



Edgar Filing: Armour Residential REIT, Inc. - Form 10-Q

**3001 Ocean Drive, Suite 201, Vero Beach, FL 32963**

(Address of principal executive offices)(zip code)

**(772) 617-4340**

(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act:**

| <b>Title of Class</b>             | <b>Name of Exchange on which registered</b> |
|-----------------------------------|---|
| Common Stock, \$0.001 par value   | NYSE  |
| Warrants to Purchase Common Stock | NYSE  |

**Securities registered pursuant to Section 12(b) of the Act:**

None.

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES  NO

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

The number of outstanding shares of the Registrant's common stock as of May 2, 2011 was 49,260,077.

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## ARMOUR Residential REIT, Inc. and Subsidiaries

## CONDENSED CONSOLIDATED BALANCE SHEETS

**PART I. Financial Information****Item 1. Financial Statements**

|  | (Unaudited)      |                   |
|--|------------------|-------------------|
| Assets   | March 31, 2011   | December 31, 2010 |
| Cash   | \$ 47,174,161    | \$ 35,343,907     |
| Restricted cash  | 13,713,222       | 4,680,603         |
| Agency securities, available for sale, at fair value (including pledged assets of \$2,206,904,817 and \$1,023,749,488)   | 2,273,914,732    | 1,161,850,680     |
| Principal payments receivable  | 2,878,391        | 2,642,149         |
| Accrued interest receivable  | 7,705,149        | 3,892,834         |
| Prepaid and other assets   | 287,908          | 266,203           |
| Refundable income taxes  | -                | 547,574           |
| Total Assets   | \$ 2,345,673,563 | \$ 1,209,223,950  |
| <b>Liabilities and Stockholders Equity</b>   |                  |                   |
| Liabilities:   |                  |                   |
| Repurchase agreements  | \$ 2,099,366,245 | \$ 971,675,658    |
| Payable for unsettled securities   | 19,941,430       | 125,418,369       |
| Interest rate contracts, at fair value   | 4,666,298        | 2,530,645         |
| Accounts payable and accrued expenses  | 971,324          | 454,379           |
| Dividends payable  | 115,891          | 436,322           |
| Total Liabilities  | 2,125,061,188    | 1,100,515,373     |
| Stockholders Equity:   |                  |                   |
| Preferred stock, \$0.001 par value, 25,000,000 shares authorized, none outstanding at March 31, 2011 and December 31, 2010   | -                | -                 |
| Common stock, \$0.001 par value, 250,000,000 shares authorized, 32,254,054 and 16,441,554 shares issued and outstanding at March 31, 2011 and December 31, 2010, respectively. | 32,254           | 16,442            |
| Additional paid-in capital   | 229,733,052      | 116,748,175       |
| Accumulated deficit  | (4,677,964)      | (3,826,510)       |
| Accumulated other comprehensive loss   | (4,474,967)      | (4,229,530)       |
| Total Stockholders Equity  | 220,612,375      | 108,708,577       |
| Total Liabilities and Stockholders Equity  | \$ 2,345,673,563 | \$ 1,209,223,950  |

See notes to condensed consolidated financial statements.



## ARMOUR Residential REIT, Inc. and Subsidiaries

## CONDENSED CONSOLIDATED STATEMENTS of OPERATIONS

(Unaudited)

|   | <b>Three months<br/>Ended</b> | <b>Three months<br/>Ended</b> |
|---|-------------------------------|-------------------------------|
|   | <b>March 31, 2011</b>         | <b>March 31, 2010</b>         |
| <b>Interest Income:</b>                           |                               |                               |
| Interest income, net of amortization of premium   | \$ 13,734,829                 | \$ 1,108,138                  |
| Total interest income                             | 13,734,829                    | 1,108,138                     |
| <b>Interest expense:</b>                          |                               |                               |
| Repurchase agreements                             | (1,355,481)                   | (120,646)                     |
| Interest rate swap contracts                      | (2,021,259)                   | -                             |
| Total interest expense                            | (3,376,740)                   | (120,646)                     |
| <b>Net interest income</b>                        | <b>10,358,089</b>             | <b>987,492</b>                |
| <b>Other Income:</b>                              |                               |                               |
| Change in fair value of interest rate contracts   | (266,223)                     | (603,579)                     |
| Net interest income after change in fair value of |                               |                               |
| interest rate contracts                           | 10,091,866                    | 383,913                       |
| Realized loss on interest rate contracts          | (116,159)                     | -                             |
| Realized gain on sale of agency securities        | -                             | 208,199                       |
| Total net revenues                                | 9,975,707                     | 592,112                       |
| <b>Expenses:</b>                                  |                               |                               |
| Professional fees                                 | 371,014                       | 146,030                       |
| Insurance   | 51,156                        | 51,912                        |
| Management fee                                    | 755,820                       | 57,598                        |
| Other   | 192,644                       | 28,339                        |
| Total expenses                                    | 1,370,634                     | 283,879                       |
| Net income before taxes                           | 8,605,073                     | 308,233                       |
| Income tax expense                                | (9,000)                       | (2,400)                       |
| <b>Net Income</b>                                 | <b>\$ 8,596,073</b>           | <b>\$ 305,833</b>             |
| Weighted average shares outstanding :             |                               |                               |
| Basic and diluted                                 | 26,398,637                    | 2,304,054                     |
| Net income per share                              |                               |                               |
| Basic and diluted                                 | \$ 0.33                       | \$ 0.13                       |

See notes to condensed consolidated financial statements.



## ARMOUR Residential REIT, Inc. and Subsidiaries

## CONDENSED CONSOLIDATED STATEMENTS of STOCKHOLDERS EQUITY

(Unaudited)

|   | Accumulated  |           |                 |                     |                    |                      | Total           |
|---|--------------|-----------|-----------------|---------------------|--------------------|----------------------|-----------------|
|   | Common Stock |           | Additional      | Other               |                    |                      |                 |
|   | Shares       | Amount    | Paid-In Capital | Accumulated Deficit | Comprehensive Loss | Comprehensive Income |                 |
| <b>Balance, December 31, 2010</b>   | 16,441,554   | \$ 16,442 | \$ 116,748,175  | \$ (3,826,510)      | \$ (4,229,530)     |                      | -\$ 108,708,577 |
| Dividends declared  | -            | -         | -               | (9,447,527)         | -                  | -                    | (9,447,527)     |
| Sale of 15,812,500 shares, net of underwriters discount and offering expenses | 15,812,500   | 15,812    | 112,974,513     | -                   | -                  | -                    | 112,990,325     |
| Stock based compensation awarded to directors                                 | -            | -         | 10,364          | -                   | -                  | -                    | 10,364          |
| Net income  | -            | -         | -               | 8,596,073           | -                  | 8,596,073            | 8,596,073       |
| Net change in unrealized loss on investment in Available for Sale securities  | -            | -         | -               | -                   | (245,437)          | (245,437)            | (245,437)       |
| Comprehensive income  | -            | -         | -               | -                   | -\$                | 8,350,636            |                 |
| <b>Balance, March 31, 2011</b>  | 32,254,054   | \$ 32,254 | \$ 229,733,052  | \$ (4,677,964)      | \$ (4,474,967)     |                      | \$ 220,612,375  |

See notes to condensed consolidated financial statements.





## ARMOUR Residential REIT, Inc. and Subsidiaries

## CONDENSED CONSOLIDATED STATEMENTS of CASH FLOWS

(Unaudited)

|   | <b>Three months<br/>Ended</b> | <b>Three months<br/>Ended</b> |
|---|-------------------------------|-------------------------------|
|   | <b>March 31, 2011</b>         | <b>March 31, 2010</b>         |
| <b>Cash Flows From Operating Activities:</b>                                      |                               |                               |
| Net income  | \$ 8,596,073                  | \$ 305,833                    |
| Adjustments to reconcile net income to net cash provided by operating activities: |                               |                               |
| Net amortization of premium on Agency Securities                                  | 3,274,606                     | 610,659                       |
| Change in fair value of interest rate contracts                                   | 2,135,653                     | 596,925                       |
| Gain on sale of Agency Securities   | -                             | (208,199)                     |
| Stock based compensation  | 10,364                        | -                             |
| Changes in operating assets and liabilities:                                      |                               |                               |
| Increase in accrued interest receivable   | (3,812,315)                   | (550,054)                     |
| Decrease (increase) in prepaid income taxes and other assets                      | 525,869                       | (24,296)                      |
| Increase in accounts payable and accrued expenses                                 | 516,945                       | 45,694                        |
| Net cash provided by operating activities   | 11,247,195                    | 776,562                       |
| <b>Cash Flows From Investing Activities:</b>                                      |                               |                               |
| Purchases of Agency Securities  | (1,189,243,231)               | (147,963,888)                 |
| Principal repayments of Agency Securities   | 71,252,666                    | 6,562,794                     |
| Proceeds from sales of Agency Securities  | -                             | 31,531,266                    |
| Unsettled security purchases  | (103,306,711)                 | (15,927,169)                  |
| Net cash used in investing activities   | (1,221,297,276)               | (125,796,997)                 |
| <b>Cash Flows From Financing Activities:</b>                                      |                               |                               |
| Sale of common stock, net of expenses   | 112,990,325                   | -                             |
| Proceeds from repurchase agreements   | 4,541,638,738                 | 306,657,050                   |
| Principal repayments on repurchase agreements                                     | (3,413,948,151)               | (184,520,559)                 |
| Increase in restricted cash   | (9,032,619)                   | (917,184)                     |
| Dividends paid  | (9,767,958)                   | (70,447)                      |
| Net cash provided by financing activities   | 1,221,880,335                 | 121,148,860                   |
| <b>Net Increase (decrease) in cash</b>  | <b>11,830,254</b>             | <b>(3,871,575)</b>            |
| Cash - beginning of period  | 35,343,907                    | 6,653,331                     |
| Cash - end of period  | \$ 47,174,161                 | \$ 2,781,756                  |
| <b>Supplemental Disclosure:</b>   |                               |                               |
| Cash paid for income taxes (not including tax refunds received)                   | \$ 12,000                     | \$ 3,025                      |
| Cash paid during the period for interest  | \$ 1,104,971                  | \$ 88,381                     |
| <b>Non-Cash Investing Activity:</b>   |                               |                               |
| Net unrealized(loss) gain or investment in available for sale securities          | \$ (245,437)                  | 542,418                       |

See notes to condensed consolidated financial statements.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

**Note 1 Basis of Presentation**

The balance sheet as of December 31, 2010, which has been derived from the audited financial statements, and the unaudited financial statements included herein have been prepared from the books and records of ARMOUR Residential REIT, Inc. ( the Company ) pursuant to the rules and regulations of the Securities and Exchange Commission for reporting in the Quarterly Report on Form 10-Q. The information and note disclosures normally included in complete financial statements prepared in accordance with generally accepted accounting principles in the U.S ( GAAP ) have been condensed or omitted pursuant to such rules and regulations. The interim financial information should be read in conjunction with the audited financial statements and notes thereto for the year ended December 31, 2010, which are filed on Form 10-K.

The Company s management is responsible for this interim financial information. Interim results may not be indicative of the results that may be expected for the year. However, we believe that all adjustments considered necessary for a fair presentation of this financial information have been included and are of a normal and recurring nature.

**Note 2 - Organization and Nature of Business Operations**

*Business*

References to we , us , our "ARMOUR" or the Company are to ARMOUR Residential REIT, Inc. References to "ARRM" are to ARMOUR Residential Management LLC, a Delaware limited liability company. References to Enterprise are to Enterprise Acquisition Corp., a wholly-owned subsidiary of ARMOUR.

We are an externally-managed Maryland corporation organized in 2008, managed by ARRM. We invest primarily in hybrid adjustable rate, adjustable rate and fixed rate residential mortgage backed securities issued or guaranteed by a U.S. Government-chartered entity, such as the Federal National Mortgage Association (more commonly known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (more commonly known as Freddie Mac), or

guaranteed by the Government National Mortgage Administration, a U.S. Government corporation (more commonly known as Ginnie Mae) (collectively, "Agency Securities"). From time to time, a portion of our portfolio may be invested in unsecured notes and bonds issued by U.S. Government-chartered entities (collectively, Agency Debt ), U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a real estate investment trust ( REIT ).

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

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

### **Note 3 - Summary of Significant Accounting Policies**

#### *Basis of Presentation and Consolidation and Use of Estimates*

Our financial statements are presented in U.S. dollars in conformity with GAAP. The condensed consolidated financial statements include the accounts of ARMOUR and all subsidiaries; all intercompany accounts and transactions have been eliminated.

The preparation of financial information in conformity with GAAP requires management to make estimates that affect the reported assets and liabilities at the date of the balance sheet and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

*Cash*

Cash includes cash on deposit with financial institutions and investments in high quality overnight money market funds, all of which have maturities of three months or less, at time of purchase. We may maintain deposits in federally insured financial institutions in excess of federally insured limits. However, management believes we are not exposed to significant credit risk due to the financial position of the depository institutions in which those deposits are held. The carrying amount of cash is deemed to be its fair value.

*Restricted Cash*

Restricted cash at March 31, 2011 and December 31, 2010, represents approximately \$13.7 million and \$4.7 million, respectively, held by counterparties as collateral for interest rate contracts.

*Agency Securities, at Fair Value*

We invest primarily in Agency Securities. A portion of our portfolio may be invested in Agency Debt, U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a REIT. We have committed ourselves to the Agency asset class by including in our charter a requirement that all of our financial instrument investments will consist of Agency Securities, Agency Debt, U.S. Treasuries and money market instruments (including reverse repurchase agreements) and hedging and other derivative instruments related to the foregoing investments.

We classify our Agency Securities as either trading, available for sale or held to maturity securities. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date.

We may recognize impairments in our investment portfolio which, among other things, requires: the determination as to when an investment is considered impaired; whether that impairment is other than temporary; the measurement of an impairment loss; accounting considerations subsequent to the recognition of an other than temporary impairment; and certain disclosures about unrealized losses that have not been recognized as other than temporary impairments.

We assess our investment portfolio for other than temporary impairment on a quarterly basis, or more frequently if conditions merit. When the fair value of an investment is less than its amortized cost at the balance sheet date of the reporting period for which impairment is assessed, the impairment is designated as either temporary or other than temporary.

#### *Fair Value of Financial Instruments*

We consider our cash, restricted cash, Agency Securities, Available for Sale (settled and unsettled), accrued interest receivable, accounts payable, interest rate contracts, repurchase agreements and accrued interest payable to meet the definition of financial instruments. The carrying amount of cash, restricted cash, accrued interest receivable and accounts payable approximate their fair value due to the short maturities of these instruments. See Notes 5 and 6, respectively, for discussion of the fair value of Agency Securities, Available for Sale and Interest Rate Contracts. The carrying amount of repurchase agreements and accrued interest payable is deemed to approximate fair value due to the short-term maturities of these instruments.

#### *Agency Security Valuation*

Agency Securities are valued using third-party pricing services and dealer quotes. The third-party pricing services use common market pricing methods including pricing models that incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of a security is not available from the independent pricing service, or such data appears unreliable, we obtain valuations from up to three dealers who make markets in similar financial instruments. The dealers will incorporate common market pricing methods, including a spread measurement to the Treasury curve or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, collateral type, rate reset period and seasoning or age of the security. Management reviews pricing used to ensure that current market conditions are properly represented. This review may include, but is not limited to, comparisons of similar market transactions, alternative third-party pricing services and dealer quotes, or comparisons to a pricing model. The resulting unrealized gains and losses are reflected in our condensed consolidated balance sheets as accumulated other comprehensive loss.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

*Repurchase Agreements*

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

*Derivatives*

We seek to mitigate the exposure to potential interest rate mismatches between the interest earned on investments and the borrowing costs caused by fluctuations in short-term interest rates. In a simple interest rate swap, one investor pays a floating rate of interest on a notional principal amount and receives a fixed rate of interest on the same notional principal amount for a specified period of time. Alternatively, an investor may pay a fixed rate and receive a floating rate. During the term of the interest rate swap, we make or receive periodic payments and unrealized gains or losses are recorded as a result of marking the swaps to their fair value. If a swap is terminated prior to maturity, we record a realized gain or loss equal to the difference between the proceeds from (or cost of) the closing transaction and our cost basis in the contract, if any. The periodic payments and any realized gains or losses are reported under realized gain (loss) on interest rate contracts in our statement of operations. All unrealized gains or losses are reported under change in fair value of interest rate contracts in our statements of operations. Swaps involve a risk that interest rates will move contrary to our expectations, which may reduce the periodic payments we receive or increase our payment obligations.

We are exposed to credit loss in the event of nonperformance by the counterparty to the swap, limited to any gains recognized. However, as of March 31, 2011, we did not anticipate nonperformance by any counterparty. Should



interest rates move unexpectedly, we may not achieve the anticipated benefits of the interest rate swaps and may realize a loss.

We recognize all derivative instruments as either assets or liabilities at fair value on our condensed consolidated balance sheet. We do not designate our interest rate risk mitigation activities as cash flow hedges, which, among other factors, would require us to match the pricing dates of both hedging transactions and repurchase agreements. Operational issues and credit market volatility make such matching impractical for us. Since we will not qualify for hedge accounting treatment as prescribed by GAAP, our operating results may reflect greater volatility than otherwise would be the case, because gains or losses on the interest rate risk mitigation instruments may not be offset by changes in the fair value or cash flows of the transaction within the same accounting period, or ever. Consequently, any declines in our interest rate contracts would result in a charge to earnings. We will continue to designate interest rate risk mitigation activities as hedges for tax purposes and any unrealized gains or losses should not affect our distributable net income.

#### *Credit Risk*

We have limited our exposure to credit losses on our portfolio of Agency Securities by only purchasing securities issued by Freddie Mac, Fannie Mae or Ginnie Mae. The payment of principal and interest on the Freddie Mac and Fannie Mae Agency Securities are guaranteed by those respective agencies, and the payment of principal and interest on the Ginnie Mae Agency Securities are backed by the full faith and credit of the U.S. government.

#### *Market Risk*

Weakness in the mortgage market may adversely affect the performance and market value of our investments. This could negatively impact our net book value. Furthermore, if our lenders are unwilling or unable to provide additional financing, we could be forced to sell our Agency Securities at an inopportune time when prices are depressed. The principal payments are guaranteed by Freddie Mac, Fannie Mae, or Ginnie Mae on our Agency Securities.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

*Preferred Stock*

We are authorized to issue 25,000,000 shares of preferred stock with such designations, voting and other rights and preferences as may be determined from time to time by the Board of Directors ( Board ) or a committee thereof.

*Common Stock and Warrants*

At March 31, 2011, we had 32,254,054 shares of common stock issued and outstanding, and have authorized 250,000,000 shares of common stock, par value \$0.001. At March 31, 2011, we had outstanding warrants to purchase 32,500,000 shares of common stock, which are exercisable at \$11.00 per share and expire in 2013.

*Income per Common Share*

Basic income per common share for all periods is computed by dividing the earnings applicable to common stockholders by the weighted average number of common shares outstanding for the period. Warrants issued in the offering and sponsor warrants were contingently exercisable upon consummation of a business combination. The basic and pro forma diluted income per common share for the quarter ended March 31, 2011 and March 31, 2010, does not include 32,500,000 warrants as the effect of including such warrants would be anti-dilutive. Pro forma diluted income per share would reflect the potential dilution assuming common shares were issued upon the exercise of outstanding warrants and the proceeds thereof were used to purchase common shares at the average market price during the period.

*Comprehensive Income*

Other comprehensive income refers to revenue, expenses, gains and losses that are recorded directly as an adjustment to shareholders' equity. Other comprehensive income arises primarily from changes in unrealized gains or losses generated from changes in market values of our Agency Securities held as available for sale.

### *Revenue Recognition*

Interest income is earned and recognized based on the outstanding principal amount of the investment securities and their contractual terms. Premiums and discounts associated with the purchase of investment securities are amortized or accreted into interest income over the actual lives of the securities.

### *Income Taxes*

We intend to qualify and have elected to be taxed as a REIT under the Code. We will generally not be subject to federal income tax to the extent that we distribute 90% of our taxable income to our shareholders, and as long as we satisfy the ongoing REIT requirements including meeting certain asset, income and stock ownership tests.

Our management is responsible for determining whether a tax position taken by us is more likely than not to be sustained on its merits. We have no material unrecognized tax benefits and have not recognized in these financial statements any interest or penalties related to income taxes. Should any such penalties and interest be recognized, they will be included in other expenses and interest expense, respectively. No tax returns of ours have been examined by federal, state or local authorities; therefore all years which are statutorily open are subject to examination by the appropriate authorities.

### **Note 4 - Recent Accounting Pronouncements**

In January 2010, the Financial Accounting Standards Board ( FASB ) issued new authoritative literature, which clarifies certain existing disclosure requirements and requires additional disclosures for recurring and nonrecurring fair value measurements. These additional disclosures include amounts and reasons for significant transfers between Level 1 and Level 2 of the fair value hierarchy; significant transfers in and out of Level 3 of the fair value hierarchy; and information about purchases, sales, issuances and settlements on a gross basis in the reconciliation of recurring Level 3 measurements. The requirements of this standard are effective for periods beginning after December 15, 2009, with the exception of the requirement of information about purchases, sales, issuances and settlements of Level 3 measurements, which becomes effective for periods beginning after December 15, 2010. We adopted the guidance related to Level 1 and Level 2 disclosures effective January 1, 2010 and adopted the guidance related to Level 3 disclosures effective January 1, 2011; the full adoption of this guidance did not have a material effect on our financial statements.



## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

In July 2010, the FASB issued guidance that primarily requires additional disaggregated disclosures of (i) credit risks associated with financing receivables, and (ii) impaired financing receivables and the related allowance for credit losses. The guidance is generally effective for the first interim or annual period ending after December 15, 2010; however certain disclosures are not required until the first interim or annual period beginning after December 15, 2010. The adoption of the guidance did not require us to include additional disclosures in the notes to our condensed consolidated financial statements.

**Note 5 - Agency Securities, Available for Sale**

All of our Agency Securities are classified as available for sale and, as such, are reported at their estimated fair value. Management generally determines the fair values of Agency Securities by using third-party pricing services and dealer quotes. The third-party pricing services use common market pricing methods including pricing models that incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. The dealer quotes incorporate common market pricing methods, including a spread measurement to the Treasury curves or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period, issuer, additional credit support and expected life of the security. Management reviews pricing used to ensure that current market conditions are represented. This review may include, but is not limited to, comparisons of similar market transactions, alternative third-party pricing services and dealer quotes, or comparisons to a pricing model. At March 31, 2011 and December 31, 2010, all of our Agency Security values were based solely on third-party sources.

As of March 31, 2011, we had the following securities in an unrealized loss and/or a gain position as presented below. The table below includes \$20.0 million of current carrying value of forward settle security purchases.

|                             | <b>Amortized<br/>Cost</b> | <b>Fair Market<br/>Value</b> | <b>Unrealized<br/>Loss</b> | <b>Unrealized<br/>Gain</b> | <b>Net Unrealized<br/>Gain (Loss)</b> |
|-----------------------------|---------------------------|------------------------------|----------------------------|----------------------------|---------------------------------------|
| Fannie Mae Certificates     | \$ 1,567,549,404          | \$ 1,563,180,227             | \$ (7,466,750)             | \$ 3,097,573               | \$ (4,369,177)                        |
| Freddie Mac<br>Certificates | 298,146,974               | 297,345,505                  | (1,883,880)                | 1,082,411                  | (801,469)                             |
| Ginnie Mae Certificates     | 412,693,321               | 413,389,000                  | (677,995)                  | 1,373,674                  | 695,679                               |
|                             | \$ 2,278,389,699          | \$ 2,273,914,732             | \$ (10,028,625)            | \$ 5,553,658               | \$ (4,474,967)                        |

**Total Agency Securities**

As of December 31, 2010, we had the following securities in an unrealized loss and/or a gain position as presented below. The table below includes \$125.3 million of current carrying value of forward settle security purchases.

|                                | <b>Amortized Cost</b>   | <b>Fair Market Value</b> | <b>Unrealized Loss</b> | <b>Unrealized Gain</b> | <b>Net Unrealized Gain(Loss)</b> |
|--------------------------------|-------------------------|--------------------------|------------------------|------------------------|----------------------------------|
| Fannie Mae Certificates        | \$ 847,473,686          | \$ 843,872,174           | \$ (5,767,276)         | \$ 2,165,764           | \$ (3,601,512)                   |
| Freddie Mac Certificates       | 258,457,021             | 257,316,342              | (2,060,057)            | 919,378                | (1,140,679)                      |
| Ginnie Mae Certificates        | 60,149,503              | 60,662,164               | (45,676)               | 558,337                | 512,661                          |
| <b>Total Agency Securities</b> | <b>\$ 1,166,080,210</b> | <b>\$ 1,161,850,680</b>  | <b>\$ (7,873,009)</b>  | <b>\$ 3,643,479</b>    | <b>\$ (4,229,530)</b>            |

The components of the carrying value of available for sale Agency Securities at March 31, 2011, are presented below.

|   | <b>March 31, 2011</b> |
|---|-----------------------|
| Principal balance settled securities          | \$ 2,169,947,596      |
| Principal balance forward settle securities   | 19,011,912            |
| Unamortized premium settled securities        | 88,500,672            |
| Unamortized premium forward settle securities | 929,519               |
| Gross unrealized gains                        | 5,553,658             |
| Gross unrealized losses                       | (10,028,625)          |
| Carrying value/estimated fair value           | \$ 2,273,914,732      |

## ARMOUR Residential REIT, Inc. and Subsidiaries

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

The components of the carrying value of available for sale Agency Securities at December 31, 2010, are presented below.

|   | <b>December 31, 2010</b> |               |
|---|--------------------------|---------------|
| Principal balance settled securities          | \$                       | 995,994,552   |
| Principal balance forward settle securities   |                          | 120,473,239   |
| Unamortized premium settled securities        |                          | 44,724,477    |
| Unamortized premium forward settle securities |                          | 4,887,942     |
| Gross unrealized gains                        |                          | 3,643,479     |
| Gross unrealized losses                       |                          | (7,873,009)   |
| Carrying value/estimated fair value           | \$                       | 1,161,850,680 |

As of March 31, 2011, our Agency Securities portfolio was purchased at a net premium to par value with a weighted average amortized cost, including settled and forward settle securities, of 104.09%, due to the average interest rates on these securities being higher than prevailing market rates. As of March 31, 2011, we had approximately \$89.4 million of unamortized premium included in the cost basis of our investments, inclusive of both settled and forward settle securities. As of March 31, 2011, our investment portfolio of securities consisted of Agency Securities as follows:

**Adjustable Rate Settled Securities as of March 31, 2011**

| Months<br>to<br>Reset | Percentage<br>of<br>Settled<br>Securities<br>Portfolio | Weighted<br>Average<br>Months<br>to<br>Reset | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Amortized<br>Purchase<br>Price(3) | Current<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current            |
|-----------------------|--|--|-----------------------------|----------------------------------|--|---------------------------------|---|--------------------|
|                       |  |  |                             |                                  |  |                                 |   | Market<br>Value(6) |
| 0-18                  | 5.1%   | 7  | \$ 109,352,905              | 3.66%                            | \$ 104.65  | \$ 114,432,859                  | 105.03                                    | \$ 114,857,148     |

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|                      |              |           |                        |              |               |                        |               |                        |
|----------------------|--------------|-----------|------------------------|--------------|---------------|------------------------|---------------|------------------------|
| 19-36                | 6.6          | 31        | 140,561,407            | 4.68         | 105.04        | 147,651,539            | 105.43        | 148,199,438            |
| 37-60                | 30.1         | 49        | 652,800,207            | 3.86         | 103.91        | 678,340,432            | 103.96        | 678,663,343            |
| 61-84                | 20.1         | 76        | 440,884,194            | 3.70         | 103.58        | 456,667,882            | 102.74        | 452,949,612            |
| 85+                  | 1.9          | 112       | 41,853,098             | 4.08         | 105.39        | 44,108,611             | 102.84        | 43,040,109             |
| <b>Total/Average</b> | <b>63.8%</b> | <b>54</b> | <b>\$1,385,451,811</b> | <b>3.88%</b> | <b>104.02</b> | <b>\$1,441,201,323</b> | <b>103.77</b> | <b>\$1,437,709,650</b> |

**Fixed Rate Settled Securities as of March 31, 2011**

| Months<br>to         | Percentage<br>of<br>Settled<br>Securities<br>Portfolio | Weighted<br>Average<br>Months<br>to<br>Reset | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average               |                       | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|----------------------|--|--|-----------------------------|----------------------------------|-----------------------------------|-----------------------|---|-------------------------------|
|                      |  |  |                             |                                  | Amortized<br>Purchase<br>Price(3) | Amortized<br>Cost(4)  |   |                               |
| 0-90                 | 0.1%   | 70   | \$ 1,581,176                | 5.60%                            | 106.51                            | \$ 1,684,121          | 107.47                                    | \$ 1,699,346                  |
| 91-180               | 36.1   | 171  | 782,914,609                 | 4.21                             | 104.17                            | 815,562,824           | 104.03                                    | 814,473,705                   |
| <b>Total/Average</b> | <b>36.2</b>  | <b>170</b>                                   | <b>\$ 784,495,785</b>       | <b>4.21%</b>                     | <b>104.17</b>                     | <b>\$ 817,246,945</b> | <b>104.04</b>                             | <b>\$ 816,173,051</b>         |

**All Settled Securities as of March 31, 2011**

| Settled<br>Securities<br>Portfolio | Percentage<br>of | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average               |                         | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|------------------------------------|------------------|-----------------------------|----------------------------------|-----------------------------------|-------------------------|---|-------------------------------|
|                                    |                  |                             |                                  | Amortized<br>Purchase<br>Price(3) | Amortized<br>Cost(4)    |   |                               |
| <b>Total/Average</b>               | <b>100.0%</b>    | <b>\$ 2,169,947,596</b>     | <b>4.00%</b>                     | <b>104.08</b>                     | <b>\$ 2,258,448,268</b> | <b>103.87</b>                             | <b>\$ 2,253,882,701</b>       |





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|                      |              |           |                     |              |                  |                     |                  |                     |
|----------------------|--------------|-----------|---------------------|--------------|------------------|---------------------|------------------|---------------------|
| 0-18                 | 4.0%         | 10        | \$ 754,533          | 5.50%        | \$ 103.88        | \$ 783,771          | \$ 105.31        | \$ 794,585          |
| 19-36                | 9.4          | 32        | 1,762,997           | 4.48         | 104.43           | 1,841,129           | 106.40           | 1,875,900           |
| 37-60                | 11.3         | 40        | 2,144,811           | 4.75         | 105.05           | 2,253,086           | 105.56           | 2,263,988           |
| 61-84                | 5.6          | 84        | 1,074,602           | 4.94         | 105.38           | 1,132,362           | 106.16           | 1,140,761           |
| <b>Total/Average</b> | <b>30.3%</b> | <b>42</b> | <b>\$ 5,736,943</b> | <b>5.11%</b> | <b>\$ 104.77</b> | <b>\$ 6,010,348</b> | <b>\$ 105.90</b> | <b>\$ 6,075,234</b> |

**Fixed Rate Forward Settle Securities as of March 31, 2011**

|                      | Percentage   |            | Weighted            |              |                  |                      |                  |                     |
|----------------------|--------------|------------|---------------------|--------------|------------------|----------------------|------------------|---------------------|
|                      | of           |            | Average             |              |                  |                      |                  |                     |
| Forward              | Weighted     | Current    | Weighted            | Amortized    | Expected         | Weighted             | Current          |                     |
| Settle               | Average      |            |                     |              |                  |                      |                  | Face                |
| Portfolio            | to Reset     | Value(1)   | Coupon(2)           | Price(3)     | Cost(4)          | Price(5)             | Value(6)         |                     |
| 90-180               | 69.7%        | 179        | \$13,274,969        | 4.50%        | \$ 104.94        | \$ 13,931,083        | \$ 105.14        | \$13,956,797        |
| <b>Total/Average</b> | <b>69.7%</b> | <b>179</b> | <b>\$13,274,969</b> | <b>4.50%</b> | <b>\$ 104.94</b> | <b>\$ 13,931,083</b> | <b>\$ 105.14</b> | <b>\$13,956,797</b> |

**All Forward Settle Securities as of March 31, 2011**

|                      | Percentage    |                      | Weighted     |                  |                      |                  |                      |
|----------------------|---------------|----------------------|--------------|------------------|----------------------|------------------|----------------------|
|                      | of            |                      | Average      |                  |                      |                  |                      |
| Forward              | Current       | Weighted             | Amortized    | Expected         | Weighted             | Current          |                      |
| Settle               |               |                      |              |                  |                      |                  | Face                 |
| Portfolio            | Value(1)      | Coupon(2)            | Price(3)     | Cost(4)          | Price(5)             | Value(6)         |                      |
| <b>Total/Average</b> | <b>100.0%</b> | <b>\$ 19,011,912</b> | <b>4.68%</b> | <b>\$ 104.89</b> | <b>\$ 19,941,431</b> | <b>\$ 105.37</b> | <b>\$ 20,032,031</b> |

**All Settled and Forward Settle Securities as of March 31, 2011**

| Percentage  | Current Face | Weighted  | Weighted  | Expected | Weighted | Current  |    |
|-------------|--------------|-----------|-----------|----------|----------|----------|----|
|             |              |           |           |          |          |          | of |
| Settled and |              | Coupon(2) | Amortized | Cost(4)  | Price(5) | Value(6) |    |
| Forward     |              |           | Purchase  |          |          |          |    |

|                      | <b>Settle</b>    |                 | <b>Price(3)</b> |           |                 |                           |
|----------------------|------------------|-----------------|-----------------|-----------|-----------------|---------------------------|
|                      | <b>Portfolio</b> |                 |                 |           |                 |                           |
| <b>Total/Average</b> | 100.0%           | \$2,188,959,508 | 4.01%           | \$ 104.09 | \$2,278,389,699 | \$ 103.88 \$2,273,914,732 |

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

- (1) The current face is the current monthly remaining dollar amount of principal of an Agency Security. We compute current face by multiplying the original face value of the security by the current principal balance factor. The current principal balance factor is a fraction, where the numerator is the current outstanding balance and the denominator is the original principal balance.
- (2) For a pass-through certificate, the coupon reflects the weighted average nominal rate of interest paid on the underlying mortgage loans, net of fees paid to the servicer and the agency. The coupon for a pass-through certificate may change as the underlying mortgage loans are prepaid.
- (3) Amortized purchase price is the dollar amount, per \$100 of current face, of our purchase price for the security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (4) Amortized cost is our total purchase price for the Agency Security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (5) Market price is the dollar amount of market value, per \$100 of nominal, or face value, of the Agency Security. We value our Agency Securities using a third party pricing service whose pricing model incorporates common market pricing methods. Management reviews the pricing to ensure that current market conditions are properly represented.
- (6) Market value is the total market value for the security.

As of December 31, 2010, our Agency Securities portfolio was purchased at a net premium to par value with a weighted average amortized cost, including settled and forward settle securities, of 104.44%, due to the average interest rates on these securities being higher than prevailing market rates. As of December 31, 2010, we had approximately \$49.6 million of unamortized premium included in the cost basis of our investments, inclusive of both settled and forward settle securities. All unsettled purchases of securities as of December 31, 2010, were settled in January and February 2011. As of December 31, 2010, our investment portfolio of settled securities consisted of Agency Securities as follows:

**Adjustable Rate Settled Securities as of December 31, 2010**

| <b>Months<br/>to<br/>Reset</b> | <b>Percentage<br/>of<br/>Settled</b> | <b>Weighted<br/>Average</b> | <b>Current<br/>Face<br/>Value(1)</b> | <b>Weighted<br/>Average<br/>Coupon(2)</b> | <b>Weighted<br/>Average<br/>Amortized</b> | <b>Amortized<br/>Cost(4)</b> | <b>Weighted<br/>Average<br/>Market<br/>Price(5)</b> | <b>Current<br/>Market<br/>Value(6)</b> |
|--------------------------------|--------------------------------------|-----------------------------|--------------------------------------|---|---|------------------------------|---|--|
|--------------------------------|--------------------------------------|-----------------------------|--------------------------------------|---|---|------------------------------|---|--|

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| Securities<br>Portfolio | Months<br>to<br>Reset |           |                      | Purchase<br>Price(3) |                  |                      |               |                      |
|-------------------------|-----------------------|-----------|----------------------|----------------------|------------------|----------------------|---------------|----------------------|
| 0-18                    | 4.8%                  | 7         | \$ 47,989,156        | 3.67%                | \$ 104.31        | \$ 50,058,987        | 104.45        | \$ 50,126,097        |
| 19-36                   | 3.3                   | 29        | 32,967,374           | 4.00                 | 103.71           | 34,192,034           | 104.37        | 34,407,131           |
| 37-60                   | 25.0                  | 52        | 247,952,187          | 4.00                 | 103.96           | 257,686,509          | 104.44        | 258,969,161          |
| 61-84                   | 32.5                  | 78        | 325,954,726          | 3.87                 | 104.26           | 339,833,155          | 103.34        | 336,849,193          |
| 85+                     | 4.4                   | 114       | 44,397,480           | 4.07                 | 105.39           | 46,789,017           | 102.66        | 45,578,166           |
| <b>Total/Average</b>    | <b>70.0%</b>          | <b>64</b> | <b>\$699,260,923</b> | <b>3.92%</b>         | <b>\$ 104.20</b> | <b>\$728,559,702</b> | <b>103.81</b> | <b>\$725,929,748</b> |

**Fixed Rate Settled Securities as of December 31, 2010**

| Months<br>to<br>Reset | Percentage<br>of<br>Settled<br>Securities<br>Portfolio | Weighted<br>Average<br>Months<br>to<br>Reset | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Purchase<br>Price(3) | Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|-----------------------|--|--|-----------------------------|----------------------------------|---|----------------------|---|-------------------------------|
| 0-90                  | 0.1%   | 63   | \$ 1,171,170                | 6.15%                            | \$ 107.23                                   | \$ 1,255,843         | \$ 108.53                                 | \$ 1,271,054                  |
| 91-180                | 29.9   | 172  | 295,562,459                 | 4.33                             | 105.19                                      | 310,903,484          | 104.65                                    | 309,319,711                   |
| <b>Total/Average</b>  | <b>30.0%</b>   | <b>171</b>                                   | <b>\$296,733,629</b>        | <b>4.34%</b>                     | <b>\$ 105.20</b>                            | <b>\$312,159,327</b> | <b>104.67</b>                             | <b>\$310,590,765</b>          |

**All Settled Securities as of December 31, 2010**

| Percentage<br>Of<br>Settled<br>Securities<br>Portfolio | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Purchase<br>Price(3) | Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|--|-----------------------------|----------------------------------|---|----------------------|---|-------------------------------|
| <b>Total/Average</b>                                   | <b>100.0%</b>               | <b>\$995,994,552</b>             | <b>4.04%</b>                                | <b>\$ 104.50</b>     | <b>\$1,040,719,029</b>                    | <b>\$ 1,036,520,513</b>       |



## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

- (1) The current face is the current monthly remaining dollar amount of principal of an Agency Security. We compute current face by multiplying the original face value of the security by the current principal balance factor. The current principal balance factor is a fraction, where the numerator is the current outstanding balance and the denominator is the original principal balance.
- (2) For a pass-through certificate, the coupon reflects the weighted average nominal rate of interest paid on the underlying mortgage loans, net of fees paid to the servicer and the agency. The coupon for a pass-through certificate may change as the underlying mortgage loans are prepaid.
- (3) Amortized purchase price is the dollar amount, per \$100 of current face, of our purchase price for the security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (4) Amortized cost is our total purchase price for the Agency Security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (5) Market price is the dollar amount of market value, per \$100 of nominal, or face value, of the Agency Security. We value our Agency Securities using a third party pricing service whose pricing model incorporates common market pricing methods. Management reviews the pricing to ensure that current market conditions are properly represented.
- (6) Market value is the total market value for the security.

As of December 31, 2010, we had committed to purchase securities for settlements in January and February of 2011. The information below was current as of December 31, 2010, but subject to change due to amortization prior to settlement. In addition, some forward trades of new issue securities are subject to modest changes in delivery size and coupon. All, but one, of the forward settling Agency Securities were adjustable rate with a minimum expected reset of 11 months and a maximum expected reset of 71 months.

**Adjustable Rate Forward Settle Securities as of December 31, 2010**

| Percentage<br>of<br>Forward<br>Settle | Weighted<br>Average<br>Months<br>to Reset | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Amortized<br>Purchase | Expected<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|---------------------------------------|---|-----------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|
|---------------------------------------|---|-----------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|

|                      | Portfolio |    |               | Price(3) |           |               |                     |
|----------------------|-----------|----|---------------|----------|-----------|---------------|---------------------|
| <b>Total/Average</b> | 63.6%     | 27 | \$ 76,288,258 | 3.22%    | \$ 104.60 | \$ 79,799,280 | 104.41 \$79,653,941 |

**Fixed Rate Forward Settle Securities as of December 31, 2010**

|                      | Percentage<br>of<br>Forward<br>Settle<br>Portfolio | Weighted<br>Average<br>Months<br>to Reset | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Amortized<br>Purchase<br>Price(3) | Expected<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|----------------------|--|---|-----------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|
| <b>Total/Average</b> | 36.4%  | 179                                       | \$ 44,184,981               | 4.00%                            | \$ 103.12  | \$ 45,561,901                    | \$ 103.38                                 | \$ 45,676,226                 |

**All Forward Settle Securities as of December 31, 2010**

|                      | Percentage<br>of<br>Forward<br>Settle<br>Portfolio | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Amortized<br>Purchase<br>Price(3) | Expected<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|----------------------|--|-----------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|
| <b>Total/Average</b> | 100.0%   | \$ 120,473,239              | 3.51%                            | \$ 104.06  | \$ 125,361,181                   | \$ 104.03                                 | \$ 125,330,167                |

**All Settled and Forward Settle Securities as of December 31, 2010**

|  | Percentage<br>of<br>Settled<br>and<br>Forward<br>Settle | Current Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Amortized<br>Purchase<br>Price(3) | Expected<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|--|---|--------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|
|--|---|--------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|



| <b>Portfolio</b>     |        |                 |       |    |        |                 |    |        |                 |
|----------------------|--------|-----------------|-------|----|--------|-----------------|----|--------|-----------------|
| <b>Total/Average</b> | 100.0% | \$1,116,467,791 | 3.98% | \$ | 104.44 | \$1,166,080,210 | \$ | 103.73 | \$1,161,850,680 |

## ARMOUR Residential REIT, Inc. and Subsidiaries

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

- (1) The current face is the current monthly remaining dollar amount of principal of an Agency Security. We compute current face by multiplying the original face value of the security by the current principal balance factor. The current principal balance factor is a fraction, where the numerator is the current outstanding balance and the denominator is the original principal balance.
- (2) For a pass-through certificate, the coupon reflects the weighted average nominal rate of interest paid on the underlying mortgage loans, net of fees paid to the servicer and the agency. The coupon for a pass-through certificate may change as the underlying mortgage loans are prepaid.
- (3) Amortized purchase price is the dollar amount, per \$100 of current face, of our purchase price for the security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (4) Amortized cost is our total purchase price for the Agency Security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (5) Market price is the dollar amount of market value, per \$100 of nominal, or face value, of the Agency Security. We value our Agency Securities using a third party pricing service whose pricing model incorporates common market pricing methods. Management reviews the pricing to ensure that current market conditions are properly represented.
- (6) Market value is the total market value for the security.

Our investment portfolio consisted of the following breakdown between Fannie Mae, Freddie Mac and Ginnie Mae at March 31, 2011.

| Agency Securities                | March 31, 2011          |               |
|----------------------------------|-------------------------|---------------|
|                                  | Estimated Fair          | Percentage    |
|                                  | Value                   | of Total      |
| <b>Settled Securities</b>        |                         |               |
| Fannie Mae Certificates          | \$ 1,549,507,563        | 68.1%         |
| Freddie Mac Certificates         | 295,920,612             | 13.0          |
| Ginnie Mae Certificates          | 408,454,526             | 18.0          |
| <b>Forward Settle Securities</b> |                         |               |
| Fannie Mae Certificates          | 13,672,664              | 0.6           |
| Freddie Mac Certificates         | 1,424,893               | 0.1           |
| Ginnie Mae Certificates          | 4,934,474               | 0.2           |
| <b>Total Securities</b>          | <b>\$ 2,273,914,732</b> | <b>100.0%</b> |

Our investment portfolio consisted of the following breakdown between Fannie Mae, Freddie Mac and Ginnie Mae at December 31, 2010.

| <b>Agency Securities</b>         | <b>December 31, 2010</b> |                   |
|----------------------------------|--------------------------|-------------------|
|                                  | <b>Estimated Fair</b>    | <b>Percentage</b> |
|                                  | <b>Value</b>             | <b>of Total</b>   |
| <b>Settled Securities</b>        |                          |                   |
| Fannie Mae Certificates          | \$ 718,542,007           | 61.8%             |
| Freddie Mac Certificates         | 257,316,342              | 22.2              |
| Ginnie Mae Certificates          | 60,662,164               | 5.2               |
| <b>Forward Settle Securities</b> |                          |                   |
| Fannie Mae Certificates          | 125,330,167              | 10.8              |
| Freddie Mac Certificates         | -                        | -                 |
| Ginnie Mae Certificates          | -                        | -                 |
| <b>Total Securities</b>          | <b>\$ 1,161,850,680</b>  | <b>100.0%</b>     |

As of March 31, 2011 and December 31, 2010, the adjustable and hybrid adjustable rate mortgage loans underlying our Agency Securities have fixed interest rates for an average period of approximately 54 months and 64 months respectively, after which time the interest rates reset and become adjustable. After a reset date, interest rates on our adjustable and hybrid adjustable Agency Securities float based on spreads over various indices, typically LIBOR or the one-year Constant Maturity Treasury ( CMT ), rate. These interest rates are subject to caps that limit the amount the applicable interest rate can increase during any year, known as an annual cap, and through the maturity of the security, known as a lifetime cap.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

**Note 6 - Interest Rate Contracts**

We enter into transactions to manage our interest rate risk exposure. These transactions include purchasing or selling Eurodollar futures contracts ( Futures Contracts ) as well as purchasing or selling interest rate swap contracts. These transactions are designed to lock in funding costs for financing activities associated with our assets in such a way to help assure the realization of attractive net interest margins. Such transactions are based on assumptions about prepayments which, if not realized, will cause transaction results to differ from expectations. We do not designate our activities as cash flow hedges, and as such, we recognize changes in the fair value of these transactions through earnings (See Note 3). For the quarter ended March 31, 2011 and 2010, we recognized non-cash losses of \$0.3 million and \$0.6 million, respectively. Our derivative instruments are carried on our condensed consolidated balance sheets at fair value, as assets, if their fair value is positive, or as liabilities, if their fair value is negative.

As of March 31, 2011 and December 31, 2010, we had entered into \$134.0 million and \$214.0 million (notional amount), respectively, of Eurodollar Future swap equivalents traded in 1,435 and 2,361 individual contract transactions, respectively. Our Futures Contracts are traded on the Chicago Mercantile Exchange ( CME ) which requires the use of daily mark-to-market collateral and the CME provides substantial credit support. The collateral requirements of the CME require us to pledge assets under a bi-lateral margin arrangement, including either cash or Agency Securities, and these requirements may vary and change over time based on the market value, notional amount, and remaining term of the Futures Contracts. In the event we are unable to meet a margin call under one of our Futures Contracts, the counterparty to such agreement may have the option to terminate or close-out all of the outstanding Futures Contracts with us. In addition, any close-out amount due to the counterparty upon termination of the counterparty's transactions would be immediately payable by us pursuant to the applicable agreement.

As of March 31, 2011 and December 31, 2010, we had entered into \$965.0 million and \$155.0 million (notional amount) of swap contracts, respectively, traded in 37 and 10 individual transactions, respectively. Consistent with market practice, we have agreements with our swap counterparties that provide for the posting of collateral based on the fair values of our interest rate contracts. Through this margining process, either we or our swap counterparty may be required to pledge cash or securities as collateral. Collateral requirements vary by counterparty and change over time based on the market value, notional amount and remaining term of the swap. Certain interest rate swap contracts provide for cross collateralization and cross default with repurchase agreements and other contracts with the same counterparty.

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We had \$4.0 million and \$4.4 million of restricted cash related to margin posted for Futures Contracts as of March 31, 2011 and December 31, 2010, respectively. We had \$9.7 million and \$0.3 million of restricted cash related to interest rate swap contracts as of March 31, 2011 and December 31, 2010, respectively.

The following tables present information about interest rate swap contracts which are included in interest rate contracts on the accompanying condensed consolidated balance sheet as of March 31, 2011 and December 31, 2010:

|   | <b>Notional</b>       | <b>Value as of</b>    |  |                   |
|---|-----------------------|-----------------------|--|-------------------|
|   | <b>Amount</b>         | <b>March 31, 2011</b> |  | <b>Fixed Rate</b> |
| Interest rate swaps maturing 12-24 months | \$ 20,000,000         | \$ (11,376)           |  | 0.5%              |
| Interest rate swaps maturing 24-36 months | 290,000,000           | 167,692               |  | 1.1               |
| Interest rate swaps maturing 36-48 months | 305,000,000           | 170,036               |  | 1.6               |
| Interest rate swaps maturing 48-60 months | 350,000,000           | (2,217,262)           |  | 2.1               |
| <b>Totals</b>                             | <b>\$ 965,000,000</b> | <b>\$ (1,890,910)</b> |  | <b>1.6%</b>       |

|   | <b>Notional</b>       | <b>Value as of</b>       |  |                   |
|---|-----------------------|--------------------------|--|-------------------|
|   | <b>Amount</b>         | <b>December 31, 2010</b> |  | <b>Fixed Rate</b> |
| Interest rate swaps maturing 12-24 months | \$ 20,000,000         | \$ (9,981)               |  | 0.5%              |
| Interest rate swaps maturing 24-36 months | 100,000,000           | 147,282                  |  | 1.0               |
| Interest rate swaps maturing 36-48 months | 10,000,000            | (9,195)                  |  | 1.4               |
| Interest rate swaps maturing 48-60 months | 25,000,000            | (26,039)                 |  | 1.9               |
| <b>Totals</b>                             | <b>\$ 155,000,000</b> | <b>\$ 102,067</b>        |  | <b>1.1%</b>       |

## ARMOUR Residential REIT, Inc. and Subsidiaries

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

The following tables present information about Futures Contracts which are included in interest rate contracts on the accompanying condensed consolidated balance sheet as of March 31, 2011 and December 31, 2010:

|   | <b>Notional</b>       | <b>Value as of</b>    | <b>Weighted</b>     |
|---|-----------------------|-----------------------|---------------------|
|   | <b>Amount</b>         | <b>March 31, 2011</b> | <b>Average Rate</b> |
| Eurodollar future strips maturing<br>3/19/12-9/17/12  | \$ 13,000,000         | \$ (118,788)          | 1.0%                |
| Eurodollar future strips maturing<br>3/18/13-9/16/13  | 47,000,000            | (954,937)             | 1.6                 |
| Eurodollar future strips maturing<br>3/17/14-12/15/14 | 64,000,000            | (1,603,725)           | 2.1                 |
| Eurodollar future strips maturing 9/14/15             | 10,000,000            | (97,938)              | 2.1                 |
| <b>Totals</b>   | <b>\$ 134,000,000</b> | <b>\$ (2,775,388)</b> | <b>1.8%</b>         |

|   | <b>Notional</b>       | <b>Value as of</b>       | <b>Weighted</b>     |
|---|-----------------------|--------------------------|---------------------|
|   | <b>Amount</b>         | <b>December 31, 2010</b> | <b>Average Rate</b> |
| Eurodollar future strips maturing<br>3/19/12-9/17/12  | \$ 28,000,000         | \$ (137,950)             | 0.8%                |
| Eurodollar future strips maturing<br>3/18/13-12/16/13 | 107,000,000           | (1,114,125)              | 1.3                 |
| Eurodollar future strips maturing<br>3/17/14-9/15/14  | 64,000,000            | (1,193,113)              | 1.8                 |
| Eurodollar future strips maturing 9/14/15             | 15,000,000            | (187,524)                | 2.1                 |
| <b>Totals</b>   | <b>\$ 214,000,000</b> | <b>\$ (2,632,712)</b>    | <b>1.6%</b>         |

**Note 7 - Repurchase Agreements**

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At March 31, 2011 and December 31, 2010, we had repurchase agreements in place in the amount of \$2.1 billion and \$1.0 billion, respectively, to finance Agency Security purchases. For the quarter ended March 31, 2011 and the year ended December 31, 2010, the weighted average interest rate or cost of funds was 0.29% and 0.35%, respectively. At March 31, 2011 and December 31, 2010, we had repurchase agreements outstanding with fourteen and eleven counterparties, respectively, with a weighted average maturity of 34 days and 32 days, respectively.

The following tables represent the contractual repricing information regarding our repurchase agreements:

|                       |                         | <b>Weighted<br/>Average<br/>Contractual</b> |           | <b>Contractual<br/>Interest<br/>Payments</b> | <b>Total<br/>Contractual<br/>Obligation</b> |
|-----------------------|-------------------------|---|-----------|--|---|
| <b>March 31, 2011</b> | <b>Balance</b>          | <b>Rate</b>                                 |           | <b>Payments</b>                              | <b>Obligation</b>                           |
| Within 30 days        | \$ 1,330,270,245        | 0.29 %                                      | \$        | 172,150                                      | \$ 1,330,442,395                            |
| 31 days to 60 days    | 459,216,000             | 0.30  |           | 151,380                                      | 459,367,380                                 |
| 61 days to 90 days    | 280,790,000             | 0.30  |           | 36,045                                       | 280,826,045                                 |
| Greater than 90 days  | 29,090,000              | 0.36  |           | 8,436  | 29,098,436                                  |
| <b>Total</b>          | <b>\$ 2,099,366,245</b> | <b>0.29 %</b>                               | <b>\$</b> | <b>368,011</b>                               | <b>\$ 2,099,734,256</b>                     |

|                          |                       | <b>Weighted<br/>Average<br/>Contractual</b> |           | <b>Contractual<br/>Interest<br/>Payments</b> | <b>Total<br/>Contractual<br/>Obligation</b> |
|--------------------------|-----------------------|---|-----------|--|---|
| <b>December 31, 2010</b> | <b>Balance</b>        | <b>Rate</b>                                 |           | <b>Payments</b>                              | <b>Obligation</b>                           |
| Within 30 days           | \$ 656,601,658        | 0.36 %                                      | \$        | 120,965                                      | \$ 656,722,623                              |
| 31 days to 60 days       | 123,840,000           | 0.33  |           | 27,244                                       | 123,867,244                                 |
| 61 days to 90 days       | 191,234,000           | 0.32  |           | 71,349                                       | 191,305,349                                 |
| <b>Total</b>             | <b>\$ 971,675,658</b> | <b>0.35 %</b>                               | <b>\$</b> | <b>219,558</b>                               | <b>\$ 971,895,216</b>                       |

## ARMOUR Residential REIT, Inc. and Subsidiaries

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

At March 31, 2011, our repurchase agreements had the following counterparties, amount at risk and weighted average remaining maturities:

| <b>Repurchase Agreement</b>                   | <b>Amount</b>           | <b>Amount at</b>      | <b>Weighted</b>      | <b>Percent of</b>  |
|---|-------------------------|-----------------------|----------------------|--------------------|
| <b>Counterparties</b>                         | <b>Outstanding</b>      | <b>Risk (1)</b>       | <b>Average</b>       | <b>Total</b>       |
|   |                         |                       | <b>Maturity of</b>   | <b>Amount</b>      |
|   |                         |                       | <b>Repurchase</b>    |                    |
|   |                         |                       | <b>Agreements in</b> |                    |
|   |                         |                       | <b>Days</b>          | <b>Outstanding</b> |
| Nomura Securities International, Inc.         | \$ 249,902,000          | \$ 12,808,695         | 40                   | 11.9%              |
| Guggenheim Liquidity Securities, LLC          | 225,435,000             | 11,045,641            | 61                   | 10.7               |
| MF Global Inc.                                | 222,488,000             | 10,517,543            | 60                   | 10.6               |
| UBS Securities LLC                            | 212,464,000             | 10,724,277            | 21                   | 10.1               |
| Goldman Sachs & Company                       | 201,662,000             | 10,418,840            | 36                   | 9.6                |
| Cantor Fitzgerald & Co.                       | 200,855,000             | 12,204,369            | 21                   | 9.6                |
| South Street Securities, LLC                  | 199,761,245             | 9,543,779             | 32                   | 9.5                |
| RBS Securities Inc.                           | 165,954,000             | 8,305,245             | 24                   | 7.9                |
| Mizuho Securities USA Inc.                    | 126,755,000             | 6,241,775             | 22                   | 6.0                |
| J.P. Morgan Securities LLC                    | 125,134,000             | 6,247,863             | 23                   | 6.0                |
| Merrill Lynch, Pierce, Fenner & Smith<br>Inc. | 66,750,000              | 3,474,913             | 21                   | 3.2                |
| Daiwa Securities America Inc.                 | 64,440,000              | 3,915,864             | 18                   | 3.1                |
| Jefferies and Company, Inc.                   | 29,791,000              | 1,268,576             | 11                   | 1.4                |
| The Prince Ridge Group LLC                    | 7,975,000               | 453,181               | 11                   | 0.4                |
| <b>Total</b>                                  | <b>\$ 2,099,366,245</b> | <b>\$ 107,170,561</b> |                      | <b>100.0%</b>      |

(1)

Equal to the fair value of securities sold, minus the sum of repurchase agreement liabilities plus accrued interest expense.



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At December 31, 2010, our repurchase agreements had the following counterparties, amount at risk and weighted average remaining maturities:

| Repurchase Agreement                  | Amount                | Amount at            | Weighted      | Percent of    |
|---------------------------------------|-----------------------|----------------------|---------------|---------------|
| Counterparties                        | Outstanding           | Risk (1)             | Average       | Total         |
|                                       |                       |                      | Maturity of   | Amount        |
|                                       |                       |                      | Repurchase    |               |
|                                       |                       |                      | Agreements in |               |
|                                       |                       |                      | Days          | Outstanding   |
| Guggenheim Liquidity Securities, LLC  | \$ 141,026,000        | \$ 4,425,424         | 56            | 14.5%         |
| South Street Securities, LLC          | 135,297,000           | 6,204,002            | 29            | 13.9          |
| Goldman Sachs & Company               | 132,638,000           | 6,424,071            | 19            | 13.7          |
| MF Global Inc.                        | 127,809,000           | 4,197,001            | 56            | 13.2          |
| Cantor Fitzgerald & Co.               | 111,982,000           | 7,658,536            | 16            | 11.5          |
| Nomura Securities International, Inc. | 95,228,000            | 2,037,191            | 40            | 9.8           |
| RBS Securities Inc.                   | 86,535,658            | 4,774,360            | 18            | 8.9           |
| UBS Securities LLC                    | 46,535,000            | 2,805,301            | 27            | 4.8           |
| Mizuho Securities USA Inc.            | 39,826,000            | 1,593,285            | 10            | 4.0           |
| Jefferies and Company, Inc.           | 31,822,000            | 426,829              | 10            | 3.3           |
| Daiwa Securities America Inc.         | 22,977,000            | 1,690,799            | 18            | 2.4           |
| <b>Total</b>                          | <b>\$ 971,675,658</b> | <b>\$ 42,236,799</b> |               | <b>100.0%</b> |

(1)

Equal to the fair value of securities sold, minus the sum of repurchase agreement liabilities plus accrued interest expense

As of March 31, 2011 and December 31, 2010, the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount, which we also refer to as the haircut, under all our repurchase agreements was approximately 5.2% and 5.3%, respectively.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

**Note 8 - Commitments and Contingencies**

*Management Agreement with ARRM*

As discussed in Note 14 *Related Party Transactions*, we are party to a management agreement with ARRM. Pursuant to the management agreement, as amended, ARRM is entitled to receive a monthly management fee equal to 1/12<sup>th</sup> of 1% of gross equity raised (including initial gross merger equity as well as any future gross equity raised) until gross equity raised is \$50 million, inclusive of gross merger equity. Thereafter, the monthly management fee shall be 1/12<sup>th</sup> of (a) 1.5% of gross equity raised up to \$1.0 billion and (b) 0.75% of gross equity raised in excess of \$1.0 billion, with a monthly minimum based on 1/12<sup>th</sup> of \$900,000 (inclusive of the original gross merger equity).

*Operating Leases*

We are not party to any agreement for the rental of real property and office space, or any significant leases for office, computer and other equipment or office furnishings.

*Litigation*

We are not party to any pending, threatened or contemplated litigation.

**Note 9 - Share-Based Compensation**

*2009 Stock Incentive Plan*

We adopted the 2009 Stock Incentive Plan (the "Plan") to attract, retain and reward directors, officers and other employees of ours, and other persons who provide services to us in the course of operations (collectively "Eligible Individuals").

The Plan provides for grants of common stock, restricted shares of common stock (RSUs), stock options, performance shares, performance units, stock appreciation rights and other equity and cash-based awards (collectively awards). On May 12, 2010, our Board allocated up to 250,000 shares to be available under the Plan. In considering such allocation, the Board considered the size of the Plan relative to our capital base and our current and potential future performance and capitalization.

The Plan allows for the Board to expand the types of awards available under the Plan and determine the maximum number of shares that may underlie these awards in any one year to any Eligible Individual. If an award granted under the Plan expires or terminates, the shares subject to any portion of the award that expires or terminates without having been exercised or paid, as the case may be, will again become available for the issuance of additional awards.

#### *Awards Under the Plan*

During the quarter ended March 31, 2011, we awarded a total of 192,500 RSUs to members of our Board (the Board Awards) and employees of ARRM (the ARRM Awards). We account for the ARRM Awards under ASC Topic No. 505-50 *Equity Based Payments to Non-Employees*. We account for the Board Awards under ASC Topic No. 718 *Compensation- Stock Compensation*. The Board Awards and the ARRM Awards were awarded at a weighted average grant date fair value per RSU of \$7.91, determined at the grant date based on the closing price of our common stock. Both awards are service-based awards, and vest quarterly in equal amounts over a five year term ending December 31, 2015. We recorded \$0.7 million of non-cash restricted cash compensation expense in the quarter ended March 31, 2011, of this amount, \$0.01 million is included in additional paid-in capital and \$0.06 million is included in accounts payable and accrued expenses, representing shares issuable per the agreements.

As of March 31, 2011, there was approximately \$1.2 million and \$0.2 million of unearned non-cash stock-based compensation related to the AARM Awards and to the Board Awards, respectively, that we expect to recognize as an expense over the next 5 years. The Board Awards are expensed on a straight-line basis over the requisite service period of 5 years; the ARRM Awards are valued and expensed as they vest at each quarter end commencing March 31, 2011 and ending December 31, 2015, based on the closing price of our common stock on the last trading day of the quarter. At March 31, 2011, 9,630 of our outstanding RSUs were vested.



## ARMOUR Residential REIT, Inc. and Subsidiaries

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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(Unaudited)

RSU transactions for the quarter ended March 31, 2011, are summarized below:

|                                      | <b>Number of Awards</b> |
|--------------------------------------|-------------------------|
| Awards Outstanding December 31, 2010 | -                       |
| Awards Granted                       | 192,500                 |
| Awards Forfeited                     | -                       |
| Awards Outstanding March 31, 2011    | 192,500                 |

Non-vested transactions for the quarter ended March 31, 2011, are summarized below:

|  | <b>Number of Awards</b> | <b>Weighted Average<br/>Grant Date Fair Value<br/>per Award</b> |
|--|-------------------------|---|
| Non-vested Awards Outstanding, December 31, 2010 | -                       | \$ -  |
| Granted  | 192,500                 | 7.91  |
| Vested   | (9,630)                 | 7.91  |
| Forfeited  | -                       | -   |
| Non-vested Awards Outstanding March 31, 2011     | 182,870                 | \$ 7.91   |

**Note 10 - Shareholders Equity**

On January 26, 2011, we completed an underwritten secondary public offering of 6,000,000 shares of common stock. The underwriters fully exercised the over-allotment option for 900,000 additional shares at a price of \$7.55 per share. Net proceeds were \$49.0 million, net of issuance costs of approximately \$3.1 million.

On January 28, 2011, a cash dividend of \$0.12 per common share, or \$2.0 million in the aggregate, was paid to holders of record on January 15, 2011. This amount included \$0.02 per common share of taxable income related to the year ended December 31, 2010.

On February 8, 2011, we completed an underwritten secondary public offering of 7,750,000 shares of common stock. The underwriters fully exercised the over-allotment option for 1,162,500 additional shares at a price of \$7.60 per share. Net proceeds were \$64.0 million, net of issuance costs of approximately \$3.7 million.

On February 25, 2011, a cash dividend of \$0.12 per common share, or \$3.9 million in the aggregate, was paid to holders of record on February 15, 2011.

On March 30, 2011, a cash dividend of \$0.12 per common share, or \$3.9 million in the aggregate, was paid to holders of record on March 15, 2011.

#### **Note 11 - Fair Value of Financial Instruments**

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of valuation hierarchy are defined as follows:

*Level 1* - inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

*Level 2* - inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

*Level 3* - inputs to the valuation methodology are unobservable and significant to the fair value measurement.

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The following describes the valuation methodologies used for our assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy.

*Cash and restricted cash* Cash includes cash on deposit with financial institutions and investments in high quality overnight money market funds, all of which have maturities of three months or less, at the time of purchase. The carrying amount of cash is deemed to be its fair value. Restricted cash includes cash held by counterparties as collateral for interest rate contracts.

*Agency Securities Available for Sale* - Fair value for the Agency Securities in our portfolio is based on obtaining a valuation for each Agency Security from third-party pricing services and dealer quotes. The third-party pricing services use common market pricing methods including pricing models that incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. The dealer quotes incorporate common market pricing methods, including a spread measurement to the Treasury curves or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period, issuer, additional credit support and expected life of the security. Management reviews pricing used to ensure that current market conditions are properly represented. This review may include, but is not limited to, comparisons of similar market transactions, alternative third-party pricing services and dealer quotes, or comparisons to a pricing model. Values obtained from the independent pricing service for similar instruments are classified as Level 2 securities if the pricing methods used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the pricing service, but dealer quotes are, the security will be re-classified as a Level 3 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information received from dealers and classify it as a Level 3 security. At March 31, 2011 and December 31, 2010, all of our Agency Security values were based solely on third-party sources.

*Derivative Transactions* - The fair value of our Eurodollar Futures Contracts are based on closing prices on the CME. The fair value of our interest rate swap contracts are valued using a third-party. Our Futures Contracts are classified as Level 1. The accrued interest of our interest rate swap contracts are Level 1. The present value of estimated future cash flows of our interest rate swap contracts are Level 3.

*Repurchase Agreements* - The fair value of repurchase agreements reflects the present value of the contractual cash flows discounted at the estimated LIBOR based market interest rates at the valuation date for repurchase agreements with a term equivalent to the remaining term to interest rate repricing, which may be at maturity, of our repurchase agreements. The carrying amount of repurchase agreements is deemed to be their fair value.

The following table presents our financial instruments measured at fair value as of March 31, 2011.

|   | <b>Level 1</b>        | <b>Level 2</b>          | <b>Level 3</b>    | <b>Total</b>            |
|---|-----------------------|-------------------------|-------------------|-------------------------|
| Assets (liabilities) carried at fair value: |                       |                         |                   |                         |
| Agency Securities, available for sale       | \$ -                  | \$ 2,273,059,805        | \$ 854,927        | \$ 2,273,914,732        |
| Interest rate contracts                     | (2,775,388)           | (1,890,910)             | -                 | (4,666,298)             |
| <b>Total</b>                                | <b>\$ (2,775,388)</b> | <b>\$ 2,271,168,895</b> | <b>\$ 854,927</b> | <b>\$ 2,269,248,434</b> |

The following table presents our financial instruments measured at fair value as of December 31, 2010

|   | <b>Level 1</b>        | <b>Level 2</b>          | <b>Level 3</b>       | <b>Total</b>            |
|---|-----------------------|-------------------------|----------------------|-------------------------|
| Assets (liabilities) carried at fair value: |                       |                         |                      |                         |
| Agency Securities, available for sale       | \$ -                  | \$ 1,114,175,921        | \$ 47,674,759        | \$ 1,161,850,680        |
| Interest rate contracts                     | (2,632,712)           | -                       | 102,067              | (2,530,645)             |
| <b>Total</b>                                | <b>\$ (2,632,712)</b> | <b>\$ 1,114,175,921</b> | <b>\$ 47,776,826</b> | <b>\$ 1,159,320,035</b> |

When a new pool of mortgages is created, the third party pricing services do not always become aware of the new pool for the early period of its existence. To the extent that we purchase a pool which the pricing service does not have listed, we seek independent third party pricing from other services or brokers. Additionally, we will ask the third party pricing service to include those assets in its list of priced assets in the future. As of December 31, 2010, we owned certain assets which were not priced by the independent third party pricing service and those assets were therefore classified as Level 3 assets. On March 31, 2011, these assets were priced by the pricing service and were therefore, reclassified as Level 2 assets. As of March 31, 2011, certain bonds purchased during the quarter were not priced by the pricing service which were valued using dealer quotes and therefore classified as Level 3 assets.



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The following table presents detail of our Level 3 financial instruments measured at fair value as of March 31, 2011.

|   | <b>Level 3</b>    |
|---|-------------------|
| Balance as of December 31, 2010   | \$ 47,776,826     |
| Reclassification of agency securities                                       | (47,776,826)      |
| Purchases of agency securities, at cost                                     | 849,582           |
| Unrealized gain on agency securities included in other comprehensive income | 5,345             |
| <b>Balance as of March 31, 2011</b>   | <b>\$ 854,927</b> |

The following table presents detail of our Level 3 financial instruments measured at fair value as of December 31, 2010.

|  | <b>Level 3</b>       |
|--|----------------------|
| Balance as of January 1, 2010  | \$ -                 |
| Purchases of agency securities, at cost  | 47,681,986           |
| Unrealized loss on agency securities included in other comprehensive income  | (7,227)              |
| Unrealized gain on interest rate contracts included in change in fair value of interest rate contracts on the Statements of Operations | 102,067              |
| <b>Balance as of December 31, 2010</b>   | <b>\$ 47,776,826</b> |

**Note 12 Income Taxes**

We intend to qualify and have elected to be taxed as a REIT under the Code. We will generally not be subject to federal income tax to the extent that we distribute 90% of our taxable income to our shareholders, and as long as we satisfy the ongoing REIT requirements including meeting certain asset, income and stock ownership tests.

We have elected to treat Enterprise as a taxable REIT subsidiary, which is a tax paying entity for income tax purposes and it is taxed separately from ARMOUR. As of December 31, 2010, we had recognized refundable income taxes of \$0.5 million, related to the carry back of net operating losses incurred by Enterprise in 2009 to prior years in which Enterprise reported taxable income. This amount was received in January 2011.

Our provision for income taxes for the quarter ended March 31, 2011 and March 31, 2010, included \$9,000 and \$2,400 of federal income tax expense resulting from undistributed REIT taxable income for the year ended December 31, 2010 and December 31, 2009, respectively which is included in accounts payable and accrued expenses.

### **Note 13 - Interest Rate Risk**

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

We seek to manage the extent to which net income changes as a function of changes in interest rates by matching adjustable rate assets with variable rate borrowings. We may seek to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in the portfolio of Agency Securities by entering into interest rate agreements such as interest rate swaps. As of March 31, 2011 and December 31, 2010, we had entered into interest rate swap contracts to pay a fixed rate and receive a floating rate of interest, with a total notional amount of \$965.0 million and \$155.0 million, respectively. Changes in interest rates may also have an effect on the rate of mortgage principal prepayments and, as a result, prepayments on Agency Securities. Prepayments, which result in the expensing of unamortized premium, will reduce net income compared to what net income would be absent such prepayments.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2011

(Unaudited)

**Note 14 - Related Party Transactions**

We entered into a Management Agreement (see Note 8 *Commitments and Contingencies* for additional discussion) with ARRM to manage our business affairs in conformity with certain restrictions contained in the management agreement, including any material operating policies we may adopt. Pursuant to the terms of the management agreement, ARRM will be responsible for the following primary roles:

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Advising us with respect to, arrange for, and manage the acquisition, financing, management and disposition of, elements of our investment portfolio,

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Evaluating the duration risk and prepayment risk within the investment portfolio and arranging borrowing and hedging strategies,

.

Coordinating capital raising activities,

.

Advising us on the formulation and implementation of operating strategies and policies, arranging for the acquisition of assets, monitoring the performance of those assets, arranging for various types of financing and hedging strategies, and providing administrative and managerial services in connection with our day-to-day operations, and

.

Providing executive personnel along with administrative personnel, office space, and other appropriate services required in rendering management services to us.

In return for these services, we incurred \$0.8 million and \$0.06 million of management fees to ARRM, for the quarter ended March 31, 2011 and March 31, 2010, respectively. We did not reimburse any expenses incurred by ARRM on our behalf.

**Note 15 Subsequent Events**

On April 13, 2011, we completed an underwritten secondary public offering of 17,000,000 shares of common stock. This included the underwriter's partially exercised over-allotment option of 1,000,000 additional shares at a price of \$7.40 per share. Net proceeds were \$121.4 million, net of issuance costs of approximately \$4.4 million.

On April 28, 2011, a cash dividend of \$0.12 per common share, or \$6.0 million in the aggregate, was paid to holders of record on April 15, 2011.

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

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

*References to we, us, our, ARMOUR or the Company are to ARMOUR Residential REIT, Inc. References to ARRM are to ARMOUR Residential Management LLC, a Delaware limited liability company. References to Enterprise are to Enterprise Acquisition Corp., which became a wholly-owned subsidiary of ARMOUR after completion of the business combination described below.*

### CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains various forward-looking statements. Forward-looking statements relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts. In some cases, you can identify forward-looking statements by the use of forward-looking terminology such as believes, expects, may, will, would, could, should, seeks, approximately, intends, estimates or anticipates or the negative of these words and phrases or similar words or phrases. All forward-looking statements may be impacted by a number of risks and uncertainties, including statements regarding the following subjects:

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our business and investment strategy;

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our anticipated results of operations;

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statements about future dividends;

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our ability to obtain financing arrangements;

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our understanding of our competition and ability to compete effectively;

market, industry and economic trends; and

interest rates.

The forward-looking statements in this report are based on our beliefs, assumptions and expectations of our future performance, taking into account all information currently available to us. These beliefs, assumptions and expectations are subject to risks and uncertainties and can change as a result of many possible events or factors, not all of which are known to us. If a change occurs, our business, financial condition, liquidity and results of operations may vary materially from those expressed in our forward-looking statements. You should carefully consider these risks before you make an investment decision with respect to our common stock.

We cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on forward-looking statements, which apply only as of the date of this report. We do not intend and disclaim any duty or obligation to update or revise any industry information or forward-looking statements set forth in this report to reflect new information, future events or otherwise, except as required under the U.S. Federal securities laws.

## Overview

We are an externally-managed Maryland corporation organized in 2008, managed by ARRM. We invest primarily in hybrid adjustable rate, adjustable rate and fixed rate residential mortgage backed securities issued or guaranteed by a U.S. Government-chartered entity, such as the Federal National Mortgage Association (more commonly known as Fannie Mae) and the Federal Home Loan Mortgage Corporation (more commonly known as Freddie Mac), or guaranteed by the Government National Mortgage Administration, a U.S. Government corporation (more commonly known as Ginnie Mae), which we refer to collectively as Agency Securities. From time to time, a portion of our portfolio may be invested in unsecured notes and bonds issued by U.S. Government-chartered entities, which we refer to as Agency Debt, U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a real estate investment trust, or REIT.

We seek attractive long-term investment returns by investing our equity capital and borrowed funds in our targeted asset class. We earn returns on the spread between the yield on our assets and our costs, including the interest cost of the funds we borrow, after giving effect to our hedges. We intend to qualify and have elected to be taxed as a REIT under the Internal Revenue Code, ( the Code ). We will generally not be subject to federal income tax to the extent that we distribute 90% of our taxable income to our shareholders, and as long as we satisfy the ongoing REIT requirements including meeting certain asset, income and stock ownership tests. Our business plan is to identify and acquire Agency Securities, finance our acquisitions with borrowings under a series of short-term repurchase agreements at the most competitive interest rates available to us and then cost-effectively mitigate our interest rate and other risks based on our entire portfolio of assets, liabilities and derivatives and our management's view of the market.

Successful implementation of our business plan requires us to address interest rate risk, maintain adequate liquidity and effectively mitigate interest rate risks. We execute our business plan in a manner consistent with our intention of qualifying as a REIT and avoiding regulation as an investment company.

## Our Manager

We are managed by ARRM pursuant to a management agreement between ourselves and ARRM. As an externally-managed company, we depend on the diligence, experience and skill of ARRM for the selection, acquisition, structuring, hedging and monitoring of our Agency Securities and associated borrowings. Pursuant to the management agreement, ARRM is entitled to receive a monthly management fee that is based on the total of all gross equity (including initial gross merger equity as well as any future equity raised), as measured as of the date of determination, regardless of our performance. The management agreement became effective on November 6, 2009 and has an initial term of 5 years; following the initial term, the management agreement automatically renews for successive 1-year renewal terms unless we or ARRM give notice to the respective other of its intent not to renew the agreement 180 days prior to the expiration of the initial term or any renewal term, as applicable. On November 6, 2009, we entered into an amended and restated management agreement with ARRM for the sole purpose of reducing the monthly management fee to 1/12<sup>th</sup> of 1% of gross equity raised (including initial gross merger equity as well as any future gross equity raised) until gross equity raised is \$50.0 million inclusive of gross merger equity. Thereafter, the monthly management fee shall be 1/12<sup>th</sup> of (a) 1.5% of gross equity raised up to \$1.0 billion and (b) 0.75% of gross equity raised in excess of \$1.0 billion, with a monthly minimum based on 1/12<sup>th</sup> of \$900,000. There is no incentive compensation payable to ARRM pursuant to the management agreement.

As of March 31, 2011, our Agency Security portfolio, both trades that have settled and forward settle trades that we have committed to settle, consisted of approximately \$2.3 billion, in market value, of Agency Securities with initial fixed-interest rate periods of three years, five years, seven years, ten years and 15 years.

The following table represents key data regarding our results of operations since the beginning of operations on November 6, 2009:

|                      | Agency Securities | Repurchase Agreements | Unsettled Security Purchases | Equity        | Shares Outstanding | Book            | Quarterly          | Diluted                   |
|----------------------|-------------------|-----------------------|------------------------------|---------------|--------------------|-----------------|--------------------|---------------------------|
|                      |                   |                       |                              |               |                    | Value Per Share | Dividends Declared | Earnings (Loss) Per Share |
| As of March 31, 2011 | \$2,273,914,732   | \$2,099,366,245       | \$19,941,430                 | \$220,612,375 | 32,254,054         | \$6.84          | \$0.34             | \$0.33                    |
| December 31, 2010    | 1,161,850,680     | 971,675,658           | 125,418,369                  | 108,708,577   | 16,441,554         | 6.61            | 0.38               | 0.71                      |
|                      | 540,070,197       | 490,727,022           | 11,130,519                   | 54,035,550    | 7,414,054          | 7.29            | 0.36               | (0.06)                    |



|                       |             |             |             |            |           |      |      |        |  |
|-----------------------|-------------|-------------|-------------|------------|-----------|------|------|--------|--|
| September<br>30, 2010 |             |             |             |            |           |      |      |        |  |
| June 30,<br>2010      | 477,579,500 | 334,703,323 | 114,870,537 | 54,319,365 | 7,414,054 | 7.33 | 0.40 | (0.22) |  |
| March 31,<br>2010     | 164,583,811 | 168,525,093 | -           | 21,417,725 | 2,304,054 | 9.30 | 0.40 | 0.13   |  |
| December<br>31, 2009  | 118,648,724 | 46,388,602  | 58,559,479  | 21,491,096 | 2,304,054 | 9.33 | -    | (0.08) |  |

### Factors that Affect our Results of Operations and Financial Condition

Our results of operations and financial condition are affected by various factors, many of which are beyond our control, including, among other things, our net interest income, the market value of our assets and the supply of and demand for such assets. We invest in financial assets and markets, and recent events, such as those discussed below, can affect our business in ways that are difficult to predict, and produce results outside of typical operating variances. Our net interest income varies primarily as a result of changes in interest rates, borrowing costs and prepayment speeds, the behavior of which involves various risks and uncertainties. Prepayment rates, as reflected by the rate of principal pay downs, and interest rates vary according to the type of investment, conditions in financial markets, government actions, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment rates on our Agency Securities purchased at a premium increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. Because changes in interest rates may significantly affect our activities, our operating results depend, in large part, upon our ability to manage interest rate risks and prepayment risks effectively while maintaining our status as a REIT.

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

Prepayments on Agency Securities and the underlying mortgage loans may be influenced by changes in market interest rates and a variety of economic and geographic factors beyond our control, as well as policy decisions by Fannie Mae, Freddie Mac and Ginnie Mae. Consequently prepayment rates cannot be predicted with certainty. To the extent we have acquired Agency Securities at a premium or discount to par, or face value, changes in prepayment rates may impact our anticipated yield. In periods of declining interest rates, prepayments on our Agency Securities will likely increase. If we are unable to reinvest the proceeds of such prepayments at comparable yields, our net interest income may suffer. The recent climate of government intervention in the mortgage markets significantly increases the risk associated with prepayments.



While we intend to use strategies to mitigate some of our interest rate risk, we do not intend to mitigate all of our exposure to changes in interest rates and prepayment rates, as there are practical limitations on our ability to insulate our portfolio from all potential negative consequences associated with changes in short-term interest rates in a manner that will allow us to seek attractive net spreads on our portfolio.

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

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our degree of leverage;

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our access to funding and borrowing capacity;

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our use of derivatives to mitigate interest rate risk; and

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the REIT requirements, the requirements to qualify for an exemption under the Investment Company Act and other regulatory and accounting policies related to our business.

ARRM, our manager, is entitled to receive a monthly management fee that is based on our equity (as defined in our management agreement), regardless of the performance of our portfolio. Accordingly, the payment of our monthly management fee may not decline in the event of a decline in our profitability and may cause us to incur losses.

For a discussion of additional risks relating to our business see **Risk Factors** in our Annual Report on Form 10-K for the year ended December 31, 2010.

## **Market and Interest Rate Trends and the Effect on our Portfolio**

### ***Credit Market Disruption***

During the past few years, the residential housing and mortgage markets in the United States have experienced a variety of difficulties and changed economic conditions including loan defaults, credit losses and decreased liquidity. These conditions have resulted in volatility in the value of the Agency Securities we purchase and an increase in the average collateral requirements under our repurchase agreements. While these markets recovered a great deal in 2010, further increased volatility and deterioration in the broader residential mortgage and Residential Mortgage Back Securities ( RMBS ) markets may adversely affect the performance and market value of the Agency Securities and other high quality RMBS. As a result, values for RMBS, including some Agency Securities, have been negatively impacted. Further increased volatility and deterioration in the broader RMBS markets may adversely affect the performance and market value of the Agency Securities in which we invest. In addition, we rely on the availability of financing to acquire Agency Securities on a leveraged basis. As values for certain types of Agency Securities declined many lenders in the Agency Securities market tightened their lending standards, and in some cases, withdrew financing of residential mortgage assets and Agency Securities. Our lenders may have owned or financed RMBS that have declined in value and caused them to incur losses. Although market conditions have returned to more normal circumstances, if they were to worsen again, our lenders 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, any of which could make it more difficult or costly for us to obtain financing.

#### ***Developments at Fannie Mae and Freddie Mac***

Payments on the Agency Securities in which we invest are guaranteed by Fannie Mae and Freddie Mac. Because of the guarantee and the underwriting standards associated with mortgages underlying Agency Securities, Agency Securities historically have had high stability in value and been considered to present low credit risk. In 2008, Fannie Mae and Freddie Mac were placed under the conservatorship of the U.S. Government due to the significant weakness of their financial condition. The turmoil in the residential mortgage sector and concern over the future role of Fannie Mae and Freddie Mac have generally increased credit spreads and decreased price stability of Agency Securities. It is unclear how and when Fannie Mae and Freddie Mac may be restructured by the U.S. Government and the impact that may have on our existing portfolio and continuing investment strategy.

In response to the credit market disruption and the deteriorating financial condition of Fannie Mae and Freddie Mac, Congress and the U.S. Treasury undertook a series of actions in 2008 aimed at stabilizing the financial markets in general, and the mortgage market in particular. These actions include the large-scale buying of mortgage backed securities, significant equity infusions into banks and aggressive monetary policy.

In addition, the U.S. Federal Reserve initiated a program in 2008 to purchase \$200.0 billion in direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks and \$1.3 trillion in Agency Securities issued and guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. The U.S. Federal Reserve stated that its actions were intended to reduce the cost and increase the availability of credit for the purchase of houses, which in turn was expected to support housing markets and foster improved conditions in financial markets more generally. This purchase program was completed on March 31, 2010. It is unclear the degree to which the completion of this program and withdrawal of substantial demand for Agency Securities by the Federal Reserve will affect the price and liquidity of Agency Securities. We are unable to predict whether or when the U.S. Treasury or the Federal Reserve will liquidate their holdings or make further interventions in the Agency Securities markets, or what impact, if any, such action could have on the Agency Securities market, the Agency Securities we hold, our business, results of operations and financial condition. It is unclear the timing or manner in which the Federal Reserve might dispose of the Agency Securities it has acquired and, consequently, any impact on the Agency Securities market and the Agency Securities we hold.

In February 2010, Fannie Mae and Freddie Mac announced that they would execute wholesale repurchases of loans which they considered seriously delinquent from existing mortgage pools. This action temporarily decreased the value of these securities until complete details of the programs and the timing were announced and reduced our yield in the months of repayment. Freddie Mac implemented its purchase program in February 2010 with actual purchases beginning in March 2010. Fannie Mae began their process in March 2010 and announced it would implement the initial purchases over a period of three months, beginning in April 2010. Further, both agencies announced that on an ongoing basis they would purchase loans from the pools of mortgage loans underlying their mortgage pass-through certificates that became 120 days delinquent.

We cannot predict whether or when new actions may occur, the timing and pace of current actions already implemented, or what impact if any, such actions, or future actions, could have on our business, results of operations and financial condition.

### ***U.S. Treasury Market Intervention***

One of the main factors impacting market prices was the U.S. Federal Reserve's program to purchase agency securities which had commenced in January 2009 and was terminated on March 31, 2010. In total, \$1.25 trillion of agency securities were purchased. In addition, through the course of 2009, the U.S. Treasury purchased \$250 billion of agency securities. An effect of these purchases has been an increase in the prices of agency securities, which has decreased our net interest margin. When these programs terminated, the market expectation was that it might cause a decrease in demand for these securities which would likely reduce their market price. However, this has not happened and we continue to see strong demand as these securities remain desirable assets in this rather volatile economic environment. It is difficult to quantify the impact, as there are many factors at work at the same time that affect the price of our securities and, therefore, our yield and book value. Due to the unpredictability in the markets for our securities in particular and yield generating assets in general, there is no pattern that can be implied with any certainty.

In March 2011, the U.S. Treasury announced that it will begin the orderly wind down of its remaining agency securities with sales up to \$10 billion per month, subject to market conditions. It is unclear how these sales will affect market conditions and pricing.

***Financial Regulatory Reform Bill and Other Government Activity***

Certain programs initiated by the U.S. Government, through the Federal Housing Administration ( FHA ) and the Federal Deposit Insurance Corporation to provide homeowners with assistance in avoiding residential mortgage loan foreclosures are currently in effect. The programs may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans or the rate of interest payable on the loans, or to extend the payment terms of the loans. One such program is the Hope for Homeowners program, which is effective from October 1, 2008, through September 30, 2011, and will enable certain distressed borrowers to refinance their mortgages into FHA-insured loans. In addition, in February 2009, the U.S. Treasury announced the Homeowner Affordability and Stability Plan, which is multi-faced plan that also is intended to prevent residential mortgage foreclosures. While the effect of these programs has not been as extensive as originally expected, the effect of such programs for holders of agency securities could be that such holders would experience changes in the anticipated yields of their agency securities due to (i) increased prepayment rates and (ii) lower interest and principal payments.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. This legislation aims to restore responsibility and accountability to the financial system. It is unclear how this legislation may impact the borrowing environment, investing environment for agency securities and interest rate swaps as much of the legislation implementation has not yet been defined by the regulators.

In November 2010, the U.S. Federal Reserve announced a program to purchase an additional \$600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about \$75 billion per month. One of the effects of this program may be to increase the price of agency securities, which may also decrease our net interest margin. Once the program is terminated it may cause a decrease in demand for these securities, which likely would reduce their market value.

In February 2011, the U.S. Treasury, along with the U.S. Department of Housing and Urban Development, released a report titled "Reforming America's Housing Finance Market" to Congress outlining recommendations for reforming the U.S. housing system, specifically Fannie Mae and Freddie Mac and transforming the government's involvement in the housing market. 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.

### *Interest Rates*

The overall credit market deterioration since August 2007, has also affected prevailing interest rates. For example, interest rates have been unusually volatile since the third quarter of 2007. Since September 18, 2007, the U.S. Federal Reserve has lowered the target for the Federal Funds Rate nine times from 4.75% to 1.0% in October 2008. In December 2008, the Federal Reserve stated that it was adopting a policy of "quantitative easing" and would target keeping the Federal Funds Rate between 0.00% and 0.25%. To date, the Federal Reserve has maintained that target range. Our funding costs, which traditionally have tracked the 30-day London Interbank Offered Rate (LIBOR) have generally benefited by this easing of monetary policy, although to a somewhat lesser extent. Because of continued uncertainty in the credit markets and U.S. economic conditions, we expect that interest rates are likely to experience continued volatility, which will likely affect our financial results since our cost of funds is largely dependent on short-term rates.

Historically, 30-day LIBOR has closely tracked movements in the Federal Funds Rate and the Effective Federal Funds Rate. The Effective Federal Funds Rate can differ from the Federal Funds Rate in that the Effective index represents the volume weighted average of interest rates at which depository institutions lend balance at the Federal Reserve to other depository institutions overnight (actual transactions, rather than target rate).

Our borrowings in the repurchase market have also historically closely tracked LIBOR. So traditionally, a lower Federal Funds Rate has indicated a time of increased net interest margin and higher asset values. However, since July 2007, (prior to our commencement of operations) LIBOR and repurchase market rates have varied greatly, and often have been significantly higher than the target and the Effective Federal Funds Rate. The difference between 30-day LIBOR and the Effective Federal Funds rate has also been quite volatile, with the spread alternately returning to more normal levels and then widening out again. The volatility in these rates and divergence from the historical relationship among these rates could negatively impact our ability to manage our portfolio. If this were to occur, our net interest margin and the value of our portfolio might suffer as a result. The following table shows 30-day LIBOR as compared to the Effective Federal Funds rate at each period end:

| <b>Quarter ended</b> | <b>30-Day</b> | <b>Effective Federal</b> |
|----------------------|---------------|--------------------------|
|----------------------|---------------|--------------------------|

|                    | <b>LIBOR</b> | <b>Funds Rate</b> |
|--------------------|--------------|-------------------|
| March 31, 2011     | 0.24 %       | 0.10%             |
| December 31, 2010  | 0.26         | 0.13              |
| September 30, 2010 | 0.26         | 0.15              |
| June 30, 2010      | 0.35         | 0.09              |
| March 31, 2010     | 0.25         | 0.09              |
| December 31, 2009  | 0.23         | 0.05              |

### **Principal Repayment Rate**

Our net income is primarily a function of the difference between the yield on our assets and the financing cost of owning those assets. Since we tend to purchase assets at a premium to par, the main item that can affect the yield on our assets after they are purchased is the rate at which the mortgage borrowers repay the loan. While the scheduled repayments, which are the principal portion of the homeowners' regular monthly payments, are fairly predictable, the unscheduled repayments, which are generally refinancing of the mortgage but can also result from repurchases of delinquent, defaulted, or modified loans, are less so. Being able to accurately estimate and manage these repayment rates is a critical portion of the management of our portfolio, not only for estimating current yield but also for considering the rate of reinvestment of those proceeds into new securities, the yields which those new securities may add to our portfolio and our hedging strategy. We expect that prepayment rates will be elevated due to repurchases of loans that reach 120 day or more delinquency by Freddie Mac and Fannie Mae on a continuing basis.



The following table shows the average principal repayment rate for those securities which have settled for each quarter since our commencement of operations (as our operations commenced in November 2009, there is only one month of prepayment data for 2009 for our portfolio of settled Agency Securities):

| <b>Average</b>             |                       |
|----------------------------|-----------------------|
| <b>Quarterly Principal</b> |                       |
| <b>Quarter ended</b>       | <b>Repayment Rate</b> |
| March 31, 2011             | 11.7%                 |
| December 31, 2010          | 10.8                  |
| September 30, 2010         | 11.1                  |
| June 30, 2010              | 15.4                  |
| March 31, 2010             | 14.5                  |
| December 31, 2009          | 8.6                   |

We typically purchase Agency Securities at premium prices. The premium price paid over par value on those assets is expensed as the underlying mortgages experience repayment or prepayment. The lower the constant prepayment rate, the lower the amount of amortization expense for a particular period. Accordingly, the yield on an asset, and earnings, are higher. If prepayment rates increase, the amount of amortization expense for a particular period will go up. These increased prepayment rates would act to decrease the yield on an asset and would decrease earnings.

### **Book Value per Share**

As of March 31, 2011, our book value per share of common stock (total shareholders' equity divided by shares of common stock outstanding) was \$6.84, an increase of \$0.23 from \$6.61 at December 31, 2010. This increase was primarily attributable to shareholder accretion from a total of two underwritten follow-on public offerings of an aggregate of 15,812,500 shares of common stock. Although we attempt to structure our interest rate contracts to offset the changes in asset prices, they are not perfectly correlated, and depend on the corresponding durations and section of the yield curve that moves to offset each other. Our interest rate contracts, which consist of using interest rate swaps and Eurodollar futures to act to fix the borrowing cost on a portion of our financing and generally help to mitigate some of the change in our book value. Generally, the value of our interest rate contracts move in the opposite direction of the value of our Agency Securities. In an environment of very low interest rates, further interest rate reductions may cause the value of interest rate swap contracts and Eurodollar futures positions to decline more than the absolute and pro rata increase in the value of our Agency Securities. For the quarter ending March 31, 2011, the unrealized change of our Eurodollar futures and interest rate swap contract positions decreased by \$0.3 million and the unrealized change of our Agency Securities decreased by \$0.2 million. For the year ended December 31, 2010, the unrealized change of our Eurodollar futures and interest rate swap contract positions declined by \$2.5 million and the unrealized change of our Agency Securities decreased by \$4.3 million.

**Investments***Agency Securities*

As of March 31, 2011, our Agency Securities portfolio was purchased at a net premium to par value with a weighted average amortized cost, including settled and forward settle securities, of 104.09%, due to the average interest rates on these securities being higher than prevailing market rates. As of March 31, 2011, we had approximately \$89.4 million of unamortized premium included in the cost basis of our investments, inclusive of both settled and forward settle securities. As of March 31, 2011, our investment portfolio of securities consisted of Agency Securities as follows:

**Adjustable Rate Settled Securities as of March 31, 2011**

| <b>Months</b>        | <b>Percentage of Settled Securities</b> | <b>Weighted Average Months to Reset</b> | <b>Current Face Value(1)</b> | <b>Weighted Average Coupon(2)</b> | <b>Weighted Average Amortized Purchase Price(3)</b> | <b>Amortized Cost(4)</b> | <b>Weighted Average Market Price(5)</b> | <b>Current Market Value(6)</b> |
|----------------------|---|---|------------------------------|-----------------------------------|---|--------------------------|---|--------------------------------|
| 0-18                 | 5.1%                                    | 7                                       | \$ 109,352,905               | 3.66%                             | \$ 104.65   | \$ 114,432,859           | \$ 105.03                               | \$ 114,857,148                 |
| 19-36                | 6.6                                     | 31                                      | 140,561,407                  | 4.68                              | 105.04  | 147,651,539              | 105.43                                  | 148,199,438                    |
| 37-60                | 30.1                                    | 49                                      | 652,800,207                  | 3.86                              | 103.91  | 678,340,432              | 103.96                                  | 678,663,343                    |
| 61-84                | 20.1                                    | 76                                      | 440,884,194                  | 3.70                              | 103.58  | 456,667,882              | 102.74                                  | 452,949,612                    |
| 85+                  | 1.9                                     | 112                                     | 41,853,098                   | 4.08                              | 105.39  | 44,108,611               | 102.84                                  | 43,040,109                     |
| <b>Total/Average</b> | <b>63.8%</b>                            | <b>54</b>                               | <b>\$ 1,385,451,811</b>      | <b>3.88%</b>                      | <b>\$ 104.02</b>                                    | <b>\$ 1,441,201,323</b>  | <b>\$ 103.77</b>                        | <b>\$ 1,437,709,650</b>        |

**Fixed Rate Settled Securities as of March 31, 2011**

| Months<br>to         | Percentage<br>of<br>Settled<br>Securities<br>Portfolio | Weighted<br>Average<br>Months<br>to<br>Reset | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average               |                       | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|----------------------|--|--|-----------------------------|----------------------------------|-----------------------------------|-----------------------|---|-------------------------------|
|                      |  |  |                             |                                  | Amortized<br>Purchase<br>Price(3) | Amortized<br>Cost(4)  |   |                               |
| 0-90                 | 0.1%   | 70   | \$ 1,581,176                | 5.60%                            | \$ 106.51                         | \$ 1,684,121          | \$ 107.47                                 | \$ 1,699,346                  |
| 91-180               | 36.1   | 171  | \$ 782,914,609              | 4.21                             | 104.17                            | \$ 815,562,824        | 104.03                                    | \$ 814,473,705                |
| <b>Total/Average</b> | <b>36.2%</b>   | <b>170</b>                                   | <b>\$ 784,495,785</b>       | <b>4.21%</b>                     | <b>\$ 104.17</b>                  | <b>\$ 817,246,945</b> | <b>104.04</b>                             | <b>\$ 816,173,051</b>         |

**All Settled Securities as of March 31, 2011**

| Settled<br>Securities<br>Portfolio | Percentage<br>Of | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average               |                         | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|------------------------------------|------------------|-----------------------------|----------------------------------|-----------------------------------|-------------------------|---|-------------------------------|
|                                    |                  |                             |                                  | Amortized<br>Purchase<br>Price(3) | Amortized<br>Cost(4)    |   |                               |
| <b>Total/Average</b>               | <b>100.0%</b>    | <b>\$ 2,169,947,596</b>     | <b>4.00%</b>                     | <b>\$ 104.08</b>                  | <b>\$ 2,258,448,268</b> | <b>\$ 103.87</b>                          | <b>\$ 2,253,882,701</b>       |

- (1) The current face is the current monthly remaining dollar amount of principal of an Agency Security. We compute current face by multiplying the original face value of the security by the current principal balance factor. The current principal balance factor is a fraction, where the numerator is the current outstanding balance and the denominator is the original principal balance.
- (2) For a pass-through certificate, the coupon reflects the weighted average nominal rate of interest paid on the underlying mortgage loans, net of fees paid to the servicer and the agency. The coupon for a pass-through certificate may change as the underlying mortgage loans are prepaid.
- (3) Amortized purchase price is the dollar amount, per \$100 of current face, of our purchase price for the security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (4) Amortized cost is our total purchase price for the Agency Security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (5) Market price is the dollar amount of market value, per \$100 of nominal, or face value, of the Agency Security. We value our Agency Securities using a third party pricing service whose pricing model incorporates common market

pricing methods. Management reviews the pricing to ensure that current market conditions are properly represented.

(6) Market value is the total market value for the security.

As of March 31, 2011, we had committed to purchase securities for settlements in April of 2011. The information below was current as of March 31, 2011, but subject to change due to amortization prior to settlement. In addition, some forward trades of new issue securities are subject to modest changes in delivery size and coupon.

**Adjustable Rate Forward Settle Securities as of March 31, 2011**

| Months to Reset      | Percentage of Forward Settle Portfolio | Weighted Average Months to Reset | Current Face Value(1) | Weighted Average Coupon(2) | Weighted Average            |                     |                                  | Current Market Value(6) |
|----------------------|--|----------------------------------|-----------------------|----------------------------|-----------------------------|---------------------|----------------------------------|-------------------------|
|                      |  |                                  |                       |                            | Amortized Purchase Price(3) | Amortized Cost(4)   | Weighted Average Market Price(5) |                         |
| 0-18                 | 4.0%                                   | 10                               | \$ 754,533            | 5.50%                      | \$ 103.88                   | \$ 783,771          | \$ 105.31                        | \$ 794,585              |
| 19-36                | 9.4                                    | 32                               | 1,762,997             | 4.48                       | 104.43                      | 1,841,129           | 106.40                           | 1,875,900               |
| 37-60                | 11.3                                   | 40                               | 2,144,811             | 4.75                       | 105.05                      | 2,253,086           | 105.56                           | 2,263,988               |
| 61-84                | 5.6                                    | 84                               | 1,074,602             | 4.94                       | 105.38                      | 1,132,362           | 106.16                           | 1,140,761               |
| <b>Total/Average</b> | <b>30.3%</b>                           | <b>42</b>                        | <b>\$ 5,736,943</b>   | <b>5.11%</b>               | <b>\$ 104.77</b>            | <b>\$ 6,010,348</b> | <b>\$ 105.90</b>                 | <b>\$ 6,075,234</b>     |

**Fixed Rate Forward Settle Securities as of March 31, 2011**

| Forward Settle Portfolio | Percentage of Forward Settle Portfolio | Weighted Average Months to Reset | Current Face Value(1) | Weighted Average Coupon(2) | Weighted Average            |                            |                                  | Current Market Value(6) |
|--------------------------|--|----------------------------------|-----------------------|----------------------------|-----------------------------|----------------------------|----------------------------------|-------------------------|
|                          |  |                                  |                       |                            | Amortized Purchase Price(3) | Expected Amortized Cost(4) | Weighted Average Market Price(5) |                         |
| 90-180                   | 69.7%                                  | 179                              | \$ 13,274,969         | 4.50%                      | \$ 104.94                   | \$ 13,931,083              | \$ 105.14                        | \$ 13,956,797           |
| <b>Total/Average</b>     | <b>69.7%</b>                           | <b>179</b>                       | <b>\$ 13,274,969</b>  | <b>4.50%</b>               | <b>\$ 104.94</b>            | <b>\$ 13,931,083</b>       | <b>\$ 105.14</b>                 | <b>\$ 13,956,797</b>    |



**All Forward Settle Securities as of March 31, 2011**

|                      | Percentage<br>of<br>Forward<br>Settle<br>Portfolio | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Amortized<br>Purchase<br>Price(3) | Expected<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|----------------------|--|-----------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|
| <b>Total/Average</b> | 100.0%   | \$ 19,011,912               | 4.68%                            | \$ 104.89  | \$ 19,941,431                    | \$ 105.37                                 | \$ 20,032,031                 |

**All Settled and Forward Settle Securities as of March 31, 2011**

|                      | Percentage<br>of<br>Settled and<br>Forward<br>Settle<br>Portfolio | Current Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Amortized<br>Purchase<br>Price(3) | Expected<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|----------------------|---|--------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|
| <b>Total/Average</b> | 100.0%  | \$ 2,188,959,508         | 4.01%                            | \$ 104.09  | \$ 2,278,389,699                 | \$ 103.88                                 | \$ 2,273,914,732              |

(1) The current face is the current monthly remaining dollar amount of principal of an Agency Security. We compute current face by multiplying the original face value of the security by the current principal balance factor. The current principal balance factor is a fraction, where the numerator is the current outstanding balance and the denominator is the original principal balance.

(2) For a pass-through certificate, the coupon reflects the weighted average nominal rate of interest paid on the underlying mortgage loans, net of fees paid to the servicer and the agency. The coupon for a pass-through certificate may change as the underlying mortgage loans are prepaid.

(3) Amortized purchase price is the dollar amount, per \$100 of current face, of our purchase price for the security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.

(4) Amortized cost is our total purchase price for the Agency Security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.

(5) Market price is the dollar amount of market value, per \$100 of nominal, or face value, of the Agency Security. We value our Agency Securities using a third party pricing service whose pricing model incorporates common market pricing methods. Management reviews the pricing to ensure that current market conditions are properly

represented.

(6) Market value is the total market value for the security.

As of December 31, 2010, our Agency Securities portfolio was purchased at a net premium to par value with a weighted average amortized cost, including settled and forward settle securities, of 104.44%, due to the average interest rates on these securities being higher than prevailing market rates. As of December 31, 2010, we had approximately \$49.6 million of unamortized premium included in the cost basis of our investments, inclusive of both settled and forward settle securities. All unsettled purchases of securities as of December 31, 2010, were settled in January and February 2011. As of December 31, 2010, our investment portfolio of settled securities consisted of Agency Securities as follows:

**Adjustable Rate Settled Securities as of December 31, 2010**

| Months<br>to         | Percentage<br>Settled<br>of<br>Securities<br>Portfolio | Weighted<br>Average<br>Months<br>to<br>Reset | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average               |                      | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|----------------------|--|--|-----------------------------|----------------------------------|-----------------------------------|----------------------|---|-------------------------------|
|                      |  |  |                             |                                  | Amortized<br>Purchase<br>Price(3) | Amortized<br>Cost(4) |   |                               |
| 0-18                 | 4.8%   | 7  | \$ 47,989,156               | 3.67%                            | \$ 104.31                         | \$ 50,058,987        | \$ 104.45                                 | \$ 50,126,097                 |
| 19-36                | 3.3  | 29   | 32,967,374                  | 4.00                             | 103.71                            | 34,192,034           | 104.37                                    | 34,407,131                    |
| 37-60                | 25.0   | 52   | 247,952,187                 | 4.00                             | 103.96                            | 257,686,509          | 104.44                                    | 258,969,161                   |
| 61-84                | 32.5   | 78   | 325,954,726                 | 3.87                             | 104.26                            | 339,833,155          | 103.34                                    | 336,849,193                   |
| 85+                  | 4.4  | 114  | 44,397,480                  | 4.07                             | 105.39                            | 46,789,017           | 102.66                                    | 45,578,166                    |
| <b>Total/Average</b> | <b>70.0%</b>   | <b>64</b>                                    | <b>\$699,260,923</b>        | <b>3.92%</b>                     | <b>\$ 104.20</b>                  | <b>\$728,559,702</b> | <b>\$ 103.81</b>                          | <b>\$725,929,748</b>          |

**Fixed Rate Settled Securities as of December 31, 2010**

| Months<br>to         | Percentage<br>Settled<br>of<br>Securities<br>Portfolio | Weighted<br>Average<br>Months<br>to<br>Reset | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average               |                      | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|----------------------|--|--|-----------------------------|----------------------------------|-----------------------------------|----------------------|---|-------------------------------|
|                      |  |  |                             |                                  | Amortized<br>Purchase<br>Price(3) | Amortized<br>Cost(4) |   |                               |
| 0-90                 | 0.1%   | 63   | \$ 1,171,170                | 6.15%                            | \$ 107.23                         | \$ 1,255,843         | \$ 108.53                                 | \$ 1,271,054                  |
| 91-180               | 29.9   | 172  | 295,562,459                 | 4.33                             | 105.19                            | 310,903,484          | 104.65                                    | 309,319,711                   |
| <b>Total/Average</b> | <b>30.0%</b>   | <b>171</b>                                   | <b>\$296,733,629</b>        | <b>4.34%</b>                     | <b>\$ 105.20</b>                  | <b>\$312,159,327</b> | <b>\$ 104.67</b>                          | <b>\$310,590,765</b>          |





**All Settled Securities as of December 31, 2010**

| Percentage<br>Of<br>Settled<br>Securities<br>Portfolio | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average               |                      |   |           | Current<br>Market<br>Value(6) |
|--|-----------------------------|----------------------------------|-----------------------------------|----------------------|---|-----------|-------------------------------|
|  |                             |                                  | Amortized<br>Purchase<br>Price(3) | Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) |           |                               |
| <b>Total/Average</b>                                   | 100.0%                      | \$995,994,552                    | 4.04%                             | \$ 104.50            | \$1,040,719,029                           | \$ 104.07 | \$1,036,520,513               |

- (1) The current face is the current monthly remaining dollar amount of principal of an Agency Security. We compute current face by multiplying the original face value of the security by the current principal balance factor. The current principal balance factor is a fraction, where the numerator is the current outstanding balance and the denominator is the original principal balance.
- (2) For a pass-through certificate, the coupon reflects the weighted average nominal rate of interest paid on the underlying mortgage loans, net of fees paid to the servicer and the agency. The coupon for a pass-through certificate may change as the underlying mortgage loans are prepaid.
- (3) Amortized purchase price is the dollar amount, per \$100 of current face, of our purchase price for the security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (4) Amortized cost is our total purchase price for the Agency Security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (5) Market price is the dollar amount of market value, per \$100 of nominal, or face value, of the Agency Security. We value our Agency Securities using a third party pricing service whose pricing model incorporates common market pricing methods. Management reviews the pricing to ensure that current market conditions are properly represented.
- (6) Market value is the total market value for the security.

As of December 31, 2010, we had committed to purchase securities for settlements in January and February of 2011. The information below was current as of December 31, 2010, but subject to change due to amortization prior to settlement. In addition, some forward trades of new issue securities are subject to modest changes in delivery size and coupon. All, but one, of the forward settling Agency Securities were adjustable rate with a minimum expected reset of 11 months and a maximum expected reset of 71 months.

**Adjustable Rate Forward Settle Securities as of December 31, 2010**

| Percentage | Weighted | Weighted | Expected |
|------------|----------|----------|----------|
|------------|----------|----------|----------|

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|                      | of<br>Forward<br>Settle<br>Portfolio | Weighted<br>Average<br>Months<br>to Reset | Current<br>Face<br>Value(1) | Average<br>Coupon(2) | Average<br>Amortized<br>Purchase<br>Price(3) | Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|----------------------|--------------------------------------|---|-----------------------------|----------------------|--|----------------------|---|-------------------------------|
| <b>Total/Average</b> | 63.6%                                | 27  | \$ 76,288,258               | 3.22%                | \$ 104.60                                    | \$ 79,799,280        | 104.41                                    | \$ 79,653,941                 |

**Fixed Rate Forward Settle Securities as of December 31, 2010**

| Percentage<br>of<br>Forward<br>Settle<br>Portfolio | Weighted<br>Average<br>Months<br>to Reset | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Purchase<br>Price(3) | Expected<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|--|---|-----------------------------|----------------------------------|---|----------------------------------|---|-------------------------------|
| <b>Total/Average</b>                               | 36.4%                                     | 179                         | \$ 44,184,981                    | 4.00%                                       | \$ 103.12                        | \$ 45,561,901                             | \$ 103.38 \$ 45,676,226       |

**All Forward Settle Securities as of December 31, 2010**

| Percentage<br>of<br>Forward<br>Settle<br>Portfolio | Current<br>Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Purchase<br>Price(3) | Expected<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|--|-----------------------------|----------------------------------|---|----------------------------------|---|-------------------------------|
| <b>Total/Average</b>                               | 100.0%                      | \$ 120,473,239                   | 3.51%                                       | \$ 104.06                        | \$ 125,361,181                            | \$ 104.03 \$ 125,330,167      |

**All Settled and Forward Settle Securities as of December 31, 2010**

| Percentage<br>of<br>Settled | Current Face<br>Value(1) | Weighted<br>Average<br>Coupon(2) | Weighted<br>Average<br>Amortized<br>Price(5) | Expected<br>Amortized<br>Cost(4) | Weighted<br>Average<br>Market<br>Price(5) | Current<br>Market<br>Value(6) |
|-----------------------------|--------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|
|-----------------------------|--------------------------|----------------------------------|--|----------------------------------|---|-------------------------------|

**and  
Forward  
Settle**

**Purchase  
Price(3)**

**Portfolio**

|                      |        |                  |       |           |                  |           |                  |
|----------------------|--------|------------------|-------|-----------|------------------|-----------|------------------|
| <b>Total/Average</b> | 100.0% | \$ 1,116,467,791 | 3.98% | \$ 104.44 | \$ 1,166,080,210 | \$ 103.73 | \$ 1,161,850,680 |
|----------------------|--------|------------------|-------|-----------|------------------|-----------|------------------|

- (1) The current face is the current monthly remaining dollar amount of principal of an Agency Security. We compute current face by multiplying the original face value of the security by the current principal balance factor. The current principal balance factor is a fraction, where the numerator is the current outstanding balance and the denominator is the original principal balance.
- (2) For a pass-through certificate, the coupon reflects the weighted average nominal rate of interest paid on the underlying mortgage loans, net of fees paid to the servicer and the agency. The coupon for a pass-through certificate may change as the underlying mortgage loans are prepaid.
- (3) Amortized purchase price is the dollar amount, per \$100 of current face, of our purchase price for the security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (4) Amortized cost is our total purchase price for the Agency Security, adjusted for amortization as a result of scheduled and unscheduled principal repayments.
- (5) Market price is the dollar amount of market value, per \$100 of nominal, or face value, of the Agency Security. We value our Agency Securities using a third party pricing service whose pricing model incorporates common market pricing methods. Management reviews the pricing to ensure that current market conditions are properly represented.
- (6) Market value is the total market value for the security.

Our investment portfolio consisted of the following breakdown between Fannie Mae, Freddie Mac and Ginnie Mae at March 31, 2011.

| Agency Securities                | March 31, 2011          |               |
|----------------------------------|-------------------------|---------------|
|                                  | Estimated Fair          | Percentage    |
|                                  | Value                   | of Total      |
| <b>Settled Securities</b>        |                         |               |
| Fannie Mae Certificates          | \$ 1,549,507,563        | 68.1%         |
| Freddie Mac Certificates         | 295,920,612             | 13.0          |
| Ginnie Mae Certificates          | 408,454,526             | 18.0          |
| <b>Forward Settle Securities</b> |                         |               |
| Fannie Mae Certificates          | 13,672,664              | 0.6           |
| Freddie Mac Certificates         | 1,424,893               | 0.1           |
| Ginnie Mae Certificates          | 4,934,474               | 0.2           |
| <b>Total Securities</b>          | <b>\$ 2,273,914,732</b> | <b>100.0%</b> |

Our investment portfolio consisted of the following breakdown between Fannie Mae, Freddie Mac and Ginnie Mae at December 31, 2010.

| Agency Securities | December 31, 2010 |            |
|-------------------|-------------------|------------|
|                   | Estimated Fair    | Percentage |

|                                  | <b>Value</b>            | <b>of Total</b> |
|----------------------------------|-------------------------|-----------------|
| <b>Settled Securities</b>        |                         |                 |
| Fannie Mae Certificates          | \$ 718,542,007          | 61.8%           |
| Freddie Mac Certificates         | 257,316,342             | 22.2            |
| Ginnie Mae Certificates          | 60,662,164              | 5.2             |
| <b>Forward Settle Securities</b> |                         |                 |
| Fannie Mae Certificates          | 125,330,167             | 10.8            |
| Freddie Mac Certificates         | -                       | -               |
| Ginnie Mae Certificates          | -                       | -               |
| <b>Total Securities</b>          | <b>\$ 1,161,850,680</b> | <b>100.0%</b>   |

As of March 31, 2011 and December 31, 2010, the adjustable and hybrid adjustable rate mortgage loans underlying our Agency Securities have fixed interest rates for an average period of approximately 54 months and 64 months respectively, after which time the interest rates reset and become adjustable. After a reset date, interest rates on our adjustable and hybrid adjustable Agency Securities float based on spreads over various indices, typically LIBOR or the one-year Constant Maturity Treasury ( CMT ), rate. These interest rates are subject to caps that limit the amount the applicable interest rate can increase during any year, known as an annual cap, and through the maturity of the security, known as a lifetime cap

### *Liabilities*

We have entered into repurchase agreements to finance most of our Agency Securities. Our repurchase agreements are secured by our Agency Securities and bear interest at rates that have historically moved in close relationship to LIBOR. We have established borrowing relationships with several investment banking firms and other lenders, fourteen of which we had done repurchase trades with as of March 31, 2011 and eleven of which we had done repurchases trades with as of December 31, 2010. We had outstanding balances under our repurchase agreements at March 31, 2011 and December 31, 2010 of \$2.1 billion and \$1.0 billion, respectively.

*Derivative Instruments*

We generally intend to mitigate as much of our interest rate risk as our manager deems prudent in light of market conditions and the associated costs. No assurance can be given that our interest rate contracts will have the desired beneficial impact on our results of operations or financial condition. We do not qualify for, and have not elected hedge accounting treatment under the authoritative guidance. Our policies do not contain specific requirements as to the percentages or amount of interest rate risk that our manager is required to mitigate.

Use of derivative instruments may fail to protect or could adversely affect us because, among other things:

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

.  
the duration of the interest rate contracts may not match the duration of the related liability;

.  
the party owing money on the interest rate contracts may default on its obligation to pay;

.  
the credit quality of the party owing money on the interest rate contracts may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and

.  
the value of interest rate contracts 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 net income or increase any net loss.

As of March 31, 2011 and December 31, 2010, we had entered into \$134.0 million and \$214.0 million (notional amount), respectively, of Eurodollar Futures contracts used as interest rate swap equivalents traded in 1,435 and 2,361 individual contract transactions, respectively. Eurodollar Futures are traded on the Chicago Mercantile Exchange ( CME ) and have limited counterparty risk because of daily mark-to-market and collateral requirements. In addition, substantial credit support for the futures contracts is provided by the CME. These Eurodollar future contracts are designed to lock in some funding costs for financing activities associated with our assets in such a way as to help

assure the realization of attractive net interest margins. Such contracts are based on assumptions about prepayments which, if not realized, will cause results to differ from expectations. In addition, as of March 31, 2011 and December 31, 2010, we had interest rate swap contracts with an aggregate notional balance of \$965.0 million and \$155.0 million respectively.

## **Results of Operations**

We commenced our operations in November 2009, upon completion of the merger with Enterprise. During the quarter ended March 31, 2011, we completed two underwritten follow-on public offerings of an aggregate of 15,812,500 shares of our common stock. Net proceeds for the two offerings were approximately \$113.0 million. Under our investment strategy, a period of time is required to deploy investment capital.

### ***Quarter Ended March 31, 2011, Compared to Quarter Ended March 31, 2010***

We raised equity capital two times during the quarter ended March 31, 2011, issuing 15,812,500 shares of common stock and raising additional net common equity of approximately \$113.0 million. These changes were material to our company and significantly affect the results we report. We believed that the timing for additional investment, in both assets and liabilities, was appropriate and beneficial to our long-term performance. In addition, there are economies of scale that also are reached as our managed assets grow. As we invest the proceeds of our offerings, we are methodical, at times purchasing our assets with forward settlements up to 90 days out, in order to minimize purchase price. This means that our earnings, particularly on a per share basis, may take time to reach a level which we consider to be indicative of a full run-rate. This also means that some quarterly comparisons will not be meaningful or may be misleading.

Our primary source of income is the interest income we earn on our investment portfolio. Our net income for the quarter ended March 31, 2011, was \$8.6 million or \$0.33 per weighted average share. These results compare to a net income of \$0.3 million or \$0.13, per weighted average share for the quarter ended March 31, 2010. The main drivers of the difference were the increased capital resources from the public offerings completed in 2010 and the first quarter of 2011 and the implementation of ARMOUR's investment strategy, offset by unrealized losses from our interest rate contracts and increasing management fees. As discussed elsewhere in this document, management fees are calculated on gross equity raised, therefore, as we complete additional equity offerings, the management fee expense will continue to increase.

Our net interest income for the quarter ended March 31, 2011, was \$10.4 million compared to \$1.0 million for the quarter ended March 31, 2010. As of March 31, 2011, our Agency Securities portfolio consisted of \$2.3 billion of securities, including \$20.0 million of current carrying value of forward settle security sales. As of December 31, 2010, our Agency Securities portfolio consisted of \$1.2 billion of securities, including \$125.3 million of current carrying value of forward settle security sales.





The following table presents the components of the yield earned on our Agency Security portfolio for the quarterly periods presented:

| <b>Quarter Ended</b> | <b>Asset Yield</b> | <b>Cost of Funds</b> | <b>Net Interest Margin</b> | <b>Interest Expense on Repurchase Agreements</b> |
|----------------------|--------------------|----------------------|----------------------------|--|
| March 31, 2011       | 3.20%              | 0.80%                | 2.40%                      | 0.33%  |
| December 31, 2010    | 3.42               | 0.47                 | 2.95                       | 0.34   |
| September 30, 2010   | 3.32               | 0.44                 | 2.88                       | 0.27   |
| June 30, 2010        | 2.98               | 0.37                 | 2.61                       | 0.30   |
| March 31, 2010       | 3.06               | 0.38                 | 2.68                       | 0.27   |
| December 31, 2009    | 4.59               | 0.72                 | 3.86                       | 0.26   |

The yield on our assets is most significantly affected by the rate of repayments on our Agency Securities. Our rate of portfolio repayment for the quarter ended March 31, 2011, was 11.7% on a Constant Prepayment Basis ( CPR ) compared to 14.5% for the quarter ended March 31, 2010.

As of March 31, 2011, our Agency Securities portfolio was purchased at a net premium to par value with a weighted average amortized cost, including settled and forward settle securities, of 104.09%, due to the average interest rates on these securities being higher than prevailing market rates.

The main indicator of our borrowing costs is 30-day LIBOR, which generally closely parallels the rates we pay on our repurchase agreements. LIBOR was 0.24% at March 31, 2011. During the quarter ended March 31, 2011, we realized losses of \$0.1 million related to our interest rate contracts compared to no losses for the quarter ended March 31, 2010. We decreased our total Eurodollar future swap equivalent notional amount from \$214.0 million at December 31, 2010 to \$134.0 million at March 31, 2011, with a weighted average swap equivalent rate of 1.8% and weighted average term of 37 months. In addition, during the quarter ended March 31, 2011, we increased our total interest rate swap contracts aggregate notional balance from \$155.0 million to \$965.0 million with, a weighted average swap rate of 1.6% and a weighted average term of 47 months.

Our total operating expenses for the quarter ended March 31, 2011, were \$1.4 million as compared to \$0.3 million for the quarter ended March 31, 2010.

We have negative retained earnings (titled Accumulated deficit in the stockholders equity section of our accompanying condensed consolidated financial statements) as of March 31, 2011, due to the consequences of our tax qualification as a REIT. Our dividends are based on our REIT taxable income, as determined for federal income tax

purposes, and not our net income computed in accordance with U.S. generally accepted accounting principles ( GAAP ) as reported in our condensed consolidated financial statements.

For the quarter ended March 31, 2011, our estimated REIT taxable income was approximately \$8.9 million. The most significant difference was the unrealized loss on interest rate contracts which is reflected in GAAP earnings but does not reduce REIT taxable income.

### **Liquidity and Capital Resources**

Our primary sources of funds are borrowings under repurchase arrangements, monthly principal and interest payments on our investments and cash generated from our operating results. Other sources of funds may include proceeds from equity and debt offerings and asset sales. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on our balance sheet is significantly less important than our potential liquidity available under our borrowing arrangements. We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings and the payment of cash dividends as required for continued qualification as a REIT.

Our primary uses of cash are to purchase Agency Securities, pay interest and principal on our borrowings, fund our operations and pay dividends. During the quarter ended March 31, 2011, we purchased, \$1.2 billion current face amount of Agency Securities using proceeds from the equity raises, repurchase agreements, principal repayments and cash. During the quarter ended March 31, 2011, we received cash of \$71.3 million, from prepayments and scheduled amortization on our investment securities and we received \$113.0 million from equity issuances. We had a net cash increase from our repurchase agreements of \$1.1 billion for the quarter ended March 31, 2011. We made cash interest payments of approximately \$1.1 million on our borrowings for the quarter ended March 31, 2011. Part of funding our operations includes providing cash margin to offset liability balances on our interest rate contracts. This required an additional \$9.0 million of cash to be placed in a restricted account with our counterparties as of the quarter ended March 31, 2011. If rates increase over time, we may recover some or all of this cash.

In response to the growth of our Agency Securities portfolio and to the relatively weak financing market, we have continued to pursue additional lending counterparties in order to help increase our financial flexibility and ability to withstand periods of contracting liquidity in the credit markets. Currently, we have Master Repurchase Agreements, which are uncommitted repurchase facilities, with 22 lending counterparties to finance our portfolio, subject to certain conditions, and have borrowings outstanding with 11 of these counterparties.

On January 28, 2011, a cash dividend of \$0.12 per common share, or \$2.0 million in the aggregate, was paid to holders of record on January 15, 2011. This amount included \$0.02 per common share of taxable income related to the year ended December 31, 2010.

On February 25, 2011, a cash dividend of \$0.12 per common share, or \$3.9 million in the aggregate, was paid to holders of record on February 15, 2011.

On March 30, 2011, a cash dividend of \$0.12 per common share, or \$3.9 million in the aggregate, was paid to holders of record on March 15, 2011.

Our board of directors ( Board ) will continue to evaluate our dividend policy each quarter and will make adjustments as necessary, based on a variety of factors, including, among other things, the need to maintain our REIT status, our financial condition, liquidity, earnings projections and business prospects. Our dividend policy does not constitute an obligation to pay dividends, which only occurs when our Board declares a dividend.

We intend to make distributions to our stockholders to comply with the various requirements to maintain our REIT status and to minimize corporate income tax and the nondeductible excise tax. However, REIT taxable income is calculated according to the requirements of the Code rather than GAAP which can cause differences between GAAP income reported by us and taxable income calculated to determine distribution requirements to stockholders. These differences are primarily due to non-taxable unrealized changes in the value of our interest rate contracts. These differences may be large and can be either positive or negative variances from GAAP income. In addition, differences in timing between the recognition of REIT taxable income and the actual receipt of cash could require us to sell assets or to borrow funds on a short-term basis to meet the REIT distribution requirements and to minimize corporate income tax and the nondeductible excise tax.

On January 26, 2011, we completed an underwritten secondary public offering of 6,000,000 shares of common stock. The underwriters fully exercised the over-allotment option for 900,000 additional shares at a price of \$7.55 per share. Net proceeds were \$49.0 million, net of issuance costs of approximately \$3.1 million.

On February 8, 2011, we completed an underwritten secondary public offering of 7,750,000 shares of common stock. The underwriters fully exercised the over-allotment option for 1,162,500 additional shares at a price of \$7.60 per share. Net proceeds were \$64.0 million, net of issuance costs of approximately \$3.7 million.

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

As of March 31, 2011 and December 31, 2010, we did not maintain any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, or special purpose or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, as of March 31, 2011 and December 31, 2010, we had not guaranteed any obligations of any unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

*Liquidity Sources Repurchase Facilities*

At March 31, 2011, our repurchase agreements had the following counterparties, amount at risk and weighted average remaining maturities:

| <b>Repurchase Agreement</b>                | <b>Amount</b>           | <b>Amount at</b>      | <b>Weighted</b>      | <b>Percent of</b>  |
|--|-------------------------|-----------------------|----------------------|--------------------|
| <b>Counterparties</b>                      | <b>Outstanding</b>      | <b>Risk (1)</b>       | <b>Average</b>       | <b>Total</b>       |
|  |                         |                       | <b>Maturity of</b>   | <b>Amount</b>      |
|  |                         |                       | <b>Repurchase</b>    |                    |
|  |                         |                       | <b>Agreements in</b> |                    |
|  |                         |                       | <b>Days</b>          | <b>Outstanding</b> |
| Nomura Securities International, Inc.      | \$ 249,902,000          | \$ 12,808,695         | 40                   | 11.9%              |
| Guggenheim Liquidity Securities, LLC       | 225,435,000             | 11,045,641            | 61                   | 10.7               |
| MF Global Inc.                             | 222,488,000             | 10,517,543            | 60                   | 10.6               |
| UBS Securities LLC                         | 212,464,000             | 10,724,277            | 21                   | 10.1               |
| Goldman Sachs & Company                    | 201,662,000             | 10,418,840            | 36                   | 9.6                |
| Cantor Fitzgerald & Co.                    | 200,855,000             | 12,204,369            | 21                   | 9.6                |
| South Street Securities, LLC               | 199,761,245             | 9,543,779             | 32                   | 9.5                |
| RBS Securities Inc.                        | 165,954,000             | 8,305,245             | 24                   | 7.9                |
| Mizuho Securities USA Inc.                 | 126,755,000             | 6,241,775             | 22                   | 6.0                |
| J.P. Morgan Securities LLC                 | 125,134,000             | 6,247,863             | 23                   | 6.0                |
| Merrill Lynch, Pierce, Fenner & Smith Inc. | 66,750,000              | 3,474,913             | 21                   | 3.2                |
| Daiwa Securities America Inc.              | 64,440,000              | 3,915,864             | 18                   | 3.1                |
| Jefferies and Company, Inc.                | 29,791,000              | 1,268,576             | 11                   | 1.4                |
| The Prince Ridge Group LLC                 | 7,975,000               | 453,181               | 11                   | 0.4                |
| <b>Total</b>                               | <b>\$ 2,099,366,245</b> | <b>\$ 107,170,561</b> |                      | <b>100.0%</b>      |

(1)

Equal to the fair value of securities sold, minus the sum of repurchase agreement liabilities plus accrued interest expense.

At December 31, 2010, our repurchase agreements had the following counterparties, amount at risk and weighted average remaining maturities:

| Repurchase Agreement<br>Counterparties | Amount                |                       | Weighted<br>Average<br>Maturity of<br>Repurchase<br>Agreements in<br>Days | Percent of<br>Total<br>Amount<br>Outstanding |
|--|-----------------------|-----------------------|---|--|
|  | Outstanding           | Amount at<br>Risk (1) |   |  |
| Guggenheim Liquidity Securities, LLC   | \$ 141,026,000        | \$ 4,425,424          | 56  | 14.5%  |
| South Street Securities, LLC           | 135,297,000           | 6,204,002             | 29  | 13.9   |
| Goldman Sachs & Company                | 132,638,000           | 6,424,071             | 19  | 13.7   |
| MF Global Inc.                         | 127,809,000           | 4,197,001             | 56  | 13.2   |
| Cantor Fitzgerald & Co.                | 111,982,000           | 7,658,536             | 16  | 11.5   |
| Nomura Securities International, Inc.  | 95,228,000            | 2,037,191             | 40  | 9.8  |
| RBS Securities Inc.                    | 86,535,658            | 4,774,360             | 18  | 8.9  |
| UBS Securities LLC                     | 46,535,000            | 2,805,301             | 27  | 4.8  |
| Mizuho Securities USA Inc.             | 39,826,000            | 1,593,285             | 10  | 4.0  |
| Jefferies and Company, Inc.            | 31,822,000            | 426,829               | 10  | 3.3  |
| Daiwa Securities America Inc.          | 22,977,000            | 1,690,799             | 18  | 2.4  |
| <b>Total</b>                           | <b>\$ 971,675,658</b> | <b>\$ 42,236,799</b>  |   | <b>100.0%</b>                                |

(1)

Equal to the fair value of securities sold, minus the sum of repurchase agreement liabilities plus accrued interest expense

As of March 31, 2011, the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount, which we also refer to as the haircut, under all our repurchase agreements was approximately 5.2% (weighted by borrowing amount). As of December 31, 2010, the weighted average margin requirement, under all our repurchase agreements was approximately 5.3%. Declines in the value of our Agency Securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event under the standard master repurchase agreement would give our counterparty the option to terminate all repurchase transactions existing with us and require any amount due to be payable immediately.

As discussed above under Market and Interest Rate Trends and the Effect on our Portfolio, the residential mortgage market in the United States has recently experienced difficult economic conditions including:

·  
increased volatility of many financial assets, including Agency Securities and other high-quality RMBS assets;

·  
increased volatility and deterioration in the broader residential mortgage and RMBS markets; and

·  
significant disruption in financing of RMBS.

While conditions have improved, should there be a reoccurrence of difficulties in the residential mortgage market, our lenders may be forced to exit the repurchase market, become insolvent or further tighten lending standards or increase the amount of required equity capital or haircut, any of which could make it more difficult or costly for us to obtain financing.

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

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

We experience margin calls in the ordinary course of our business, and under certain conditions, such as during a period of declining market value for Agency Securities, we may experience margin calls monthly or more frequently. In seeking to manage effectively the margin requirements established by our lenders, we maintain a position of cash and unpledged securities. We refer to this position as our liquidity. The level of liquidity we have available to meet margin calls is directly affected by our leverage levels, our haircuts and the price changes on our securities. If interest

rates increase as a result of a yield curve shift or for another reason or if credit spreads widen, the prices of our collateral (and our unpledged assets that constitute our liquidity) will decline and we may experience margin calls. We will use our liquidity to meet such margin calls. There can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls. If our haircuts increase, our liquidity will proportionately decrease. If we increase our borrowings, our liquidity will decrease by the amount of additional haircut on the increased level of indebtedness. In addition, certain of our master repurchase agreements contain a restriction that prohibits our leverage from exceeding twelve times our stockholders' equity as well as termination events in the case of significant reductions in equity capital.

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

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

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

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

We generally seek to borrow (on a recourse basis) between six and ten times the amount of our shareholders' equity, although we are not limited to that range. At March 31, 2011 and December 31, 2010, our total borrowings were approximately \$2.1 billion and \$1.0 billion (excluding accrued interest), respectively, which represented a leverage ratio of approximately 9.52:1 and 8.94:1, respectively.





## **Critical Accounting Policies**

A summary of our critical accounting policies is included in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2010. There have been no significant changes to those policies during 2011.

## **Inflation**

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and any distributions we may make will be determined by our Board based in part on our REIT taxable income as calculated according to the requirements of the Code; in each case, our activities and balance sheet are measured with reference to fair value without considering inflation.

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

We seek to manage our risks related to the credit quality of our assets, interest rates, liquidity, prepayment speeds and market value while, at the same time, seeking to provide an opportunity to shareholders to realize attractive risk-adjusted returns through ownership of our capital stock. While we do not seek to avoid risk completely, we believe the risk can be quantified from historical experience and seek to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

### ***Interest Rate, Cap, and Mismatch Risk***

We invest in adjustable rate, hybrid and fixed rate Agency Securities. Hybrid mortgages are adjustable rate mortgages ( ARMs ) that have a fixed interest rate for an initial period of time (typically three years or greater) and then convert to an adjustable rate for the remaining loan term. Our debt obligations are generally repurchase agreements of limited duration that are periodically refinanced at current market rates.

ARM-related assets are typically subject to periodic and lifetime interest rate caps that limit the amount an ARM-related asset's interest rate can change during any given period. ARM securities are also typically subject to a minimum interest rate payable. Our borrowings are not subject to similar restrictions. Hence, in a period of increasing interest rates, interest rates on our borrowings could increase without limitation, while the interest rates on our

mortgage-related assets could be limited. This problem would be magnified to the extent we acquire Agency Securities that are not fully indexed. Further, some ARM-related assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. These factors could lower our net interest income or cause a net loss during periods of rising interest rates, which would negatively impact our liquidity, net income and our ability to make distributions to stockholders.

We fund the purchase of a substantial portion of our ARM-related assets with borrowings that have interest rates based on indices and repricing terms similar to, but of shorter maturities than, the interest rate indices and repricing terms of our mortgage assets. Thus, we anticipate that in most cases the interest rate indices and repricing terms of our mortgage assets and our funding sources will not be identical, thereby creating an interest rate mismatch between assets and liabilities. During periods of changing interest rates, such interest rate mismatches could negatively impact our net interest income, dividend yield and the market price of our common stock. Most of our adjustable rate assets are based on the one-year CMT rate and the one-year LIBOR rate and our debt obligations are generally based on LIBOR. These indices generally move in the same direction, but there can be no assurance that this will continue to occur.

Our ARM-related assets and borrowings reset at various different dates for the specific asset or obligation. In general, the repricing of our debt obligations occurs more quickly than on our assets. Therefore, on average, our cost of funds may rise or fall more quickly than does our earnings rate on the assets.

Further, our net income may vary somewhat as the spread between one-month interest rates, the typical term for our repurchase agreements and six- and twelve-month interest rates, the typical reset term of adjustable rate Agency Securities, varies.

### ***Prepayment Risk***

As we receive repayments of principal on our Agency Securities from prepayments and scheduled payments, premiums paid on such securities are amortized against interest income and discounts are accreted to interest income as realized. Premiums arise when we acquire Agency Securities at prices in excess of the principal balance of the mortgage loans underlying such Agency Securities. Conversely, discounts arise when we acquire Agency Securities at prices below the principal balance of the mortgage loans underlying such Agency Securities. To date, all of our Agency Securities have been purchased at a premium.

***Interest Rate Risk and Effect on Market Value Risk***

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

We primarily assess our interest rate risk by estimating the effective duration of our assets and the effective duration of our liabilities and by estimating the time difference between the interest rate adjustment of our assets and the interest rate adjustment of our liabilities. Effective duration essentially measures the market price volatility of financial instruments as interest rates change. We generally estimate effective duration using various financial models and empirical data. Different models and methodologies can produce different effective duration estimates for the same securities.

The sensitivity analysis tables presented below reflects the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments and net interest income, at March 31, 2011 and December 31, 2010, assuming a static portfolio. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on our manager's expectations. The analysis presented utilized assumptions, models and estimates of the manager based on the manager's judgment and experience.

**As of March 31, 2011**

| Change in<br>Interest Rates | Percentage Change<br>in | Projected Net   |   | Percentage Change in<br>Projected Portfolio<br>Value Including |   |
|-----------------------------|-------------------------|-----------------|---|--|---|
|                             |                         | Interest Income |   | Interest Rate Contracts  |   |
| 1.00                        | %                       | (9.72)          | % | (1.74)   | % |
| 0.50                        |                         | (4.61)          |   | (0.79)   |   |
| (0.50)                      |                         | 3.34            |   | 0.61   |   |
| (1.00)                      |                         | (0.59)          |   | 1.03   |   |

**As of December 31, 2010**

|                       |   | <b>Percentage Change in</b> |   | <b>Percentage Change in</b>    |   |
|-----------------------|---|-----------------------------|---|--------------------------------|---|
|                       |   | <b>in</b>                   |   | <b>Projected Portfolio</b>     |   |
|                       |   | <b>Projected Net</b>        |   | <b>Value Including</b>         |   |
| <b>Change in</b>      |   | <b>Interest Income</b>      |   | <b>Interest Rate Contracts</b> |   |
| <b>Interest Rates</b> |   |                             |   |                                |   |
| 1.00                  | % | (19.58)                     | % | (2.40)                         | % |
| 0.50                  |   | (11.55)                     |   | (1.12)                         |   |
| (0.50)                |   | 5.35                        |   | 0.93                           |   |
| (1.00)                |   | (1.14)                      |   | 1.70                           |   |

While the table above reflects the estimated immediate impact of interest rate increases and decreases on a static portfolio, we rebalance our portfolio from time to time either to seek to take advantage of or reduce the impact of changes in interest rates. It is important to note that the impact of changing interest rates on market value and net interest income can change significantly when interest rates change beyond 100 basis points from current levels. Therefore, the volatility in the market value of our assets could increase significantly when interest rates change beyond amounts shown in the table above. In addition, other factors impact the market value of and net interest income from our interest rate-sensitive investments and hedging instruments, such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, interest income would likely differ from that shown above, and such difference might be material and adverse to our shareholders.

The above table quantifies the potential changes in net interest income and portfolio value, which includes the value of our interest rate contracts, should interest rates immediately change. Given the low level of interest rates at March 31, 2011 and December 31, 2010, we applied a floor of 0% for all anticipated interest rates included in our assumptions. Due to the presence of this floor, it is anticipated that any hypothetical interest rate decrease would have a limited positive impact on our funding costs beyond a certain level; however, because prepayments speeds are unaffected by this floor, it is expected that any increase in our prepayment speeds (occurring as a result of any interest rate decrease or otherwise) could result in an acceleration of our premium amortization and the reinvestment of such prepaid principal in lower yielding assets. As a result, the presence of this floor limits the positive impact of any interest rate decrease on our funding costs. Therefore, at some point, hypothetical interest rate decreases could cause the fair value of our financial instruments and our net interest income to decline.

### ***Market Value Risk***

All of our Agency Securities are classified as available for sale assets. As such, they are reflected at fair value (i.e., market value) with the periodic adjustment to fair value (that is not considered to be an other than temporary impairment) reflected as part of Accumulated other comprehensive loss that is included in the equity section of our condensed consolidated balance sheet. The market value of our assets can fluctuate due to changes in interest rates and other factors. Weakness in the mortgage market may adversely affect the performance and market value of our investments. This could negatively impact our net book value. Furthermore, if our lenders are unwilling or unable to provide additional financing, we could be forced to sell our Agency Securities at an inopportune time when prices are depressed. The principal payments are guaranteed by Freddie Mac, Fannie Mae, or Ginnie Mae on our Agency Securities.

### ***Liquidity Risk***

Our primary liquidity risk arises from financing long-maturity Agency Securities with short-term debt. The interest rates on our borrowings generally adjust more frequently than the interest rates on our adjustable rate Agency Securities. Accordingly, in a period of rising interest rates, our borrowing costs will usually increase faster than our interest earnings from Agency Securities.

### ***Credit Risk***

We have limited our exposure to credit losses on our portfolio of Agency Securities by only purchasing securities issued by Freddie Mac, Fannie Mae or Ginnie Mae. The payment of principal and interest on the Freddie Mac and Fannie Mae Agency Securities are guaranteed by those respective agencies and the payment of principal and interest on the Ginnie Mae Agency Securities are backed by the full faith and credit of the U.S. government.

## **Item 4. Controls and Procedures**

Our management, including our Co-Chief Executive Officer (the CEO) and Chief Financial Officer (the CFO), reviewed and evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act) as of the end of the period covered by this quarterly report. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed and implemented, (1) were effective in ensuring that information regarding us and our subsidiaries is accumulated and communicated to our management, including our CEO and CFO, by our employees, as appropriate to allow timely decisions regarding required disclosure and (2) were effective in providing

reasonable assurance that information we must disclose in our periodic reports under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods prescribed by the Securities and Exchange Commission's rules and forms.

There have been no changes in our internal controls over financial reporting that occurred during the quarter ended March 31, 2011, that have materially affected, or are reasonably likely to affect our internal control over financial reporting.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation under the framework in Internal Control – Integrated Framework, our management concluded that our internal control over financial reporting was effective as of March 31, 2011.

### **Management Report On Internal Control Over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rules 13a-15(f) under the Securities Exchange Act as a process designed by, or under the supervision of, our principal executive and principal financial officers and effected by our Board, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that:

·  
pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

·  
provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and

·  
provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on the financial statements.





Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. As a result, even systems determined to be effective can provide only reasonable assurance regarding the preparation and presentation of financial statements. Moreover, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

## **PART II. Other Information**

### **Item 1. Legal Proceedings**

Our company and our manager are not currently subject to any legal proceedings.

### **Item 1A. Risk Factors**

There have been no material changes from the risk factors disclosed in the Risk Factors section of our Annual Report on Form 10-K filed on March 10, 2011 with the SEC.

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

None.

### **Item 3. Defaults Upon Senior Securities**

None.

### **Item 4. Removed and Reserved**

### **Item 5. Other Information**

None.

### **Item 6. Exhibits**

See Exhibit Index.



SIGNATURES

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

Date: May 3, 2011

ARMOUR RESIDENTIAL REIT, INC.

/s/ Scott J. Ulm

Scott J. Ulm

Co-Chief Executive Officer, Chief Investment Officer,  
Head of Risk Management and Co-Vice Chairman  
(Principal Executive Officer)

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## EXHIBIT INDEX

| <b>Exhibit Number</b> | <b>Description</b>   |
|-----------------------|--|
| 3.1                   | Amended and Restated Article of Incorporation.*  |
| 3.2                   | Amended Bylaws.**  |
| 4.1                   | Warrant Agreement between Continental Stock Transfer & Trust Company and Enterprise Acquisition Corp. (incorporated by reference to Enterprise Acquisition Corp.'s Current Report on Form 8-K filed with the SEC on July 29, 2009) |
| 4.2                   | Amendment to Warrant Agreement dated November 5, 2009 (incorporated by reference to Exhibit 4.4 to ARMOUR's Current Report on Form 8-K filed with the SEC on November 12, 2009)  |
| 4.3                   | Specimen Common Stock Certificate of ARMOUR (incorporated by reference to Amendment No. 4 to Registration Statement on Form S-4 filed with the SEC on October 13, 2009)  |
| 4.4                   | Specimen Warrant Certificate of ARMOUR (incorporated by reference to Amendment No. 4 to Registration Statement on Form S-4 filed with the SEC on October 13, 2009)   |
| 31.1                  | Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14(a)/15d-14(a)***   |
| 31.2                  | Certification of Chief Financial Officer Pursuant to SEC Rule 13a-14(a)/15d-14(a)***   |
| 32.1                  | Certification of Chief Executive Officer Pursuant to 18 U.S.C. §1350***  |
| 32.2                  | Certification of Chief Financial Officer Pursuant to 18 U.S.C. §1350***  |

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\* Incorporated by reference to Exhibit 3.4 to ARMOUR's Current Report on Form 8-K filed with the SEC on November 12, 2009.

\*\* Incorporated by reference to Exhibit 3.5 to ARMOUR's Current Report on Form 8-K filed with the SEC on November 12, 2009.

\*\*\* Filed herewith