reclassify any unissued shares of common or preferred stock and set the preferences, rights and other terms of the classified or reclassified shares. As a result, our board of directors may establish a series of shares of common or preferred stock that could delay or prevent a transaction or a change in control that might involve a premium price for our shares of common stock or otherwise be in the best interest of our stockholders.

***Ownership limitations may restrict change of control or business combination opportunities in which our stockholders might receive a premium for their shares.***

In order for us to qualify as a REIT for each taxable year after 2012, no more than 50% in value of our outstanding capital stock may be owned, directly or indirectly, by five or fewer individuals during the last half of any calendar year. "Individuals" for this purpose include natural persons, private

Table of Contents

foundations, some employee benefit plans and trusts, and some charitable trusts. To assist us in maintaining our qualification as a REIT, our amended and restated certificate of incorporation generally prohibits any person from directly or indirectly owning more than 9.8% in value or in number of shares, whichever is more restrictive, of the outstanding shares of our capital stock or more than 9.8% in value or in number of shares, whichever is more restrictive, of the outstanding shares of our common stock. This ownership limitation could have the effect of discouraging a takeover or other transaction in which holders of our common stock might receive a premium for their shares over the then prevailing market price or which holders might believe to be otherwise in their best interests.

***Provisions in our amended and restated certificate of incorporation, our amended and restated bylaws and Delaware law may have the effect of preventing or hindering a change in control and adversely affecting the market price of our common stock.***

Provisions in our amended and restated certificate of incorporation and our amended and restated bylaws and applicable provisions of the Delaware General Corporation Law may make it more difficult and expensive for a third party to acquire control of us even if a change of control would be beneficial to the interests of our stockholders. These provisions could discourage potential takeover attempts and could adversely affect the market price our common stock.

***We may pay distributions from offering proceeds, borrowings or the sale of assets to the extent that distributions exceed earnings or cash flow from our operations.***

We may pay distributions from offering proceeds, borrowings or the sale of assets to the extent that distributions exceed earnings or cash flow from our operations. Such distributions would reduce the amount of cash we have available for investing and other purposes and could be dilutive to our financial results. In addition, funding our distributions from our net proceeds may constitute a return of capital to our investors, which would have the effect of reducing each stockholder's basis in its shares of common stock.

**Tax risks**

***If we do not qualify as a REIT or fail to remain qualified as a REIT, we will be subject to U.S. federal income tax as a regular corporation and could face a substantial tax liability, which would reduce the amount of cash available for distribution to our stockholders.***

We believe we have operated and intend to continue to operate in a manner that will allow us to qualify as a REIT commencing with our taxable year ending December 31, 2012. Although we have not requested a ruling from the Internal Revenue Service, or the IRS, as to our REIT qualification, we will receive an opinion of our counsel, Skadden, Arps, Slate, Meagher & Flom LLP, with respect to our qualification as a REIT in connection with this offering. Investors should be aware, however, that opinions of counsel are not binding on the IRS or any court. The opinion of Skadden, Arps, Slate, Meagher & Flom LLP will represent only the view of our counsel based on our counsel's review and analysis of existing law and on certain representations as to factual matters and covenants made by us and our Manager, including representations relating to the values of our assets and the sources of our income. The opinion will be expressed as of the date issued. Skadden, Arps, Slate, Meagher & Flom LLP will have no obligation to advise us or the holders of our common stock of any subsequent change in the matters stated, represented or assumed, or of any subsequent change in applicable law. Furthermore, both the validity of the opinion of Skadden, Arps, Slate, Meagher & Flom LLP, and our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis, the results of which will not be monitored by Skadden, Arps, Slate, Meagher & Flom LLP. Our ability to satisfy the asset tests depends upon our analysis of the characterization and fair market values of our assets, some of which are not susceptible to a precise determination, and for which we will not obtain independent

Table of Contents

appraisals. Our compliance with the REIT income and quarterly asset requirements also depends upon our ability to successfully manage the composition of our income and assets on an ongoing basis. Accordingly, there can be no assurance that the IRS will not contend that our interests in subsidiaries or in securities of other issuers will not cause a violation of the REIT requirements.

If we were to fail to qualify as a REIT in any taxable year, we would be subject to U.S. federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates, and dividends paid to our stockholders would not be deductible by us in computing our taxable income. Any resulting corporate tax liability could be substantial and would reduce the amount of cash available for distribution to our stockholders, which in turn could have an adverse impact on the value of our common stock. Unless we were entitled to relief under certain Internal Revenue Code provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year in which we failed to qualify as a REIT.

***Dividends payable by REITs do not qualify for the reduced tax rates available for some dividends.***

The maximum tax rate applicable to income from "qualified dividends" payable to domestic stockholders that are individuals, trusts and estates is 15% through the end of 2012. Dividends payable by REITs, however, generally are not eligible for the reduced rates. Although this legislation does not adversely affect the taxation of REITs or dividends payable by REITs, the more favorable rates applicable to regular corporate qualified dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the stock of REITs, including our common stock.

***REIT distribution requirements could adversely affect our ability to execute our business plan.***

We generally must distribute annually at least 90% of our net taxable income in order for U.S. federal corporate income tax not to apply to earnings that we distribute. To the extent that we satisfy this distribution requirement, but distribute less than 100% of our net taxable income, we will be subject to U.S. federal corporate income tax on our undistributed net taxable income. In addition, we will be subject to a 4% nondeductible excise tax if the actual amount that we pay out to our stockholders in a calendar year is less than a minimum amount specified under U.S. federal tax laws. We intend to make distributions to our stockholders to comply with the REIT requirements of the Internal Revenue Code.

From time to time, we may generate taxable income greater than our income for financial reporting purposes prepared in accordance with U.S. GAAP, or differences in timing between the recognition of taxable income and the actual receipt of cash may occur. If we do not have other funds available in these situations we could be required to borrow funds on unfavorable terms, sell investments at disadvantageous prices or distribute amounts that would otherwise be invested in future acquisitions to make distributions sufficient to enable us to pay out enough of our taxable income to satisfy the REIT distribution requirement and to avoid corporate income tax and the 4% excise tax in a particular year. These alternatives could increase our costs or reduce our equity. Thus, compliance with the REIT requirements may hinder our ability to grow, which could adversely affect the value of our common stock.

***Even if we remain qualified as a REIT, we may face other tax liabilities that reduce our cash flow.***

Even if we remain qualified for taxation as a REIT, we may be subject to certain U.S. federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure, and state or local income, property and transfer taxes, such as mortgage recording taxes. See "U.S. federal income tax considerations

Table of Contents

Taxation of Western Asset Mortgage Capital Corporation." Any of these taxes would decrease cash available for distribution to our stockholders. In addition, in order to meet the REIT qualification requirements, or to avert the imposition of a 100% tax that applies to certain gains derived by a REIT from dealer property or inventory, we intend to hold some of our assets through a TRS or other subsidiary corporations that will be subject to corporate-level income tax at regular rates. Any of these taxes would decrease cash available for distribution to our stockholders.

***Complying with REIT requirements may cause us to liquidate or forgo otherwise attractive opportunities.***

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 and qualified REIT real estate assets, including certain mortgage loans and securities. The remainder of our investments (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our total assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 25% of the value of our total assets can be represented by securities of one or more TRSs. See "U.S. federal income tax considerations Taxation of Western Asset Mortgage Capital Corporation." If we fail to comply with these requirements at the end of any calendar quarter, we must correct the failure within 30 days after the end of the calendar quarter or qualify for certain statutory relief provisions to avoid losing our REIT qualification and suffering adverse tax consequences. As a result, we may be required to liquidate from our investment portfolio otherwise attractive investments. These actions could have the effect of reducing our income and amounts available for distribution to our stockholders.

In addition to the asset tests set forth above, to qualify as a REIT we must continually satisfy tests concerning, among other things, the sources of our income, the amounts we distribute to our stockholders and the ownership of our stock. We may be unable to pursue investments that would be otherwise advantageous to us in order to satisfy the source-of-income or asset-diversification requirements for qualifying as a REIT. Thus, compliance with the REIT requirements may hinder our ability to make certain attractive investments.

***We may be required to report taxable income for certain investments in excess of the economic income we ultimately realize from them.***

We may acquire mortgage-backed securities in the secondary market for less than their face amount. In addition, pursuant to our ownership of certain mortgage-backed securities, we may be treated as holding certain debt instruments acquired in the secondary market for less than their face amount. The discount at which such securities or debt instruments are acquired may reflect doubts about their ultimate collectability rather than current market interest rates. The amount of such discount will nevertheless generally be treated as "market discount" for U.S. federal income tax purposes. Accrued market discount is reported as income when, and to the extent that, any payment of principal of the mortgage-backed security or debt instrument is made. If we collect less on the mortgage-backed security or debt instrument than our purchase price plus the market discount we had previously reported as income, we may not be able to benefit from any offsetting loss deductions. In addition, pursuant to our ownership of certain mortgage-backed securities, we may be treated as holding distressed debt investments that are subsequently modified by agreement with the borrower. If the amendments to the outstanding debt are "significant modifications" under applicable Treasury regulations, the modified debt may be considered to have been reissued to us at a gain in a debt-for-debt exchange with the borrower. In that event, we may be required to recognize taxable gain to the extent the principal amount of the modified debt exceeds our adjusted tax basis in the unmodified debt, even if the value of the debt or the payment expectations have not changed.

Table of Contents

Moreover, some of the mortgage-backed securities that we acquire may have been issued with original issue discount. We are required to report such original issue discount based on a constant yield method and will be taxed based on the assumption that all future projected payments due on such mortgage-backed securities will be made. If such mortgage-backed securities turn out not to be fully collectable, an offsetting loss deduction will become available only in the later year that uncollectability is provable.

Finally, in the event that mortgage-backed securities or any debt instruments we are treated as holding pursuant to our investments in mortgage-backed securities are delinquent as to mandatory principal and interest payments, we may nonetheless be required to continue to recognize the unpaid interest as taxable income as it accrues, despite doubt as to its ultimate collectability. Similarly, we may be required to accrue interest income with respect to subordinate mortgage-backed securities at the stated rate regardless of whether corresponding cash payments are received or are ultimately collectable. In each case, while we would in general ultimately have an offsetting loss deduction available to us when such interest was determined to be uncollectable, the utility of that deduction could depend on our having taxable income in that later year or thereafter.

***Certain apportionment rules may affect our ability to comply with the REIT asset and gross income tests.***

The Internal Revenue Code provides that a regular or a residual interest in a real estate mortgage investment conduit, or REMIC, is generally treated as a real estate asset for the purpose of the REIT asset tests, and any amount includible in our gross income with respect to such an interest is generally treated as interest on an obligation secured by a mortgage on real property for the purpose of the REIT gross income tests. If, however, less than 95% of the assets of a REMIC in which we hold an interest consist of real estate assets (determined as if we held such assets), we will be treated as holding our proportionate share of the assets of the REMIC for the purpose of the REIT asset tests and receiving directly our proportionate share of the income of the REMIC for the purpose of determining the amount of income from the REMIC that is treated as interest on an obligation secured by a mortgage on real property. In connection with the recently expanded Agency RMBS-backed HARP loan program in which we may invest, the IRS recently issued guidance providing that, among other things, if a REIT holds a regular interest in an "eligible REMIC," or a residual interest in an "eligible REMIC" that informs the REIT that at least 80% of the REMIC's assets constitute real estate assets, then the REIT may treat 80% of the interest in the REMIC as a real estate asset for the purpose of the REIT income and asset tests. Although the portion of the income from such a REMIC interest that does not qualify for purposes of the REIT 75% gross income test would likely be qualifying income for the purpose of the 95% REIT gross income test, the remaining 20% of the REMIC interest generally would not qualify as a real estate asset, which could adversely affect our ability to satisfy the REIT asset tests. Accordingly, owning such a REMIC interest could adversely affect our ability to qualify as a REIT.

***The "taxable mortgage pool" rules may increase the taxes that we or our stockholders may incur, and may limit the manner in which we effect future securitizations.***

Securitizations could result in the creation of taxable mortgage pools for U.S. federal income tax purposes. As a REIT, so long as we own 100% of the equity interests in a taxable mortgage pool, we generally would not be adversely affected by the characterization of the securitization as a taxable mortgage pool. Certain categories of stockholders, however, such as foreign stockholders eligible for treaty or other benefits, stockholders with net operating losses, and certain tax-exempt stockholders that are subject to unrelated business income tax, could be subject to increased taxes on a portion of their dividend income from us that is attributable to the taxable mortgage pool. In addition, to the extent that our stock is owned by tax-exempt "disqualified organizations," such as certain government-related entities and charitable remainder trusts that are not subject to tax on unrelated business income, we

Table of Contents

may incur a corporate level tax on a portion of our income from the taxable mortgage pool. In that case, we may reduce the amount of our distributions to any disqualified organization whose stock ownership gave rise to the tax. Moreover, we would be precluded from selling equity interests in these securitizations to outside investors, or selling any debt securities issued in connection with these securitizations that might be considered to be equity interests for tax purposes. These limitations may prevent us from using certain techniques to maximize our returns from securitization transactions.

***Our ability to invest in and dispose of "to be announced" securities could be limited by our election to be subject to tax as a REIT.***

We may purchase Agency RMBS through "to-be-announced" forward contracts, or TBAs. In certain instances, rather than take delivery of the Agency RMBS subject to a TBA, we may dispose of the TBA through a dollar roll transaction in which we agree to purchase similar securities in the future at a predetermined price or otherwise, which may result in the recognition of income or gains. We account for dollar roll transactions as purchases and sales of securities. The law is unclear regarding whether TBAs will be qualifying assets for the 75% asset test and whether income and gains from dispositions of TBAs will be qualifying income for the 75% gross income test. Accordingly, our ability to purchase Agency RMBS through TBAs and to dispose of TBAs, through dollar roll transactions or otherwise, could be limited.

***The failure of securities subject to repurchase agreements to qualify as real estate assets could adversely affect our ability to qualify as a REIT.***

We enter into financing arrangements that are structured as sale and repurchase agreements pursuant to which we nominally sell certain of our securities to a counterparty and simultaneously enter into an agreement to repurchase these securities at a later date in exchange for a purchase price. Economically, these agreements are financings which are secured by the securities sold pursuant thereto. We believe that we will be treated for REIT asset and income test purposes as the owner of the securities that are the subject of any such sale and repurchase agreement notwithstanding that such agreements may transfer record ownership of the securities to the counterparty during the term of the agreement. It is possible, however, that the IRS could assert that we did not own the securities during the term of the sale and repurchase agreement, in which case we could fail to qualify as a REIT.

***Liquidation of assets may jeopardize our REIT qualification.***

To qualify as a REIT, we must comply with requirements regarding our assets and our sources of income. If we are compelled to liquidate our investments to repay obligations to our lenders, we may be unable to comply with these requirements, ultimately jeopardizing our qualification as a REIT, or we may be subject to a 100% tax on any resultant gain if we sell assets that are treated as dealer property or inventory.

***Complying with REIT requirements may limit our ability to hedge effectively and may cause us to incur tax liabilities.***

The REIT provisions of the Internal Revenue Code substantially limit our ability to hedge our assets and liabilities. Any income from a hedging transaction we enter into to manage risk of interest rate changes with respect to borrowings made or to be made to acquire or carry real estate assets does not constitute "gross income" for purposes of the 75% or 95% gross income tests. To the extent that we enter into other types of hedging transactions, the income from those transactions is likely to be treated as non-qualifying income for purposes of both of the gross income tests. See "U.S. federal income tax considerations Taxation of Western Asset Mortgage Capital Corporation." As a result of these rules, we limit our use of advantageous hedging techniques or implement those hedges through a domestic TRS. This could increase the cost of our hedging activities because our TRS would be subject

Table of Contents

to tax on gains or expose us to greater risks associated with changes in interest rates than we would otherwise want to bear. In addition, losses in our TRS will generally not provide any tax benefit, except for being carried forward against future taxable income in the TRS.

***Qualifying as a REIT involves highly technical and complex provisions of the Internal Revenue Code.***

Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only limited judicial and administrative authorities exist. Even a technical or inadvertent violation could jeopardize our REIT qualification. Our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis. In addition, our ability to satisfy the requirements to qualify as a REIT depends in part on the actions of third parties over which we have no control or only limited influence, including in cases where we own an equity interest in an entity that is classified as a partnership for U.S. federal income tax purposes.



Table of Contents

**Forward-looking statements**

We believe that some of the information in this prospectus constitutes forward-looking statements within the definition of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are subject to risks and uncertainties. They include information about possible or assumed future results of our business, financial condition, liquidity, results of operations, plans and objectives. When we use the words "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "may" or similar expressions, we intend to identify forward-looking statements. Statements regarding the following subjects, among others, may be forward-looking:

use of proceeds of this offering;

our business and investment strategy;

our projected operating results;

our estimate of our book value per share as of September 14, 2012, which is described in "Summary Recent developments";

our ability to obtain financing arrangements;

financing and advance rates for Agency RMBS and our potential target assets;

our expected leverage;

general volatility of the securities markets in which we invest and the market price of our common stock;

our expected investments;

interest rate mismatches between Agency RMBS and our potential target assets and our borrowings used to fund such investments;

changes in interest rates and the market value of Agency RMBS and our potential target assets;

changes in prepayment rates on Agency RMBS and non-Agency RMBS;

effects of hedging instruments on Agency RMBS and our potential target assets;

rates of default or decreased recovery rates on Agency RMBS and our potential target assets;

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

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

impact of and changes in governmental regulations, tax law and rates, accounting guidance and similar matters;

our ability to maintain our qualification as a REIT;

our ability to maintain our exemption from registration under the 1940 Act;

availability of investment opportunities in mortgage-related, real estate-related and other securities;

availability of qualified personnel;

estimates relating to our ability to make distributions to our stockholders in the future;

our understanding of our competition; and

market trends in our industry, interest rates, real estate values, the debt securities markets or the general economy, including, without limitation, the impact of QE3 on our investments and business.

Table of Contents

The forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. You should not place undue reliance on these forward-looking statements. These beliefs, assumptions and expectations can change as a result of many possible events or factors, not all of which are known to us. Some of these factors are described in this prospectus under the headings "Summary," "Risk factors," "Management's discussion and analysis of financial condition and results of operations" and "Business." If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. Any forward-looking statement speaks only as of the date on which it is made. New risks and uncertainties arise over time, and it is not possible for us to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

In addition, the estimate of our book value per share as of September 14, 2012 may differ from the book value per share that is ultimately reflected in our financial statements as of and for the period ending September 30, 2012. Fair values for our securities are dependent upon a number of market-based assumptions including future interest rates, prepayment rates, discount rates, credit loss rates, and the timing of credit losses.

Table of Contents

**Use of proceeds**

In this offering, we are offering 12,000,000 shares of our common stock at \$22.20 per share. Assuming no shares are issued pursuant to the underwriters' option to purchase up to an additional 1,800,000 shares, this offering would result in gross proceeds of \$262.2 million to us. We currently estimate the expenses attributable to this offering to be \$0.5 million. Therefore, we estimate that our aggregate net proceeds from this offering will be \$261.7 million, after deducting our estimated offering expenses (or \$301 million, if the underwriters exercise their option to purchase up to an additional 1,800,000 shares, in full).

We plan to use the net proceeds from this offering to purchase Agency RMBS and our potential target assets, focusing predominantly on Agency RMBS. Subject to prevailing market conditions at the time of purchase, we currently expect that the capital we deploy will be used initially to purchase Agency RMBS and our potential target assets in order to construct an overall portfolio with asset allocations in the following ranges: approximately 85-100% Agency RMBS, approximately 0-15% non-Agency RMBS, approximately 0-5% CMBS and approximately 0-5% ABS. Until appropriate investments can be identified, our Manager may invest the net proceeds from this offering in interest-bearing short-term investments, including money market accounts and/or funds, that are consistent with our intention to qualify as a REIT and maintain our exemption from registration under the 1940 Act. These initial investments, if any, are expected to provide a lower net return than we seek to achieve from investments in Agency RMBS and our potential target assets. We anticipate that we will be able to identify a sufficient amount of investments in Agency RMBS and our potential target assets within approximately one to two months after the closing of this offering. However, depending on the availability of appropriate investment opportunities and subject to market prevailing conditions, there can be no assurance that we will be able to identify a sufficient amount of investments within this timeframe.

Prior to the time we have fully used the net proceeds of this offering to acquire Agency RMBS and our potential target assets, we may fund our quarterly distributions out of such net proceeds.

Table of Contents**Market prices and distribution policy**

Our common stock is listed on the NYSE under the symbol "WMC". On September 26, 2012, the closing price of our common stock was reported by the NYSE was \$23.90. As of September 27, 2012, we had 15 stockholders of record.

The following table sets forth the range of high and low sales prices of our common stock as reported on NYSE and our dividends paid or declared for the period from May 10, 2012 (date trading commenced) to September 26, 2012.

Period	Sales Price		Dividends Declared
	High	Low	
For the period from May 10 to June 30, 2012	\$ 19.89	\$ 17.57	\$ 0.38
For the period from July 1, 2012 to September 26, 2012	\$ 24.72	\$ 19.25	\$ 0.85

We intend to make regular quarterly distributions to holders of our common stock. U.S. federal income tax law generally requires that a REIT distribute annually at least 90% of its net taxable income and that it pay tax at regular corporate rates to the extent that it annually distributes less than 100% of its net taxable income. We generally intend to make total annual distributions equal to all or substantially all of our taxable income for that year. On July 26, 2012, we declared a dividend of \$0.38 per share for the period from May 15, 2012 to June 30, 2012, which was paid August 14, 2012 to holders of record as of August 6, 2012. On September 20, 2012, we declared a dividend of \$0.85 per share for the period from July 1, 2012 to September 30, 2012, to be paid October 25, 2012 to holders of record as of October 1, 2012.

If we pay a taxable stock distribution, our stockholders would be sent a form that would allow each stockholder to elect to receive its proportionate share of such distribution in all cash or in all stock, and the distribution will be made in accordance with such elections, provided that if the stockholders' elections, in the aggregate, would result in the payment of cash in excess of the maximum amount of cash to be distributed, then cash payments to stockholders who elect to receive cash will be prorated, and the excess of each such stockholder's entitlement in the distribution, less such prorated cash payment, would be paid to such stockholder in shares of our common stock.

To the extent that in respect of any calendar year, cash available for distribution is less than our net taxable income, we could be required to sell assets or borrow funds to make cash distributions or make a portion of the required distribution in the form of a taxable stock distribution or distribution of debt securities. In addition, prior to the time we have fully invested the net proceeds of this offering, we may fund our quarterly distributions out of such net proceeds, which would reduce the amount of cash we have available for investing and other purposes. We will generally not be required to make distributions with respect to activities conducted through any TRSs. For more information, see "U.S. federal income tax considerations Taxation of Western Asset Mortgage Capital Corporation."

To satisfy the requirements to qualify as a REIT and generally not be subject to U.S. federal income and excise tax, we intend to make regular quarterly distributions and to distribute all or substantially all of our net taxable income on an annual basis to holders of our common stock out of assets legally available therefor. The amount of cash available for distribution will be decreased by any fees or expenses payable by us to our Manager under the Management Agreement. Any distributions we make will be at the discretion of our board of directors and will depend upon our earnings and financial condition, debt covenants, funding or margin requirements under repurchase agreements, warehouse facilities or other secured and unsecured borrowing agreements, maintenance of our REIT qualification, restrictions under Delaware law, and such other factors as our board of directors deems relevant. Our earnings and financial condition will be affected by various factors, including the net interest and other income from our portfolio, our operating expenses and any other expenditures. For

Table of Contents

more information regarding risk factors that could materially adversely affect our earnings and financial condition, see "Risk factors."

We anticipate that our distributions generally will be taxable as ordinary income to our stockholders, although a portion of the distributions may be designated by us as qualified dividend income or capital gain, or may constitute a return of capital. We will furnish annually to each of our stockholders a statement setting forth distributions paid during the preceding year and their characterization as ordinary income, return of capital, qualified dividend income or capital gain. For more information, see "U.S. federal income tax considerations Taxation of stockholders Taxation of taxable domestic stockholders."

Table of Contents**Capitalization**

The following table sets forth (1) our actual capitalization at June 30, 2012, and (2) our capitalization as adjusted to reflect the effect of:

The sale of 12,000,000 shares of our common stock in this offering at an offering price of \$22.20 per share;

the deduction of the underwriting discount of \$4.2 million; and

the deduction of our estimated offering expenses of \$0.5 million.

You should read this table together with "Use of proceeds" included elsewhere in this prospectus.

	As of June 30, 2012	
	Actual	As Adjusted
	(in thousands)	
Cash and cash equivalents	\$ 26,781	\$ 288,481
<b>Liabilities:</b>		
Borrowings under repurchase agreements	\$ 1,736,493	\$ 1,736,493
Other liabilities	119,695	119,695
Total liabilities	\$ 1,856,188	\$ 1,856,188
<b>Stockholder's equity:</b>		
Common stock, par value \$0.01 per share; 500,000,000 shares authorized and 10,343,944 shares issued and outstanding, actual and 500,000,000 shares authorized and 22,343,944 shares issued and outstanding , as adjusted <sup>(1)</sup>	\$ 103	\$ 223
Preferred stock, par value \$0.01 per share; 100,000,000 shares authorized and 0 shares issued and outstanding, actual and as adjusted		
Additional paid in capital <sup>(2)</sup>	204,308	465,888
Retained earnings	4,261	4,261
<b>Total stockholder's equity</b>	<b>\$ 208,672</b>	<b>\$ 470,372</b>

(1) Does not include (i) the approximately 1,115,893 shares initially issuable upon exercise of our outstanding warrants, and (ii) the shares of our common stock available for future grants under our equity incentive plans, which is expected to be equal to 602,221 shares of our common stock at the completion of this offering (after deduction of the grant of 51,159 shares of restricted common stock to our Manager and an aggregate of 4,500 shares of restricted common stock to our three independent directors upon the consummation of our IPO and the grant of 10,455 shares of restricted common stock to our chief financial officer on June 25, 2012).

(2) Additional paid-in-capital, as adjusted has been reduced by our estimated offering expenses, which we currently estimate to be \$0.5 million and the underwriting discount of \$4.2 million.

Table of Contents**Selected financial information**

The following table presents selected financial information as of June 30, 2012 and for the period May 15, 2012 to June 30, 2012 that has been derived from our historical financial statements and the related notes included elsewhere in this prospectus.

The following selected financial information is only a summary and is qualified by reference to and should be read in conjunction with "Management's discussion and analysis of financial condition and results of operations" and our audited balance sheet as of March 31, 2012 and our unaudited financial statements as of June 30, 2012 and for the period May 15, 2012 to June 30, 2012 and the related notes thereto included elsewhere in this prospectus.

**Statement of operations data:**

	<b>For the period from May 15, 2012 (commencement of operations) through June 30, 2012 (in thousands)</b>
<b>Net Interest Income:</b>	
Interest income	\$ 6,850
Interest expense	725
<b>Net Interest Income</b>	<b>6,125</b>
<b>Other Income (Loss):</b>	
Realized gain on sale of Residential mortgage-backed securities and other securities, net	1,120
Other loss on Residential mortgage-backed securities	(605)
Unrealized gain on Residential mortgage-backed securities and other securities, net	3,925
Loss on derivative instruments (includes (\$5,408) mark-to-market adjustments on derivative instruments), net	(5,313)
<b>Other Income (Loss), net</b>	<b>(873)</b>
<b>Operating Expenses:</b>	
General and administrative (includes \$54 non-cash stock based compensation)	584
Management fee related party	407
<b>Total Operating Expenses</b>	<b>991</b>
<b>Net income available to Common Stock and participating securities</b>	<b>\$ 4,261</b>
<b>Earnings per Common Share Basic and Diluted</b>	<b>\$ 0.41</b>
<b>Basic and diluted weighted average number of common shares outstanding</b>	<b>10,334,824</b>
<b>Dividends Declared per Share of Common Stock</b>	<b>\$</b>



Table of Contents**Balance sheet data:**

	June 30, 2012	December 31, 2011
	(in thousands)	
<b>Assets:</b>		
Cash and cash equivalents	\$ 26,781	\$ 1
Residential mortgage-backed securities, at fair value (\$1,819,089 pledged as collateral, at fair value)	1,918,832	
Investment related receivables	102,336	
Accrued interest receivable	7,076	
Due from counterparties	8,000	
Derivative assets, at fair value	1,283	
Other assets	552	
<b>Total Assets</b>	<b>2,064,860</b>	<b>1</b>
<b>Liabilities and Stockholders' Equity:</b>		
<b>Liabilities:</b>		
Borrowings under repurchase agreements	\$ 1,736,493	\$
Investment related payables	106,019	
Accrued interest payable	1,000	
Due to counterparties	4,309	
Derivative liability, at fair value	6,327	
Accounts payable and accrued expenses	433	
Payable to related party	1,607	
<b>Total Liabilities</b>	<b>1,856,188</b>	
<b>Commitments and contingencies</b>		
<b>Stockholders' Equity:</b>		
Common stock, \$0.01 par value, 500,000,000 and 100,000 shares authorized, 10,343,944 and 100 shares issued and outstanding, respectively	103	
Preferred stock, \$0.01 par value, 100,000,000 shares authorized and no shares outstanding		
Additional paid-in capital	204,308	1
Retained earnings	4,261	
<b>Total Stockholders' Equity</b>	<b>208,672</b>	<b>1</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 2,064,860</b>	<b>\$ 1</b>

Table of Contents

**Management's discussion and analysis of financial condition  
and results of operations**

*You should read the following discussion in conjunction with the sections of this prospectus entitled "Risk factors," "Forward-looking statements" and "Business" and our audited balance sheet dated as of March 31, 2012 and our unaudited financial statements dated as of June 30, 2012 and for the period May 15, 2012 to June 30, 2012 and the related notes thereto included elsewhere in this prospectus. This discussion contains forward-looking statements reflecting current expectations that involve risks and uncertainties. Actual results and the timing of events may differ materially from those contained in these forward-looking statements due to a number of factors, including those discussed in the section entitled "Risk factors" and elsewhere in this prospectus.*

**Overview**

We are primarily focused on investing in, financing and managing Agency RMBS. Although our core investment strategy is focused on Agency RMBS, we may opportunistically supplement our portfolio with non-Agency RMBS, CMBS and ABS, which we refer to as our potential target assets. We finance investments in Agency RMBS and our potential target assets primarily through the use of repurchase agreements.

We are organized as a Delaware corporation. We intend to elect and qualify to be taxed as a REIT, commencing with our taxable year ending December 31, 2012. We generally will not be subject to U.S. federal income taxes on our taxable income to the extent that we annually distribute all of our net taxable income to stockholders and maintain our intended qualification as a REIT. We also operate our business in a manner that will permit us to maintain our exemption from registration under the 1940 Act.

We are externally managed and advised by our Manager, an SEC-registered investment advisor and a wholly-owned subsidiary of Legg Mason. Our Manager is responsible for administering our business activities and our day-to-day operations, subject to the supervision of our board of directors. On May 9, 2012, we entered into: (i) a binding underwriting agreement with a group of underwriters to sell 8.0 million shares of our common stock for \$20.00 per share in our IPO for an aggregate offering price of \$160.0 million; (ii) unit purchase agreements pursuant to a private placement with certain institutional investors to sell 2,231,787 units for \$20.00 per unit for an aggregate offering price of approximately \$44.6 million; and (iii) a securities purchase agreement to sell 46,043 shares of our common stock for \$20.00 per share to our Manager's deferred compensation plan in another private placement for an aggregate offering price of approximately \$0.9 million.

Each of the aforementioned units consists of one share of our common stock and a warrant to purchase 0.5 of a share of our common stock. Each warrant has an exercise price of \$20.50 per share, subject to adjustment upon the occurrence of customary events triggering an anti-dilution adjustment and certain sales of our common stock and subject to certain limitations on exercise.

The net proceeds from our IPO and concurrent private placements were received on May 15, 2012. The net proceeds to us were approximately \$204.4 million, net of offering expenses of \$1.2 million for which we agreed to be responsible. Our Manager agreed to be responsible for: (i) all offering expenses in excess of \$1.2 million; and (ii) the underwriting discount and other costs in our IPO and the placement agent fees in the two private placements (in the aggregate, approximately \$7.8 million).

We use leverage, currently comprised of borrowings under repurchase agreements, as part of our business strategy in order to increase potential returns to stockholders. We accomplish this by borrowing against existing mortgage-backed securities through repurchase agreements. There are no limits on the maximum amount of leverage that we may use, and we are not required to maintain any

Table of Contents

particular debt-to-equity leverage ratio. We may also change our financing strategy and leverage without the consent of stockholders.

As of June 30, 2012, we had entered into master repurchase agreements with nine counterparties representing over \$1.9 billion of potential funding capacity. Since June 30, 2012, we have entered into repurchase agreements with an additional four counterparties, and we are in discussions with other financial institutions for additional repurchase agreement capacity. As of June 30, 2012, we had approximately \$1.7 billion of borrowings outstanding under our repurchase agreements collateralized by approximately \$1.8 billion of Agency RMBS. We have entered into swaps to effectively fix (for the life of the swap) the floating interest rate of approximately \$1.0 billion of borrowings under our repurchase agreements as of June 30, 2012. As of June 30, 2012, our debt-to-equity ratio was approximately 8.3 to 1.

**Recent market conditions and strategy**

Our business is affected by general U.S. residential real estate fundamentals and the overall U.S. economic environment. In particular, our strategy is influenced by the specific characteristics of these markets, including prepayment rates and interest rate levels. We expect the results of our operations to be affected by various factors, many of which are beyond our control. Our results of operations will primarily depend on, among other things, the level of our net interest income, the market value of our investment portfolio and the supply of and demand for mortgage-related securities. Our net interest income, which includes the amortization of purchase premiums and accretion of discounts, will vary primarily as a result of changes in interest rates, borrowing costs, and prepayment speeds on our RMBS investments, which is a measurement of how quickly borrowers pay down the unpaid principal balance on their residential mortgage loans.

The current economic and market outlook are shaped in a significant manner by the unprecedented level of fiscal and monetary stimulus that the U.S. Government and U.S. Federal Reserve Board provided in the aftermath of the 2008 credit crisis. The current rate environment is characterized by a steep yield curve with the spread between two-year U.S. Treasury Notes and ten-year U.S. Treasury Notes well above the average spread over the last three decades. The U.S. Federal Reserve Board has maintained a near-zero target for the federal funds rate, and has reiterated its commitment to fulfilling its mandate to promote higher growth and lower unemployment and to maintain price stability in the U.S. economy.

It is our Manager's view that while recent economic data suggests an improvement in U.S. economic growth, the significant mortgage debt burden, run-off of fiscal stimulus and budget discipline at both the U.S. federal and state level will serve as a heavy anchor to real GDP and employment growth in 2012 and 2013. Recent inflation data has been relatively modest, and we do not believe core rates will increase meaningfully, largely due to a plentiful supply of labor preventing wage pressure and low rates of resource utilization. For these reasons, and considering its dual mandate to manage both inflation and unemployment, we believe that the U.S. Federal Reserve Board will exercise patience before unwinding any form of monetary stimulus now in effect. We expect this type of muted recovery to keep the yield curve relatively steep and, barring any system shocks to the capital markets, for healthy demand for Agency RMBS to continue.

We believe investors continue to seek incremental spreads relative to U.S. Treasury Notes in a low yield environment and financial institutions continue to prefer high quality, liquid Agency RMBS. Yield spreads on Agency RMBS securities are attractive relative to historical spread levels. Prepayments that are being made at rates less than the historical average should provide opportunity to capture such spread, which we refer to as the carry premium. As the capital markets have recovered, commercial banks have re-entered the secured lending market, which has quickened the pace of asset recovery, and the return to more normalized credit spreads. Financing of Agency and non-Agency RMBS is currently

## Table of Contents

widely available through, among other vehicles, repurchase agreements. Haircuts, or the discount attributed to the value of securities sold under repurchase agreements, average between 3% and 10% for Agency RMBS and average between 10% and 50% for non-Agency RMBS, depending on the specific security used as collateral for such repurchase agreements.

The U.S. government, through the FHA, the Federal Deposit Insurance Corporation, or FDIC, and the U.S. Treasury, has commenced or proposed implementation of programs designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. These loan modification and refinancing programs, future U.S. federal, state and/or local legislative or regulatory actions that result in the modification of outstanding mortgage loans, as well as changes in the requirements necessary to qualify for refinancing mortgage loans with FNMA, FHLMC or GNMA, may adversely affect the value of, and the returns on, residential mortgage loans, RMBS, real estate-related securities and various other asset classes in which we may invest. In addition to the foregoing, the U.S. Congress and/or various states and local legislators may enact additional legislation or regulatory action designed to address the current economic crisis or for other purposes that could have a material adverse effect on our ability to execute our business strategies.

On January 4, 2012, the U.S. Federal Reserve Board released a report titled *"The U.S. Housing Market: Current Conditions and Policy Considerations"* to Congress providing a framework for thinking about certain issues and tradeoffs that policy makers might consider. It is unclear how future legislation may impact the housing finance market and the investing environment for agency securities as the method of reform is undecided and has not yet been defined by the regulators.

In a statement issued at the conclusion of its August 1, 2012 meeting, the U.S. Federal Reserve Board acknowledged that despite some signs of improvement, the U.S. housing sector remains depressed. Based on the deceleration in economic and employment growth as well as the expectation for continued low inflation, the U.S. Federal Reserve Board announced that it would continue its highly accommodative fiscal policy and extend through the end of the year its program to extend the average maturity of its holdings of securities by continuing to reinvest principal payments received on its holdings of Agency debt and Agency RMBS in additional Agency RMBS. This program, dubbed "Operation Twist," was originally announced in September 2011. On June 20, 2012, the U.S. Federal Reserve announced that it would extend "Operation Twist" through 2012 by purchasing and selling an additional \$267 billion of such securities. By extending the average maturity of securities held by the U.S. Federal Reserve Board in its portfolio, the expectation is that such action will create downward pressure on longer-term interest rates, which, in turn, will ease financial conditions in the U.S. and provide additional stimulus to support the economic recovery. For additional information regarding recent developments impacting the RMBS market, see "Summary Recent developments".

## **Investment strategy**

Our Manager's investment philosophy, which developed from a singular focus in fixed-income asset management over a variety of credit cycles and conditions, is to provide clients with diversified, tightly controlled, long-term value-oriented portfolios. Through rigorous analysis of all sectors of the fixed-income market, our Manager seeks to identify assets with the greatest risk-adjusted total value potential. In making investment decisions on our behalf, our Manager incorporates its views on the economic environment and the outlook for the mortgage markets, including relative valuation, supply and demand trends, the level of interest rates, the shape of the yield curve, prepayment rates, financing and liquidity, commercial and residential real estate prices, delinquencies, default rates, recovery of various segments of the economy and vintage of collateral, subject to maintaining our REIT qualification and our exemption from registration under the 1940 Act. We benefit from the breadth and depth of our Manager's overall investment philosophy, which focuses on a macroeconomic analysis as well as an in-depth analysis of individual assets and their relative value.

Table of Contents

We rely on our Manager's expertise in asset allocation and identifying attractive assets within our investment strategy. Although our core investment strategy is currently focused on Agency RMBS, our Manager's expertise in related investment disciplines such as non-Agency RMBS, CMBS, and ABS provides our Manager with both: (1) valuable investment insights to our Agency RMBS investment selection and strategy; and (2) flexibility to invest in assets other than Agency RMBS opportunistically as market conditions warrant.

We currently purchase and sell Agency RMBS and, in the future, may purchase and sell our other potential target assets. Our Manager has not and does not purchase securities on our behalf with a view to selling them shortly after purchase. However, in order to maximize returns and manage portfolio risk while remaining opportunistic, we may dispose of securities earlier than anticipated or hold securities longer than anticipated depending upon prevailing market conditions, credit performance, availability of leverage or other factors regarding a particular security or our capital position.

**Target assets**

We have invested the proceeds of our IPO and concurrent private placements and expect to continue to focus on investing in the following types of securities:

*Agency RMBS*

Agency RMBS, which are RMBS for which the principal and interest payments are guaranteed by a U.S. Government agency, such as GNMA, or a U.S. Government-sponsored entity, such as FNMA or FHLMC. The Agency RMBS we acquire could be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages. Fixed-rate mortgages have interest rates that are fixed for the term of the loan and do not adjust. The interest rates on adjustable-rate mortgages generally adjust annually (although some may adjust more frequently) to an increment over a specified interest rate index. Hybrid adjustable-rate mortgages have interest rates that are fixed for a specified period of time (typically three, five, seven or ten years) and, thereafter, adjust to an increment over a specified interest rate index. Adjustable-rate mortgages and hybrid adjustable-rate mortgages generally have periodic and lifetime constraints on how much the loan interest rate can change on any predetermined interest rate reset date. As of June 30, 2012, all of our Agency RMBS were secured by fixed-rate mortgages.

*Mortgage pass-through certificates.* Mortgage pass-through certificates are securities representing interests in "pools" of mortgage loans secured by residential real property where payments of both interest and principal, plus pre-paid principal, on the securities are made monthly to holders of the securities, in effect "passing through" monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer/guarantor and servicers of the securities

*Agency Derivatives*

*Agency Interest-Only Strips.* This type of security only entitles the holder to interest payments. The yield to maturity of Agency Interest-Only Strips is extremely sensitive to the rate of principal payments (particularly prepayments) on the underlying pool of mortgages. We invest in these types of securities primarily to take advantage of particularly attractive prepayment-related or structural opportunities in the Agency RMBS markets, as well as to help manage the duration of our overall portfolio.

*Agency Inverse Interest-Only RMBS.* This type of security has a coupon with an inverse relationship to its index and is subject to caps and floors. Agency Inverse Interest-Only RMBS entitles the holder to interest only payments based on a notional principal balance, which is typically equal to a fixed rate of interest on the notional principal balance less a floating rate of interest on the notional

Table of Contents

principal balance that adjusts according to an index subject to set minimum and maximum rates. The value of Agency Inverse Interest-Only RMBS will generally decrease when its related index rate increases and increase when its related index rate decreases.

*Collateralized Mortgage Obligations, or CMOs.* CMOs are securities that are structured from residential pass-through certificates, which receive monthly payments of principal and interest. CMOs divide the cash flows which come from the underlying mortgage pass-through certificates into different classes of securities that may have different maturities and different weighted average lives than the underlying pass-through certificates.

One type of Agency RMBS we intend to invest in, but have not yet done so, is described below.

*TBA.* We may utilize "to-be-announced" forward contracts, or TBAs, in order to invest in Agency RMBS. Pursuant to these TBAs, we would agree to purchase, for future delivery, Agency RMBS with certain principal and interest terms and certain types of underlying collateral, but the particular Agency RMBS to be delivered would not be identified until shortly before the TBA settlement date. Our ability to purchase Agency RMBS through TBAs may be limited by the 75% income and asset tests applicable to REITs.

**Potential target assets**

Although our core investment strategy is focused on Agency RMBS, we may opportunistically supplement our portfolio with the types of assets described below.

*Non-Agency RMBS.* RMBS that are not guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, with an emphasis on securities that, when originally issued, were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations.

The mortgage loan collateral for non-Agency RMBS consists of residential mortgage loans that do not generally conform to underwriting guidelines issued by a U.S. Government agency or U.S. Government-sponsored entity due to certain factors, including mortgage balances in excess of agency underwriting guidelines, borrower characteristics, loan characteristics and level of documentation, and therefore are not issued or guaranteed by an Agency. The mortgage loan collateral may be classified as subprime, Alternative-A or prime depending on the borrower's credit rating and the underlying level of documentation. The non-Agency RMBS we may acquire could be secured by fixed-rate mortgages, adjustable-rate mortgages or hybrid adjustable-rate mortgages.

*CMBS.* Fixed and floating rate CMBS, with an emphasis on securities that, when originally issued, were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. We have not established a minimum current rating requirement.

*ABS.* Debt and/or equity tranches of securitizations backed by various asset classes including, but not limited to, small balance commercial mortgages, aircrafts, automobiles, credit cards, equipment, manufactured housing, franchises, recreational vehicles and student loans with an emphasis on securities that when originally issued were rated in the highest rating category by one or more of the nationally recognized statistical rating organizations. Investments in ABS generally are not qualifying assets for purposes of the 75% asset test applicable to REITs and generally do not generate qualifying income for purposes of the 75% income test applicable to REITs. As a result, we may be limited in our ability to invest in such assets.

*Other Agency MBS.* We may also invest in mortgage-backed securities, or MBS, for which the principal and interest payments are guaranteed by a U.S. Government agency or U.S. Government-sponsored entity, but for which the underlying mortgage loans are secured by real property other than single family residences. These may include, but are not limited to FNMA DUS (Delegated

Table of Contents

Underwriting and Servicing) MBS, FHLMC Multifamily Mortgage Participation Certificates and GNMA project loan pools, and/or CMOs structured from such collateral.

**Financing strategy**

The leverage that we employ is specific to each asset class and is determined based on several factors, including potential asset price volatility, margin requirements, the current cycle for interest rates, the shape of the yield curve, the outlook for interest rates and our ability to use and the effectiveness of interest rate hedges. We analyze both historical volatility and market-driven implied volatility for each asset class in order to determine potential asset price volatility. Our leverage targets attempt to risk-adjust asset classes based on each asset class's potential price volatility. The goal of our leverage strategy is to ensure that, at all times, our investment portfolio's overall leverage ratio is appropriate for the level of risk inherent in the investment portfolio, and that each asset class has individual leverage targets that are appropriate for its potential price volatility.

We fund the acquisition of our assets through the use of leverage from a number of financing sources, subject to maintaining our qualification as a REIT. We finance purchases of Agency RMBS and fund our potential target assets primarily through the use of repurchase agreements.

Our operating results depend in large part on differences between the income earned on our assets and our cost of borrowing and hedging activities. We use leverage to increase potential returns to our stockholders. We accomplish this by borrowing against existing assets through repurchase agreements. There are no limits on the maximum amount of leverage that we may use, and we are not required to maintain any particular debt-to-equity leverage ratio. We may also change our financing strategy and leverage without the consent of our stockholders.

The costs associated with our borrowings are generally based on prevailing market interest rates. During a period of rising interest rates, our borrowing costs generally will increase while the yields earned on our existing portfolio of leveraged fixed-rate RMBS will remain static. This could result in a decline in our net interest spread and net interest margin. The severity of any such decline would depend on our asset/liability composition at the time, as well as the magnitude and duration of the interest rate increase. Further, an increase in short-term interest rates could also have a negative impact on the market value of our assets. If any of these events happen, we could experience a decrease in net income or incur a net loss during these periods, which could adversely affect our liquidity and results of operations.

We currently maintain a debt to equity ratio between seven to eleven times the amount of our stockholders' equity (calculated in accordance with U.S. GAAP), although there is no minimum or maximum leverage that our investment policies explicitly require. Depending on the different cost of borrowing funds at different maturities, we vary the maturities of our borrowed funds to attempt to produce lower borrowing costs and reduce interest rate risk. We enter into collateralized borrowings only with institutions that are rated investment grade by at least one nationally-recognized statistical rating organization. We rely on financing to acquire, on a leveraged basis, the target assets in which we invest. If market conditions deteriorate, our lenders may exit the repurchase market, and tighten lending standards, or increase the amount of equity capital required to obtain financing making it more difficult and costly for us to obtain financing.

For the period from May 15, 2012 (commencement of operations) through June 30, 2012, we financed Agency RMBS with repurchase agreements employing, on a debt-to-equity basis, approximately eight-to-one leverage. In the future, we may, however, be limited or restricted in the amount of leverage we may employ by the terms and provisions of any financing or other agreements, and may be subject to margin calls as a result of its financing activity. We had an aggregate debt-to-equity ratio of approximately 8.3 to 1 at June 30, 2012.

Table of Contents

We initially financed our Agency RMBS with repurchase agreement financing with maturities from one to three months, but in some cases may be longer. At June 30, 2012, we had entered into master repurchase agreements with nine counterparties representing over \$1.9 billion of potential funding capacity, and are in discussions with additional financial institutions in order to potentially provide us with additional repurchase agreement capacity. As of June 30, 2012, we had approximately \$1.7 billion outstanding under our repurchase facilities.

**Hedging Strategy**

Subject to maintaining our qualification as a REIT for U.S. federal income purposes, we pursue various hedging strategies to seek to reduce our exposure to adverse changes in interest rates. The U.S. federal income tax rules applicable to REITs may require us to implement certain of these techniques through a domestic TRS that is fully subject to federal corporate income taxation. At this stage we do not utilize a domestic TRS, although we may consider doing so in future. Our hedging activity varies in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. As of June 30, 2012, we had entered into swaps designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swaps provide for fixed interest rates indexed off of LIBOR and effectively fix the floating interest rates on approximately \$1.0 billion of borrowings under our repurchase agreements as of June 30, 2012. To date, we have not elected to apply hedge accounting for our derivatives and, as a result, we record the change in estimated fair value of our derivatives and the associated interest in earnings.

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

**Critical accounting policies**

Our financial statements are prepared in accordance with U.S. GAAP, which requires the use of estimates and assumptions that involve the exercise of judgment and use of assumptions as to future uncertainties. In accordance with SEC guidance, the following discussion addresses the accounting policies that we apply. Our most critical accounting policies involve decisions and assessments that could affect our reported assets and liabilities, as well as our reported revenues and expenses. We believe that all of the decisions and assessments upon which our financial statements have been based were reasonable at the time made and based upon information available to us at that time. We rely on independent pricing of our assets at each quarter's end to arrive at what we believe to be reasonable estimates of fair market value. We have identified what we believe will be our most critical accounting policies to be the following:

**Investments**

We have elected the fair value option for all of our RMBS at the date of purchase, which permits us to measure these securities at estimated fair value with the change in estimated fair value included as a component of earnings.

**Valuation of financial instruments**

We disclose the estimated fair value of our financial instruments according to a fair value hierarchy (Levels I, II, and III, as defined below). In accordance with U.S. GAAP, we are required to provide enhanced disclosures regarding instruments in the Level III category (which require significant management judgment), including a separate reconciliation of the beginning and ending balances for each major category of assets and liabilities. U.S. GAAP establishes a framework for measuring



Table of Contents

estimated fair value in accordance with U.S. GAAP and expands financial statement disclosure requirements for fair value measurements. U.S. GAAP further specifies a hierarchy of valuation techniques, which is based on whether the inputs into the valuation technique are observable or unobservable. The hierarchy is as follows:

Level I Quoted prices in active markets for identical assets or liabilities.

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

Level III Prices are determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used.

The level in the fair value hierarchy within which a fair measurement in its entirety falls is based on the lowest level input that is significant to the fair value measurement in its entirety.

When available, we use quoted market prices to determine the estimated fair value of an asset or liability. If quoted market prices are not available, we consult with independent pricing services or third party broker quotes, provided that there is no ongoing material event that affects the issuer of the securities being valued or the market thereof. If there is such an ongoing event, or if quoted market prices are not available, our Manager determines the estimated fair value of the securities using valuation techniques that use, when possible, current market-based or independently-sourced market parameters, such as interest rates. In the event pricing is based on broker quotes, our Manager performs additional analysis on prices received based on broker quotes to validate the prices and adjustments are made as deemed necessary by our Manager to capture current market information.

Valuation techniques for RMBS may be based on models that consider the estimated cash flows of each debt tranche of the issuer, establish a benchmark yield, and develop an estimated tranche-specific spread to the benchmark yield based on the unique attributes of the tranche including, but not limited to, assumptions related to prepayment speed, the frequency of defaults and, for non-Agency RMBS, severity of defaults, and attributes of the collateral underlying such securities. To the extent the inputs are observable and timely, the values would be categorized in Level II of the fair value hierarchy; otherwise they would be categorized as Level III.

Fair value under U.S. GAAP represents an exit price in the normal course of business, not a forced liquidation price. If we were forced to sell assets in a short period to meet liquidity needs, the prices we receive could be substantially less than the recorded fair values of our assets. Furthermore, the analysis of whether it is more likely than not that we will be required to sell securities in an unrealized loss position prior to an expected recovery in value (if any), the amount of such expected required sales, and the projected identification of which securities would be sold is also subject to significant judgment, particularly in times of market illiquidity.

We determine the estimated fair value of derivative financial instruments and obtain quotations from a third party to facilitate the process of determining these fair values.

We review any changes to the valuation methodology to ensure the changes are appropriate. As markets and products develop and the pricing for certain products becomes more transparent, we continue to refine our valuation methodologies. The methods used may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Furthermore, while we anticipate that our valuation methods will be appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the estimated fair value of certain financial instruments could result in a different estimate of estimated fair value at the reporting date. We use inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced.

Table of Contents

**Interest income**

Interest income on mortgage-backed securities is accrued based on the outstanding principal balance and their contractual terms. Premiums and discounts associated with Agency RMBS and non-Agency RMBS rated AA and higher at the time of purchase are amortized into interest income over the estimated life of such securities using the effective yield method. We estimate prepayments for our securities and, as a result, if prepayments increase (or are expected to increase), we will accelerate the rate of amortization on premiums or discounts and make a retrospective adjustment to historical amortization. Alternatively, if prepayments decrease (or are expected to decrease) we will reduce the rate of amortization on the premiums or discounts and make a retrospective adjustment to historical amortization.

Interest income on the non-Agency RMBS purchased at a discount to par value and/or rated below AA at the time of purchase and Agency Interest-Only Strips not classified as derivatives is recognized based on the effective yield method. The effective yield on these securities is based on the projected cash flows from each security, which are estimated based on our observation of current information and events and include assumptions related to interest rates, prepayment rates and the timing and amount of credit losses. To the extent we invest in such securities, our Manager, on no less that a quarterly basis, will review and, if appropriate, make adjustments to its cash flow projections based on input and analysis received from external sources, internal models, and its judgment about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. Changes in cash flows from those originally projected, or from those estimated at the prior evaluation, may result in a change in the yield/interest income recognized on such securities. Actual maturities of these securities are affected by the contractual lives of the associated mortgage collateral, periodic payments of principal, and prepayments of principal. Therefore, actual maturities of these securities are generally shorter than stated contractual maturities. As of June 30, 2012, we had not invested in any non-Agency RMBS.

Based on the projected cash flows from any non-Agency RMBS which we may purchase at a discount to par value, a portion of the purchase discount may be designated as credit protection against future credit losses and, therefore, not accreted into interest income. The amount designated as credit discount may be adjusted over time, based on the actual performance of the security, its underlying collateral, actual and projected cash flow from such collateral, economic conditions and other factors. If the performance of a security with a credit discount is more favorable than forecasted, a portion of the amount designated as credit discount may be accreted into interest income prospectively.

**Repurchase agreements**

Mortgage-backed securities sold under repurchase agreements are treated as collateralized financing transactions, unless they meet sales treatment. Securities financed through a repurchase agreement remain on our balance sheet as an asset and cash received from the lender is recorded in our balance sheet as a liability. Interest paid in accordance with repurchase agreements is recorded as interest expense.

In instances where we acquire securities through repurchase agreements with the same counterparty from which the securities were purchased, we account for the purchase commitment and repurchase agreement on a net basis and record a forward commitment to purchase securities as a derivative instrument if the transaction does not comply with the criteria for gross presentation. Such forward commitments are recorded at fair value with subsequent changes in fair value recognized in income. Additionally, we record the cash portion of our investment in securities as a mortgage-related receivable from the counterparty on our balance sheet. If the transaction complies with the criteria for gross presentation, we record the assets and the related financing on a gross basis in our balance sheet, and the corresponding interest income and interest expense in our statements of operations.

Table of Contents

**Derivatives and hedging activities**

Subject to maintaining our qualification as a REIT for U.S. federal income tax purposes, we utilize derivative financial instruments to hedge the interest rate risk associated with our borrowings. Derivatives are used for hedging purposes rather than speculation. We determine their estimated fair value and obtain quotations from a third party to facilitate the process of determining these estimated fair values. If our hedging activities do not achieve the desired results, reported earnings may be adversely affected.

U.S. GAAP requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at estimated fair value. Fair value adjustments are recorded in earnings immediately, if the reporting entity does not elect hedge accounting for a derivative instrument.

We have elected not to apply hedge accounting for these derivative instruments and record the change in estimated fair value and net interest rate swap payments (including accrued amounts) related to interest rate swaps in earnings.

We evaluate all of our financial instruments to determine if such instruments are derivatives or contain features that qualify as embedded derivatives. For derivative financial instruments that are accounted for as liabilities, the derivative instrument is initially recorded at its fair value and is then re-valued at each reporting date, with changes in the fair value reported in the statements of operations. For stock-based derivative financial instruments, we use a variation of the adjusted Black-Scholes option valuation model to value the derivative instruments at inception.

We also invest in Agency Interest-Only Strips. We have evaluated the terms and conditions of our holdings of Agency Interest-Only Strips to determine if these instruments have the characteristics of an investment or should be considered a derivative under U.S. GAAP. Accordingly, interest-only strips having the characteristics of derivatives have been accounted for at fair value with changes in recognized in Loss on derivative instruments in our statement of operations, along with any interest received. The carrying value of these Agency Interest-Only Strips is included in Residential mortgage-backed securities on the balance sheet.

**Income taxes**

We intend to elect and qualify to be taxed as a REIT commencing with our taxable year ending December 31, 2012. Accordingly, we will generally not be subject to corporate U.S. federal or state income tax to the extent that we make qualifying distributions to our stockholders, and provided that we satisfy on a continuing basis, through actual investment and operating results, the REIT requirements including certain asset, income, distribution and stock ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal, state and local income taxes and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year in which we lost our REIT qualification. Accordingly, our failure to qualify as a REIT could have a material adverse impact on our results of operations and amounts available for distribution to our stockholders.

Our dividends paid deduction for qualifying dividends paid to our stockholders is computed using our taxable income as opposed to net income reported on the financial statements. Taxable income, generally, will differ from net income reported on the financial statements because the determination of taxable income is based on tax provisions and not financial accounting principles.

We may elect to treat certain of our subsidiaries as TRSs. In general, a TRS of ours may hold assets and engage in activities that we cannot hold or engage in directly and generally may engage in any real estate or non-real estate-related business. A TRS is subject to U.S. federal, state and local corporate income taxes. While a TRS will generate net income, a TRS can declare dividends to us,

Table of Contents

which will be included in our taxable income and necessitate a distribution to our stockholders. Conversely, if we retain earnings at a TRS level, no distribution is required and we can increase book equity of the consolidated entity. As of June 30, 2012, we did not have a TRS, or any other subsidiary.

**Warrants**

We account for the warrants comprising a part of the units issued in the concurrent private placement to certain institutional investors in accordance with Accounting Standards Codification 815, Accounting for Derivative Instruments and Hedging Activities, which provides guidance on the specific accounting treatment of a multitude of derivative instruments. The warrants issued have been evaluated by us and have been recorded at their relative fair value as a component of equity, using a variation of the adjusted Black-Scholes option valuation model to record these financial instruments at their relative fair values at issuance.

**Share-Based Compensation**

We account for share-based compensation to our independent directors, to our officers and employees, to our Manager and to employees of our Manager and its affiliates using the fair value based methodology prescribed by U.S. GAAP. Compensation cost related to restricted common stock issued to our independent directors and employees is measured at its estimated fair value at the grant date, and amortized into expense over the vesting period on a straight-line basis. Compensation costs related to restricted common stock issued to our Manager and to employees of our Manager and its affiliates are initially measured at estimated fair value at the grant date, and remeasured on subsequent dates to the extent the awards are unvested and are reported in the statement of operations as non-cash stock based compensation.

**Accounting standards applicable to emerging growth companies**

The JOBS Act contains provisions that relax certain requirements for "emerging growth companies which we qualify as. For as long as we are an emerging growth company, which may be up to five full fiscal years, unlike other public companies, we will not be required to: (i) comply with any new or revised financial accounting standards applicable to public companies until such standards are also applicable to private companies under Section 102(b)(1) of the JOBS Act; (ii) provide an auditor's attestation report on management's assessment of the effectiveness of our system of internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act; (iii) comply with any new requirements adopted by the PCAOB requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer; or (iv) comply with any new audit rules adopted by the PCAOB after April 5, 2012 unless the SEC determines otherwise. We have not made a decision whether to take advantage of all of these exemptions, but we may take advantage of any or all of such exemptions.

As noted above, under the JOBS Act, emerging growth companies can delay adopting new or revised accounting standards that have different effective dates for public and private companies until such time as those standards apply to private companies. We currently take advantage of such extended transition period. Since we are not required to comply with new or revised accounting standards on the relevant dates on which adoption of such standards is required for other public companies, our financial statements may not be comparable to the financial statements of companies that comply with public company effective dates. If we were to elect to comply with these public company effective dates, such election would be irrevocable pursuant to Section 107 of the JOBS Act.

Table of Contents

**Recent accounting pronouncements**

In May 2011, the Financial Accounting Standards Board, or FASB, issued guidance that clarifies its intent regarding the application of existing fair value measurement requirements including: 1) prohibiting the inclusion of block discounts in all fair value measurements, not just Level I measurements; 2) adding guidance on when to include other premiums and discounts in fair value measurements; 3) clarifying that the concepts of "highest and best use" and "valuation premise" apply only when measuring the fair value of non-financial assets; and 4) adding an exception that allows the measurement of a group of financial assets and liabilities with offsetting risks (a portfolio of derivative contracts) at their net exposure to a particular risk if certain criteria are met. For non-public entities, this guidance is effective for fiscal years beginning after December 15, 2011. We do not hold any Level III assets and, therefore, this update is not expected to have a material impact on our financial statements.

In December 2011, the FASB issued guidance requiring additional disclosure information about offsetting and related arrangements. Entities will be required to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet as well as instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of U.S. GAAP and those entities that prepare their financial statements on the basis of International Financial Reporting Standards. The guidance is effective for periods beginning on or after January 1, 2013 and interim periods within those annual periods. While this guidance may result in certain additional disclosures, it is not expected to have a material impact on our financial statements.

**Results of operations**

The following discussion of our results of operations highlights our performance for the period from May 15, 2012 (commencement of operations) through June 30, 2012. We commenced operations on May 15, 2012 and, accordingly, our results discussed below reflect our ramp up period and are not necessarily indicative of a fully invested portfolio over such period.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

### Table of Contents

#### **Investments**

The following table presents certain information about our investment portfolio at June 30, 2012:

	Principal Balance <sup>(1)</sup>	Unamortized Premium (Discount)	Amortized Cost <sup>(1)</sup>	Unrealized Gain (Loss)	Estimated Fair Value <sup>(1)</sup>	Net Weighted Average Coupon <sup>(2)</sup>	Weighted Average Yield <sup>(3)</sup>
<b>30-Year Mortgage</b>							
Coupon Rate:							
3.00%	\$ 159,816	\$ 3,034	\$ 162,850	\$ 1,189	\$ 164,039	3.0%	2.8%
3.50%	784,902	40,643	825,545	2,639	828,184	3.5%	3.0%
4.00%	419,065	31,108	450,173	(77)	450,096	4.0%	3.0%
7.00%	77,035	12,449	89,484	179	89,663	7.0%	0.9%
	1,440,818	87,234	1,528,052	3,930	1,531,982	3.8%	2.8%
<b>20-Year Mortgage</b>							
Coupon Rate:							
3.50%	186,074	11,062	197,136	(252)	196,884	3.5%	2.4%
4.00%	24,916	2,008	26,924	(88)	26,836	4.0%	2.3%
	210,990	13,070	224,060	(340)	223,720	3.6%	2.4%
<b>CMO Fixed Rate</b>	66,000	11,124	77,124	(316)	76,808	6.5%	4.9%
<b>IOs and IIOs<sup>(4)</sup></b>			58,827	651	59,478	4.3%	8.6%
<b>Agency interest-only strips accounted for as derivatives<sup>(4)</sup></b>					26,844	4.2% <sup>(5)</sup>	1.6%
					86,322	4.3%	6.4%
<b>Total</b>			\$ 1,888,063	\$ 3,925	\$ 1,918,832	4.0%	3.0%

- (1) Includes unsettled purchases with an aggregate cost of \$105,912 and estimated fair value of \$106,019 at June 30, 2012.
- (2) Net weighted average coupon as of June 30, 2012 is presented net of servicing and other fees.
- (3) Weighted average yield as of June 30, 2012 incorporates estimates for future prepayment and loss assumptions.
- (4) IOs and IIOs and Agency Interest-Only Strips accounted for as derivatives have no principal balances and bear interest based on a notional balance. The notional balance is used solely to determine interest distributions on interest-only class of securities.
- (5) Interest on these securities is reported as a component of Loss on derivative instruments.

As of June 30, 2012, our portfolio consisted primarily of fixed rate RMBS which our Manager believes exhibit prepayment mitigation attributes, including Agency RMBS collateralized by low loan balances or loans where the underlying borrower is unable to access the Making Home Affordable Program, including the HARP.

#### **Investment activity**

*RMBS, Agency Derivatives and Other Securities.* For the period from May 15, 2012 (commencement of operations) through June 30, 2012, we acquired approximately \$2.2 billion of Agency RMBS, including Agency Derivatives and \$100.7 million of other securities consisting

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

of U.S Treasury Notes. During the same period, we received principal payments of approximately \$8.0 million for Agency RMBS. Proceeds from sales received for the period from May 15, 2012 (commencement of operations) through June 30, 2012 were approximately \$238.9 million for Agency RMBS, including Agency Derivatives and \$100.9 million for other securities. The average unlevered yield on Agency

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

### Table of Contents

RMBS for the period from May 15, 2012 (commencement of operations) through June 30, 2012 was 3.04%.

*Financing and Other Liabilities.* We have entered into repurchase agreements to finance a substantial majority of our Agency RMBS. These agreements are secured by substantially all of our Agency RMBS and bear interest at rates that have historically moved in close relationship to LIBOR. For the period from May 15, 2012 (commencement of operations) through June 30, 2012, we received proceeds of approximately \$3.2 billion and made repayments of approximately \$1.5 billion under repurchase agreements. At June 30, 2012, we had outstanding repurchase agreement borrowings with the following nine counterparties totaling approximately \$1.7 billion:

(dollars in thousands) Repurchase Agreement Counterparties	Amount Outstanding	Percent of Total Amount Outstanding	Company MBS Held as Collateral <sup>(1)</sup>
Merrill Lynch Pierce Fenner & Smith Inc.	\$ 271,316	15.6%	\$ 281,668
Barclays Capital Inc.	160,818	9.3%	169,684
BNP Paribas Securities Corporation	70,904	4.1%	75,678
Credit Suisse Securities (USA) LLC	255,720	14.7%	267,024
Deutsche Bank Securities LLC	246,903	14.2%	260,938
Goldman Sachs Bank USA	97,064	5.6%	102,477
JP Morgan Securities LLC	299,274	17.2%	308,641
Morgan Stanley & Co. LLC	192,469	11.1%	203,063
RBC Capital Markets LLC	142,025	8.2%	149,916
<b>Total</b>	<b>\$ 1,736,493</b>	<b>100.0%</b>	<b>\$ 1,819,089</b>

(1) At fair value.

We record the liability for RMBS purchased, for which settlement has not taken place as an investment related payable. As of June 30, 2012, we had investment related payables of approximately \$106.0 million, of which no items were outstanding greater than 30 days.

The following table presents our borrowings by type of collateral pledged as of June 30, 2012, and the respective Effective Cost of Funds (a non-GAAP financial measure) for the period then ended (dollars in thousands). See " Non-GAAP financial measures":

Collateral	Balance June 30, 2012	Weighted Average Cost of Funds for the period ended June 30, 2012	Weighted Average Effective Cost of Funds for the period ended June 30, 2012 <sup>(1)</sup>
Agency RMBS	\$ 1,736,493	0.38%	0.76%
<b>Total</b>	<b>\$ 1,736,493</b>	<b>0.38%</b>	<b>0.76%</b>

(1) The effective cost of funds for the period presented is calculated on an annualized basis and includes interest expense for the period and net payments on interest rate swaps of approximately \$0.7 million. While swaps are not accounted for using hedge accounting, such instruments are viewed by us as an economic hedge against increases in interest rates.

*Derivative Instruments.* As of June 30, 2012, we had entered into swaps designed to mitigate the effects of increases in interest rates under a portion of our repurchase agreements. These swaps provide for fixed interest rates indexed off of LIBOR and are viewed by us to effectively fix the floating interest rates on approximately \$1.0 billion of borrowings under our repurchase agreements as of June 30, 2012.



## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

### Table of Contents

The following table presents information about our interest rate swaps as of June 30, 2012 (dollars in thousands):

Remaining Interest Rate interest rate swap Term	Notional Amount	Average Fixed Pay Rate	Average Maturity (Years)
Greater than 1 year and less than 3 years	\$ 320,000	0.7%	2.4
Greater than 3 years and less than 5 years	165,000	1.1	4.6
Greater than 5 years	530,500	1.8	10.0
<b>Total</b>	<b>\$ 1,015,500</b>	<b>1.3%</b>	<b>6.7</b>

### *Net interest income*

We earned interest income of approximately \$6.9 million for the period from May 15, 2012 (commencement of operations) through June 30, 2012, representing interest earned on our assets. We incurred interest expense of approximately \$0.7 million for the period from May 15, 2012 (commencement of operations) through June 30, 2012, which was related to borrowings from repurchase agreements.

(dollars in thousands)

Average amortized cost of RMBS <sup>(1)</sup>	\$ 1,724,206
Total interest income <sup>(2)</sup>	\$ 6,850
Yield on average RMBS	3.04%
Average balance of repurchase agreements	\$ 1,508,909
Total interest expense	\$ 725
Average cost of funds <sup>(3)</sup>	0.38%
Net interest income	\$ 6,125
Net interest rate spread	2.66%

(1) Amount reflects amortized cost, which does not include net mark-to-market adjustments on Agency Interest-Only Strips accounted for as derivatives.

(2) Amount includes net amortization of premiums and discounts of approximately \$(2.2) million.

(3) Cost of funds does not include accrual and settlement of interest associated with derivative instruments. In accordance with U.S. GAAP, those costs are included in gain (loss) on derivative instruments in the statement of operations.

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

### Table of Contents

The following table sets forth certain information regarding our net investment income for the period from May 15, 2012 (commencement of operations) through June 30, 2012. See " Non-GAAP financial measures":

#### **Non-GAAP Financial Measures:**

Average amortized cost of RMBS held including Agency Interest-Only Strips accounted for as derivatives	\$ 1,752,229
Total interest income including interest income on Agency Interest-Only Strips accounted for as derivatives <sup>(1)</sup>	\$ 7,230
Yield on average amortized cost of RMBS including adjustments related to purchase premiums and discounts on Agency Interest-Only Strips accounted for as derivatives	3.21%
Total interest expense including interest income (expense), net incurred on interest rate swaps <sup>(2)</sup>	\$ 1,450
Average cost of funds including interest income on Agency Interest-Only Strips accounted for as derivatives	0.76%
Net interest income including interest income on Agency Interest-Only Strips accounted for as derivatives and net settlement costs on interest rate swaps	\$ 5,780
Net interest rate spread including interest income on Agency Interest-Only Strips classified as derivatives and net settlement costs on interest rate swaps	2.45%

(1) Amount also includes net amortization of premiums and discounts of approximately \$(2.6 million) and approximately \$0.4 million of amortization of premiums on Agency Interest-Only Strips accounted for as derivatives, not reported in interest income for U.S. GAAP.

(2) Represents the net amount paid, including accrued amounts and realized termination gain (loss), for interest rate swaps during the period.

Interest income is subject to interest rate risk.

#### ***Realized and unrealized gain (loss)***

During the period from May 15, 2012 (commencement of operations) through June 30, 2012, we sold Agency RMBS and other securities of approximately \$339.7 million realizing gross gains of approximately \$1.1 million and gross losses of approximately \$25 thousand. We sold these RMBS in order to: (i) adjust the prepayment characteristics of our portfolio or (ii) adjust the duration of our portfolio.

With respect to our RMBS, we elected the fair value option and, as a result, we record the change in estimated fair value related to RMBS in earnings. The following table presents amounts related to realized gains and losses as well as changes in estimated fair value of our RMBS portfolio and

## Edgar Filing: Western Asset Mortgage Capital Corp - Form 424B5

### Table of Contents

derivative instruments that are included in our statement of operations for the period from May 15, 2012 (commencement of operations) through June 30, 2012 (dollars in thousands):

Description	Interest Income (Expense), net	Other loss on Residential mortgage- backed securities	Unrealized Gain (Loss), net	Mark-to- market adjustments	Total
RMBS and Other Securities	\$ 1,120	\$	\$ 3,925	\$	\$ 5,045
IOs and IIOs		(605)			(605)
Interest rate swaps <sup>(1)</sup>	(722)		(5,044)		(5,766)
Agency Interest-Only Strips accounted for as derivatives <sup>(2)</sup>	817			(364)	453
<b>Total</b>	<b>\$ 1,215</b>	<b>\$ (605)</b>	<b>\$ (1,724)</b>	<b>\$ (364)</b>	<b>\$ 873</b>

(1) Interest Income (Expense), net on interest rate swaps represents the net amount paid, including accrued amounts, for swaps during the period and realized gains (losses) on swap terminations.

(2) Mark-to-market adjustments on Agency Interest-Only Strips accounted for as derivatives represent interest income on these securities based on the actual coupon.

In order to mitigate interest rate risk resulting from our repurchase agreements, we entered into interest rate swaps with an aggregate notional amount of approximately \$1.0 billion. While not designated as a hedge for accounting purposes, our interest rate swaps are viewed as an economic hedge on a portion of our floating-rate borrowings. Since we do not apply hedge accounting for our interest rate swaps, we record the change in estimated fair value related to such agreements in earnings as unrealized gain or loss on derivative transactions. Included in realized gain or loss on derivative instruments are the net interest rate swap payments (including accrued amounts) associated with our interest rate swaps.

### *Expenses*

#### *General and administrative expenses*

We incurred general and administrative expenses of approximately \$0.6 million for the period from May 15, 2012 (commencement of operations) through June 30, 2012, which represents professional fees, insurance, non-cash stock based compensation and overhead costs.

#### *Management fee expense*

We incurred management fee expense of approximately \$0.4 million for the period from May 15, 2012 (commencement of operations) through June 30, 2012, all of which was payable to our Manager under the Management Agreement. Pursuant to the terms of the Management Agreement, our Manager is paid a management fee equal to 1.5% per annum of our stockholders' equity (as defined in the Management Agreement), calculated and payable (in cash) quarterly in arrears.

#### *Subsequent events*

#### *Dividends*

The following table presents cash dividends declared by us on our common stock:

Declaration Date	Record Date	Payment Date	Amount per Share
July 26, 2012	August 6, 2012	August 14, 2012	\$ 0.38
September 20, 2012	October 1, 2012	October 25, 2012	\$ 0.85

