

CAPSTEAD MORTGAGE CORP  
Form 10-Q  
August 03, 2012  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

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

**For the quarterly period ended: June 30, 2012**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 001-08896**

**CAPSTEAD MORTGAGE CORPORATION**

(Exact name of Registrant as specified in its Charter)

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

**75-2027937**  
(I.R.S. Employer  
Identification No.)

**8401 North Central Expressway, Suite 800, Dallas, TX**  
(Address of principal executive offices)

**75225**  
(Zip Code)

**(214) 874-2323**

(Registrant's telephone number, including area code)

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

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

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

Large accelerated filer  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

### APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock (\$0.01 par value)

98,656,620 as of August 3, 2012

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**FORM 10-Q**  
**FOR THE QUARTER ENDED JUNE 30, 2012**  
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**Table of Contents****ITEM 1. FINANCIAL STATEMENTS****PART I. FINANCIAL INFORMATION****CAPSTEAD MORTGAGE CORPORATION****CONSOLIDATED BALANCE SHEETS***(in thousands, except per share amounts)*

|  | <i>June 30, 2012</i> | <i>December 31, 2011</i> |
|--|----------------------|--------------------------|
|  | <i>(unaudited)</i>   |                          |
| <b>Assets:</b>   |                      |                          |
| Residential mortgage investments<br>(\$13.38 and \$11.93 billion pledged under repurchase arrangements at June 30, 2012 and<br>December 31, 2011, respectively)  | \$13,799,487         | \$12,264,906             |
| Cash collateral receivable from interest rate swap counterparties  | 55,758               | 48,505                   |
| Interest rate swap agreements at fair value  |                      | 617                      |
| Cash and cash equivalents  | 433,241              | 426,717                  |
| Receivables and other assets   | 118,962              | 100,760                  |
| Investments in unconsolidated affiliates   | 3,117                | 3,117                    |
|  | \$14,410,565         | \$12,844,622             |
| <b>Liabilities:</b>  |                      |                          |
| Repurchase arrangements and similar borrowings   | \$12,728,797         | \$11,352,444             |
| Interest rate swap agreements at fair value  | 37,874               | 31,348                   |
| Unsecured borrowings   | 103,095              | 103,095                  |
| Common stock dividend payable  | 39,427               | 38,184                   |
| Accounts payable and accrued expenses  | 20,920               | 26,844                   |
|  | 12,930,113           | 11,551,915               |
| <b>Stockholders equity:</b>  |                      |                          |
| Preferred stock - \$0.10 par value; 100,000 shares authorized:   |                      |                          |
| \$1.60 Cumulative Preferred Stock, Series A, 186 shares issued and outstanding (\$3,054 and \$3,056<br>aggregate liquidation preference) at June 30, 2012 and December 31, 2011, respectively                                  | 2,604                | 2,605                    |
| \$1.26 Cumulative Convertible Preferred Stock, Series B, 16,493 and 16,184 shares issued and<br>outstanding (\$187,692 and \$184,175 aggregate liquidation preference) at June 30, 2012 and<br>December 31, 2011, respectively | 186,388              | 181,909                  |
| Common stock - \$0.01 par value; 250,000 shares authorized: 97,456 and 88,287 shares issued and<br>outstanding at June 30, 2012 and December 31, 2011, respectively  | 975                  | 883                      |
| Paid-in capital  | 1,380,445            | 1,257,653                |
| Accumulated deficit  | (354,883)            | (354,883)                |
| Accumulated other comprehensive income   | 264,923              | 204,540                  |
|  | 1,480,452            | 1,292,707                |
|  | \$14,410,565         | \$12,844,622             |

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*See accompanying notes to consolidated financial statements.*

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**CAPSTEAD MORTGAGE CORPORATION**  
**CONSOLIDATED STATEMENTS OF INCOME**

*(in thousands, except per share amounts)*

*(unaudited)*

|  | <i>Quarter Ended</i> |                  | <i>Six Months Ended</i> |                  |
|--|----------------------|------------------|-------------------------|------------------|
|  | <i>June 30</i>       |                  | <i>June 30</i>          |                  |
|  | <i>2012</i>          | <i>2011</i>      | <i>2012</i>             | <i>2011</i>      |
| <b>Interest income:</b>  |                      |                  |                         |                  |
| Residential mortgage investments                                     | \$ 65,787            | \$ 63,136        | \$ 131,520              | \$ 116,277       |
| Other  | 176                  | 58               | 326                     | 171              |
|  | 65,963               | 63,194           | 131,846                 | 116,448          |
| <b>Interest expense:</b>   |                      |                  |                         |                  |
| Repurchase arrangements and similar borrowings                       | (16,451)             | (13,706)         | (30,554)                | (26,028)         |
| Unsecured borrowings   | (2,187)              | (2,187)          | (4,374)                 | (4,374)          |
| Other  |                      | (1)              |                         | (5)              |
|  | (18,638)             | (15,894)         | (34,928)                | (30,407)         |
|  | 47,325               | 47,300           | 96,918                  | 86,041           |
| <b>Other revenue (expense):</b>                                      |                      |                  |                         |                  |
| Miscellaneous other revenue (expense)                                | 13                   | (599)            | (156)                   | (817)            |
| Incentive compensation   | (1,295)              | (1,487)          | (2,833)                 | (2,720)          |
| Salaries and benefits  | (1,682)              | (1,672)          | (3,509)                 | (3,373)          |
| Other general and administrative expense                             | (1,091)              | (1,066)          | (2,045)                 | (2,028)          |
|  | (4,055)              | (4,824)          | (8,543)                 | (8,938)          |
| <b>Income before equity in earnings of unconsolidated affiliates</b> | <b>43,270</b>        | <b>42,476</b>    | <b>88,375</b>           | <b>77,103</b>    |
| <b>Equity in earnings of unconsolidated affiliates</b>               | <b>65</b>            | <b>65</b>        | <b>130</b>              | <b>130</b>       |
| <b>Net income</b>  | <b>\$ 43,335</b>     | <b>\$ 42,541</b> | <b>\$ 88,505</b>        | <b>\$ 77,233</b> |
| <b>Net income available to common stockholders:</b>                  |                      |                  |                         |                  |
| Net income   | \$ 43,335            | \$ 42,541        | \$ 88,505               | \$ 77,233        |
| Less cash dividends paid on preferred shares                         | (5,268)              | (5,060)          | (10,481)                | (10,118)         |
|  | \$ 38,067            | \$ 37,481        | \$ 78,024               | \$ 67,115        |
| <b>Net income per common share:</b>                                  |                      |                  |                         |                  |
| Basic  | \$0.40               | \$0.48           | \$0.85                  | \$0.90           |
| Diluted  | 0.40                 | 0.48             | 0.85                    | 0.90             |

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**Cash dividends declared per share:**

|                    |         |         |         |         |
|--------------------|---------|---------|---------|---------|
| Common             | \$0.400 | \$0.480 | \$0.830 | \$0.890 |
| Series A Preferred | 0.400   | 0.400   | 0.800   | 0.800   |
| Series B Preferred | 0.315   | 0.315   | 0.630   | 0.630   |

*See accompanying notes to consolidated financial statements.*

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**CAPSTEAD MORTGAGE CORPORATION**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

*(in thousands, unaudited)*

|  | <i>Quarter Ended<br/>June 30</i> |             | <i>Six Months Ended<br/>June 30</i> |             |
|--|----------------------------------|-------------|-------------------------------------|-------------|
|  | <i>2012</i>                      | <i>2011</i> | <i>2012</i>                         | <i>2011</i> |
| <b>Net income</b>  | \$ 43,335                        | \$ 42,541   | \$ 88,505                           | \$ 77,233   |
| <b>Other comprehensive income:</b>                             |                                  |             |                                     |             |
| Amounts related to available-for-sale securities:              |                                  |             |                                     |             |
| Change in net unrealized gains                                 | 27,061                           | 29,439      | 67,673                              | 30,447      |
| Amounts related to cash flow hedges:                           |                                  |             |                                     |             |
| Change in net unrealized losses                                | (15,334)                         | (16,883)    | (17,085)                            | (17,561)    |
| Reclassification adjustment for amounts included in net income | 4,830                            | 7,467       | 9,795                               | 13,579      |
|  | 16,557                           | 20,023      | 60,383                              | 26,465      |
| <b>Comprehensive income</b>                                    | \$ 59,892                        | \$ 62,564   | \$ 148,888                          | \$ 103,698  |

*See accompanying notes to consolidated financial statements.*



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**CAPSTEAD MORTGAGE CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

*(in thousands, unaudited)*

|  | <i>Six Months Ended June 30</i> |                    |
|--|---------------------------------|--------------------|
|  | <i>2012</i>                     | <i>2011</i>        |
| <b>Operating activities:</b>   |                                 |                    |
| Net income   | \$ 88,505                       | \$ 77,233          |
| Noncash items:   |                                 |                    |
| Amortization of investment premiums  | 40,195                          | 28,351             |
| Depreciation and other amortization  | 99                              | 107                |
| Equity-based compensation costs  | 1,098                           | 884                |
| Change in measureable hedge ineffectiveness related to interest rate swap agreements     | (147)                           | (116)              |
| Impairment charge related to real estate held for sale                                   |                                 | 470                |
| Gain on sales of real estate held for sale   | (199)                           |                    |
| Net change in receivables, other assets, accounts payable and accrued expenses           | (19,418)                        | (7,367)            |
| <b>Net cash provided by operating activities</b>   | <b>110,133</b>                  | <b>99,562</b>      |
| <b>Investing activities:</b>   |                                 |                    |
| Purchases of residential mortgage investments  | (2,684,789)                     | (3,858,053)        |
| Purchased interest receivable related to purchases of residential mortgage investments   | (4,382)                         | (8,290)            |
| Proceeds from sales of real estate held for sale   | 1,415                           | 523                |
| Principal collections on residential mortgage investments                                | 1,177,686                       | 951,679            |
| <b>Net cash used in investing activities</b>   | <b>(1,510,070)</b>              | <b>(2,914,141)</b> |
| <b>Financing activities:</b>   |                                 |                    |
| Proceeds from repurchase arrangements and similar borrowings                             | 62,587,261                      | 37,924,609         |
| Principal payments on repurchase arrangements and similar borrowings                     | (61,210,906)                    | (35,279,964)       |
| (Increase) decrease in cash collateral receivable from interest rate swap counterparties | (7,253)                         | 1,962              |
| Decrease in cash collateral payable to interest rate swap counterparties                 |                                 | (8,424)            |
| Capital stock transactions   | 125,548                         | 143,347            |
| Dividends paid   | (88,189)                        | (68,164)           |
| <b>Net cash provided by financing activities</b>   | <b>1,406,461</b>                | <b>2,713,366</b>   |
| <b>Net change in cash and cash equivalents</b>   | <b>6,524</b>                    | <b>(101,213)</b>   |
| Cash and cash equivalents at beginning of period   | 426,717                         | 359,590            |
| <b>Cash and cash equivalents at end of period</b>  | <b>\$ 433,241</b>               | <b>\$ 258,377</b>  |

*See accompanying notes to consolidated financial statements.*

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**CAPSTEAD MORTGAGE CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**JUNE 30, 2012**

*(unaudited)*

**NOTE 1 BUSINESS**

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

**NOTE 2 BASIS OF PRESENTATION**

***Interim Financial Reporting and Reclassifications***

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

**NOTE 3 NET INCOME PER COMMON SHARE**

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

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

|  | <i>Quarter Ended</i> |             | <i>Six Months Ended</i> |             |
|--|----------------------|-------------|-------------------------|-------------|
|  | <i>June 30</i>       |             | <i>June 30</i>          |             |
|  | <i>2012</i>          | <i>2011</i> | <i>2012</i>             | <i>2011</i> |
| <b>Basic net income per common share</b>           |                      |             |                         |             |
| Numerator for basic net income per common share:   |                      |             |                         |             |
| Net income   | \$ 43,335            | \$ 42,541   | \$ 88,505               | \$ 77,233   |
| Series A and B preferred share dividends           | (5,268)              | (5,060)     | (10,481)                | (10,118)    |
| Unvested stock award participation in earnings     | (100)                | (145)       | (206)                   | (274)       |
|  | \$ 37,967            | \$ 37,336   | \$ 77,818               | \$ 66,841   |
| Denominator for basic net income per common share: |                      |             |                         |             |
| Weighted average common shares outstanding         | 94,362               | 77,631      | 92,171                  | 74,652      |
| Average unvested stock awards outstanding          | (505)                | (460)       | (518)                   | (459)       |
|  | 93,857               | 77,171      | 91,653                  | 74,193      |
|  | \$ 0.40              | \$ 0.48     | \$ 0.85                 | \$ 0.90     |

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| <b>Diluted net income per common share</b>             |           |           |           |           |
| Numerator for diluted net income per common share:     |           |           |           |           |
| Net income   | \$ 43,335 | \$ 42,541 | \$ 88,505 | \$ 77,233 |
| Dividends on antidilutive convertible preferred shares | (5,194)   | (4,985)   | (10,332)  | (9,968)   |
| Unvested stock award participation in earnings         | (100)     | (145)     | (206)     | (274)     |
|  | \$ 38,041 | \$ 37,411 | \$ 77,967 | \$ 66,991 |
| Denominator for diluted net income per common share:   |           |           |           |           |
| Weighted average common shares outstanding             | 94,362    | 77,631    | 92,171    | 74,652    |
| Average unvested stock awards outstanding              | (505)     | (460)     | (518)     | (459)     |
| Net effect of dilutive stock and option awards         | 121       | 80        | 111       | 73        |
| Net effect of dilutive convertible preferred shares    | 308       | 309       | 309       | 309       |
|  | 94,286    | 77,560    | 92,073    | 74,575    |
|  | \$ 0.40   | \$ 0.48   | \$ 0.85   | \$ 0.90   |

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

|  | <i>Quarter Ended</i> |             | <i>Six Months Ended</i> |             |
|--|----------------------|-------------|-------------------------|-------------|
|  | <i>June 30</i>       |             | <i>June 30</i>          |             |
|  | <i>2012</i>          | <i>2011</i> | <i>2012</i>             | <i>2011</i> |
| Antidilutive convertible preferred shares                              | 16,493               | 15,865      | 16,493                  | 15,865      |
| Antidilutive equity awards excludable under the treasury stock method: |                      |             |                         |             |
| Shares issuable under option awards                                    | 10                   | 10          | 10                      | 10          |
| Unvested stock awards  | 3                    |             | 3                       |             |



**Table of Contents****NOTE 4 RESIDENTIAL MORTGAGE INVESTMENTS**

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

|                                      | <i>Unpaid</i>    |                   | <i>Amortized</i>  | <i>Carrying</i>              | <i>Net</i> | <i>Average</i> |
|--------------------------------------|------------------|-------------------|-------------------|------------------------------|------------|----------------|
|                                      | <i>Principal</i> | <i>Investment</i> | <i>Cost Basis</i> | <i>Amount</i> <sup>(a)</sup> | <i>WAC</i> | <i>Yield</i>   |
|                                      | <i>Balance</i>   | <i>Premiums</i>   | <i>Cost Basis</i> | <i>Amount</i> <sup>(a)</sup> | <i>(b)</i> | <i>(b)</i>     |
| <b>June 30, 2012</b>                 |                  |                   |                   |                              |            |                |
| Agency Securities:                   |                  |                   |                   |                              |            |                |
| Fannie Mae/Freddie Mac:              |                  |                   |                   |                              |            |                |
| Fixed-rate                           | \$ 3,668         | \$ 10             | \$ 3,678          | \$ 3,685                     | 6.70%      | 6.62%          |
| ARMs                                 | 11,567,604       | 340,810           | 11,908,414        | 12,189,397                   | 2.79       | 2.02           |
| Ginnie Mae ARMs                      | 1,527,148        | 46,389            | 1,573,537         | 1,594,919                    | 2.87       | 2.13           |
|                                      | 13,098,420       | 387,209           | 13,485,629        | 13,788,001                   | 2.80       | 2.03           |
| Residential mortgage loans:          |                  |                   |                   |                              |            |                |
| Fixed-rate                           | 3,123            | 5                 | 3,128             | 3,128                        | 6.96       | 7.05           |
| ARMs                                 | 5,248            | 21                | 5,269             | 5,269                        | 3.51       | 3.76           |
|                                      | 8,371            | 26                | 8,397             | 8,397                        | 4.79       | 4.97           |
| Collateral for structured financings | 3,038            | 51                | 3,089             | 3,089                        | 8.07       | 7.55           |
|                                      | \$ 13,109,829    | \$ 387,286        | \$ 13,497,115     | \$ 13,799,487                | 2.81       | 2.04           |
| <b>December 31, 2011</b>             |                  |                   |                   |                              |            |                |
| Agency Securities:                   |                  |                   |                   |                              |            |                |
| Fannie Mae/Freddie Mac:              |                  |                   |                   |                              |            |                |
| Fixed-rate                           | \$ 4,015         | \$ 12             | \$ 4,027          | \$ 4,035                     | 6.73%      | 6.55%          |
| ARMs                                 | 10,378,503       | 285,963           | 10,664,466        | 10,880,200                   | 2.85       | 2.08           |
| Ginnie Mae ARMs                      | 1,312,049        | 37,191            | 1,349,240         | 1,368,197                    | 3.02       | 2.31           |
|                                      | 11,694,567       | 323,166           | 12,017,733        | 12,252,432                   | 2.87       | 2.11           |
| Residential mortgage loans:          |                  |                   |                   |                              |            |                |
| Fixed-rate                           | 3,234            | 5                 | 3,239             | 3,239                        | 6.96       | 6.58           |
| ARMs                                 | 5,887            | 22                | 5,909             | 5,909                        | 3.48       | 3.66           |
|                                      | 9,121            | 27                | 9,148             | 9,148                        | 4.71       | 4.69           |
| Collateral for structured financings | 3,272            | 54                | 3,326             | 3,326                        | 8.04       | 7.60           |
|                                      | \$ 11,706,960    | \$ 323,247        | \$ 12,030,207     | \$ 12,264,906                | 2.87       | 2.11           |

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

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

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### *prepayments.*

Agency Securities are considered to have limited, if any, credit risk, particularly in light of the conservatorship of the GSEs by the federal government in 2008. Residential mortgage loans held by the Company were originated prior to 1995 when Capstead operated a mortgage conduit and the related credit risk is borne by the Company. Collateral for structured financings consists of private residential mortgage securities obtained through the above-mentioned mortgage conduit that are pledged to secure repayment of related structured financings. The credit risk for these securities is borne by the related bondholders. The maturity of *Residential mortgage investments* that are mortgage securities is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, actual maturities will be significantly shorter than the portfolio's weighted average contractual maturity of 293 months.

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

Capstead classifies its ARM securities based on each security's average number of months until coupon reset ( months to roll ). Months to roll is an indicator of asset duration which is a measure of market price sensitivity to interest rate movements. Current-reset ARM securities have months to roll of less than 18 months while longer-to-reset ARM securities have months to roll of 18 months or greater. As of June 30, 2012, the average months to roll for the Company's \$8.41 billion (basis) in current-reset ARM securities was 5.4 months while the average months-to-roll for the Company's \$5.08 billion (basis) in longer-to-reset ARM securities was 45.0 months.

In October 2009, under variable interest entity accounting rules, the Company began consolidating two townhome developments in the Dallas, Texas area that were collateral for subordinated loans made by the Company. In November 2011, the Company completed foreclosure proceedings, assuming ownership of the underlying collateral. As of June 30, 2012, the Company's investment consisted of two unsold completed units with a basis of \$529,000 that is included in *Receivables and other assets* on the balance sheet. These remaining units were sold in July 2012. Included in *Miscellaneous other revenue (expense)* is \$108,000 and \$7,000 of gains on unit sales, net of operating costs, recorded during the quarter and six months ended June 30, 2012, respectively. During the quarter and six months ended June 30, 2011, operating costs totaled \$570,000 and \$673,000, respectively, including a \$470,000 impairment charge reflecting slow sales of these units and poor housing market conditions. In addition, the Company is a subordinated participant in the lending group to the Four Seasons resort in Nevis, West Indies which was foreclosed on in May 2010. The resort closed in October 2008 after sustaining hurricane damage and reopened in December 2010. The Company wrote off its \$39.2 million investment in December 2009. A recovery on this investment of any amount would come from the eventual disposition of the resort by the lending group which may not occur for several years.

**NOTE 5 INVESTMENTS IN UNCONSOLIDATED AFFILIATES**

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

**NOTE 6 REPURCHASE ARRANGEMENTS AND SIMILAR****BORROWINGS, INCLUDING RELATED HEDGING ACTIVITY**

Capstead generally pledges its *Residential mortgage investments* as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties,

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

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

| <i>Collateral Type</i>   | <i>Collateral<br/>Carrying<br/>Amount</i> | <i>Accrued<br/>Interest<br/>Receivable</i> | <i>Borrowings<br/>Outstanding</i> | <i>Average<br/>Borrowing<br/>Rates</i> |
|--|---|--|-----------------------------------|--|
| <b>As of June 30, 2012:</b>  |   |  |                                   |  |
| Borrowings with maturities of 30 days or less:   |   |  |                                   |  |
| Agency Securities  | \$ 13,325,708                             | \$ 31,481                                  | \$ 12,680,934                     | 0.39%                                  |
| Borrowings with maturities greater than 30 days:   |   |  |                                   |  |
| Agency Securities (31 to 90 days)  | 49,903                                    | 59   | 44,774                            | 0.42                                   |
| Similar borrowings:  |   |  |                                   |  |
| Collateral for structured financings   | 3,089                                     |  | 3,089                             | 8.07                                   |
|  | \$ 13,378,700                             | \$ 31,540                                  | \$ 12,728,797                     | 0.39                                   |
| Quarter-end borrowing rates adjusted for effects of related derivatives held as cash flow hedges |   |  |                                   | 0.56                                   |
| <b>As of December 31, 2011:</b>  |   |  |                                   |  |
| Borrowings with maturities of 30 days or less:   |   |  |                                   |  |
| Agency Securities  | \$ 11,306,478                             | \$ 25,630                                  | \$ 10,754,835                     | 0.37%                                  |
| Borrowings with maturities greater than 30 days:   |   |  |                                   |  |
| Agency Securities (31 to 90 days)  | 619,710                                   | 1,551                                      | 594,283                           | 0.32                                   |
| Similar borrowings:  |   |  |                                   |  |
| Collateral for structured financings   | 3,326                                     |  | 3,326                             | 8.04                                   |
|  | \$ 11,929,514                             | \$ 27,181                                  | \$ 11,352,444                     | 0.37                                   |
| Quarter-end borrowing rates adjusted for effects of related derivatives held as cash flow hedges |   |  |                                   | 0.58                                   |



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

|   | <i>Quarter Ended</i>          |                          | <i>Average</i>                |             |
|---|-------------------------------|--------------------------|-------------------------------|-------------|
|   | <i>June 30, 2012</i>          | <i>December 31, 2011</i> |                               |             |
|   | <i>Borrowings Outstanding</i> | <i>Average Rate</i>      | <i>Borrowings Outstanding</i> | <i>Rate</i> |
| Average borrowings and rates for the indicated quarters, adjusted for the effects of related derivatives held as cash flow hedges | \$ 12,140,904                 | 0.54%                    | \$ 11,278,675                 | 0.54%       |

To help mitigate exposure to higher short-term interest rates, Capstead uses currently-paying and forward-starting, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that typically require interest payments for two-year terms. These derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate of current and forecasted 30- to 90-day repurchase arrangements. This hedge relationship establishes a relatively stable fixed rate on related borrowings because the variable-rate payments received on the swap agreements largely offset interest accruing on the related borrowings, leaving the fixed-rate payments to be paid on the swap agreements as the Company's effective borrowing rate, subject to certain adjustments including the effects of measured hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and actual borrowing rates.

Capstead entered into new forward-starting swap agreements hedging short-term interest rates totaling \$700 million during the quarter. At June 30, 2012, the Company was a party to swap agreements hedging short-term interest rates with an average expiration of 17 months and the following characteristics (dollars in thousands):

| <i>Quarter of</i>           | <i>Notional</i> | <i>Average Fixed Rate</i>  |
|-----------------------------|-----------------|----------------------------|
| <i>Contract Expiration</i>  | <i>Amount</i>   | <i>Payment Requirement</i> |
| Currently-paying contracts: |                 |                            |
| Third quarter 2012          | \$ 200,000      | 0.83%                      |
| First quarter 2013          | 1,100,000       | 0.81                       |
| Second quarter 2013         | 700,000         | 0.96                       |
| Third quarter 2013          | 300,000         | 0.87                       |
| Fourth quarter 2013         | 800,000         | 0.78                       |
| First quarter 2014          | 200,000         | 0.60                       |
| Second quarter 2014         | 400,000         | 0.51                       |
|                             | 3,700,000       | 0.80                       |
| Forward-starting contracts: |                 |                            |
| Third quarter 2014          | 200,000         | 0.51                       |
| Fourth quarter 2014         | 500,000         | 0.58                       |
| First quarter 2015          | 700,000         | 0.53                       |
|                             | \$ 5,100,000    |                            |

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



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Interest rate swap agreements are measured at fair value on a recurring basis primarily using Level Two Inputs in accordance with Fair Value Measurements and Disclosures (ASC 820). In determining fair value estimates for these derivatives, the Company utilizes the standard methodology of netting the discounted future fixed cash payments and the discounted expected variable cash receipts based on expected future interest rates derived from observable market interest rate curves. The Company also incorporates both its own nonperformance risk and its counterparties' nonperformance risk in determining the fair value of its interest rate swap derivatives. In considering the effect of nonperformance risk, the Company considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and has concluded that counterparty risk is not significant to the overall valuation of these agreements. Included in the *Accumulated other comprehensive income* component of *Stockholders' equity* are unrealized losses on derivatives held as cash flow hedges of \$37.4 million and \$30.2 million as of June 30, 2012 and December 31, 2011, respectively.

The following tables include fair value and other related disclosures regarding all derivatives held as of and for the indicated periods (in thousands):

|  | <i>Location in<br/>Balance Sheet</i> | <i>June 30,<br/>2012</i> | <i>December 31,<br/>2011</i> |
|--|--------------------------------------|--------------------------|------------------------------|
| <b><i>Balance sheet-related</i></b>  |                                      |                          |                              |
| Interest rate swap agreements in a gain position (an asset) related to:    |                                      |                          |                              |
| Repurchase arrangements and similar borrowings                             | <i>(a)</i>                           | \$                       | \$ 617                       |
| Interest rate swap agreements in a loss position (a liability) related to: |                                      |                          |                              |
| Repurchase arrangements and similar borrowings                             | <i>(a)</i>                           | (19,175)                 | (15,691)                     |
| Unsecured borrowings   | <i>(a)</i>                           | (18,699)                 | (15,657)                     |
| Related net interest payable   | <i>(b)</i>                           | (7,462)                  | (10,023)                     |
|  |                                      | \$ (45,336)              | \$ (40,754)                  |

(a) The fair value of derivatives with realized and unrealized gains are aggregated and recorded as an asset on the face of the balance sheet separately from the fair value of derivatives with realized and unrealized losses that are recorded as a liability. The amount of unrealized losses that will be recognized in the statement of income over the next twelve months in the form of fixed- and variable-rate swap payments in excess of current market rates totaled \$16.0 million at June 30, 2012.

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

|  | <i>Location of<br/>Gain or<br/>(Loss)</i> | <i>Quarter Ended<br/>June 30</i> |             | <i>Six Months Ended<br/>June 30</i> |             |
|--|---|----------------------------------|-------------|-------------------------------------|-------------|
|  | <i>Recognized<br/>in<br/>Net Income</i>   | <i>2012</i>                      | <i>2011</i> | <i>2012</i>                         | <i>2011</i> |
| <b><i>Income statement-related</i></b>   |   |                                  |             |                                     |             |
| Components of effect on interest expense:  |   |                                  |             |                                     |             |
| Amount of loss reclassified from AOCI:   |   |                                  |             |                                     |             |
| Effective portion of active positions  |   | \$ (4,830)                       | \$ (7,467)  | \$ (9,795)                          | \$ (13,579) |
| Amount of gain (loss) recognized (ineffective portion)   |   | (448)                            | 109         | (307)                               | (49)        |
| Increase in interest expense and decrease in <i>Net income</i> as a result of the use of derivatives | <i>(a)</i>                                | \$ (5,278)                       | \$ (7,358)  | \$ (10,102)                         | \$ (13,628) |

***Other comprehensive income-related***

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|   |             |             |             |             |
|---|-------------|-------------|-------------|-------------|
| Amount of loss recognized in other comprehensive income<br>(loss) (effective portion) | \$ (15,334) | \$ (16,883) | \$ (17,085) | \$ (17,561) |
|---|-------------|-------------|-------------|-------------|

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

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**Table of Contents****NOTE 7 UNSECURED BORROWINGS**

*Unsecured borrowings* consist of 30-year junior subordinated notes issued in 2006 and 2005 to three special-purpose statutory trusts. These unconsolidated affiliates were formed to issue \$3.1 million of the trusts' common securities to Capstead and to privately place \$100 million of preferred securities with unrelated third party investors. Included in *Receivables and other assets* are \$2.4 million in remaining issue costs associated with these transactions at June 30, 2012 and December 31, 2011. Note balances and related weighted average interest rates as of June 30, 2012 and December 31, 2011 (calculated including issue cost amortization) were as follows (dollars in thousands):

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

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

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

**NOTE 8 DISCLOSURES REGARDING FAIR VALUES OF FINANCIAL INSTRUMENTS**

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

*Residential mortgage investments*, nearly all of which are mortgage securities classified as available-for-sale, are measured at fair value on a recurring basis. In determining fair value estimates for mortgage securities the Company considers recent trading activity for similar investments and pricing levels indicated by lenders in connection with designating collateral for repurchase arrangements, provided such pricing levels are considered indicative of actual market clearing transactions. Included in the *Accumulated other comprehensive income* component of *Stockholders' equity* are unrealized gains on available-for-sale mortgage securities totaling \$302.4 million and \$234.7 million as of June 30, 2012 and December 31, 2011, respectively. In determining fair value estimates for longer-term borrowings under repurchase arrangements, the Company considers pricing levels indicated by lenders for entering into new transactions using similar pledged collateral with terms equal to the remaining terms of the longer-term

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

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

|   | <i>June 30, 2012</i>   |                   | <i>December 31, 2011</i> |                   |
|---|------------------------|-------------------|--------------------------|-------------------|
|   | <i>Carrying Amount</i> | <i>Fair Value</i> | <i>Carrying Amount</i>   | <i>Fair Value</i> |
| <b>Financial assets:</b>  |                        |                   |                          |                   |
| Residential mortgage loans  | \$ 8,397               | \$ 8,500          | \$ 9,148                 | \$ 9,300          |
| Interest rate swap agreements                                       |                        |                   | 617                      | 617               |
| <b>Financial liabilities:</b>                                       |                        |                   |                          |                   |
| Repurchase arrangements with initial terms of greater than 120 days | 44,774                 | 44,800            | 47,419                   | 47,400            |
| Unsecured borrowings  | 103,095                | 104,300           | 103,095                  | 104,200           |
| Interest rate swap agreements                                       | 37,874                 | 37,874            | 31,348                   | 31,348            |

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

|  | <i>Amortized Cost Basis</i> | <i>Gross Unrealized Gains / Losses</i> |        | <i>Fair Value</i> |
|--|-----------------------------|--|--------|-------------------|
| <b>As of June 30, 2012</b>                                     |                             |  |        |                   |
| Agency Securities classified as available-for-sale             | \$ 13,482,041               | \$ 302,771                             | \$ 399 | \$ 13,784,413     |
| Residential mortgage securities classified as held-to-maturity | 6,677                       | 340                                    |        | 7,017             |

|  |            |         |       |            |
|--|------------|---------|-------|------------|
| <b>As of December 31, 2011</b>                                 |            |         |       |            |
| Agency Securities classified as available-for-sale             | 12,013,804 | 236,000 | 1,301 | 12,248,503 |
| Residential mortgage securities classified as held-to-maturity | 7,255      | 349     |       | 7,604      |

|   | <i>June 30, 2012</i> |                        | <i>December 31, 2011</i> |                        |
|---|----------------------|------------------------|--------------------------|------------------------|
|   | <i>Fair Value</i>    | <i>Unrealized Loss</i> | <i>Fair Value</i>        | <i>Unrealized Loss</i> |
| <b>Securities in an unrealized loss position:</b> |                      |                        |                          |                        |
| One year or greater                               | \$ 26,049            | \$ 198                 | \$ 4,933                 | \$ 26                  |
| Less than one year                                | 97,944               | 201                    | 369,226                  | 1,275                  |
|   | \$ 123,993           | \$ 399                 | \$ 374,159               | \$ 1,301               |

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

financing spreads diminished during periods of rising interest rates.

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

**NOTE 9 COMPENSATION PROGRAMS**

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

***Performance-based Cash Compensation Program to Augment Base Salaries***

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

| <i>Month of<br/>Grant</i> | <i>Total<br/>Grant</i> | <i>Quarter Ended<br/>June 30, 2012</i> | <i>Six Months Ended<br/>June 30, 2012</i> |
|---------------------------|------------------------|--|---|
| July 2008                 | 225,000                | \$90,000                               | \$187,000                                 |
| July 2009                 | 225,000                | 90,000                                 | 187,000                                   |
| July 2010                 | 60,000                 | 24,000                                 | 50,000                                    |
| August 2011               | 72,000                 | 28,000                                 | 59,000                                    |
| July 2012                 | 72,000                 |  |   |
|                           |                        | \$232,000                              | \$483,000                                 |

***Annual Incentive Compensation***

To provide employees with an appropriate performance-based annual incentive compensation opportunity, each year the Committee approves an incentive formula designed to create an incentive pool to serve as a guideline for the award of annual incentive compensation that is directly linked with the performance of the Company. The formula adopted accomplishes this by establishing an incentive pool equal to a percentage participation in the Company's earnings in excess of a pre-established performance threshold subject to a maximum amount, or cap, available to be paid in any one year. The Committee has complete discretion with respect to the amount to be distributed from the pool, including its allocation between executive officers and other employees and the form of payment (e.g., cash or equity awards). Distributions are typically made subsequent to year-end.

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



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*Net income* excluding (i) *Incentive compensation*, (ii) any gains or losses from asset sales or writedowns, including impairment charges, and (iii) interest on *Unsecured borrowings*, net of equity in the earnings of related statutory trusts reflected in the balance sheet as *Investments in unconsolidated affiliates*. Average long-term investment capital for formula purposes is defined as average *Unsecured borrowings*, net of related investments in statutory trusts, and average *Stockholders' equity*, excluding (i) *Accumulated other comprehensive income*, (ii) incentive compensation accruals, (iii) certain gains or losses from asset sales or writedowns, and (iv) interest accruals on *Unsecured borrowings*.

**Long-term Equity-based Awards**

The Company sponsors equity-based award plans to provide for the issuance of stock awards, option awards and other long-term equity-based awards to directors and employees (collectively, the Plans). At June 30, 2012, the Plans had 831,668 common shares remaining available for future issuance.

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

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

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

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

| Year of Grant | Grant Date<br>Fair Value<br>Per Share | Total<br>Original<br>Grants | As of December 31, 2011 |           | Remaining Shares<br>Scheduled to Vest During: |        |        |
|---------------|---------------------------------------|-----------------------------|-------------------------|-----------|---|--------|--------|
|               |                                       |                             | Vested                  | Forfeited | 2012  | 2013   | 2014   |
| 2007          | \$12.93                               | 156,000                     | 70,009                  | 12,499    | 22,498*                                       | 22,497 | 22,497 |
| 2008          | 12.87                                 | 6,000                       | 6,000                   |           |   |        |        |
| 2009          | 11.39                                 | 6,000                       | 6,000                   |           |   |        |        |
| 2010          | 11.64                                 | 12,000                      | 12,000                  |           |   |        |        |
| 2011          | 13.23                                 | 24,000                      |                         |           | 24,000**                                      |        |        |
| 2012          | 13.53                                 | 27,000                      |                         |           |   | 27,000 |        |

\* *Shares vested in January 2012.*

\*\* *Shares vested in April 2012.*

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

|  | <i>Number of<br/>Shares</i> | <i>Weighted Average<br/>Grant Date<br/>Fair Value</i> |
|--|-----------------------------|---|
| Unvested stock awards outstanding at December 31, 2011 | 597,418                     | \$12.41   |
| Grants   | 27,000                      | 13.53   |
| Vestings   | (114,097)                   | 11.39   |
| Unvested stock awards outstanding at June 30, 2012     | 510,321                     | 12.70   |

During the quarter and six months ended June 30, 2012, the Company recognized in *Salaries and benefits* \$468,000 and \$937,000, respectively, related to amortization of the grant date fair value of employee performance- and service-based stock awards. The amounts amortized for these periods assumed that performance criteria, if applicable, would continue to be met for related initial measurement periods. In addition, the Company recognized in *Other general and administrative expense* \$81,000 and \$161,000 related to amortization of the grant date fair value of service-based director stock awards during the quarter and six months ended June 30, 2012, respectively. All service-based stock awards, as well as performance-based stock awards granted in 2008 and 2009, are entitled to receive dividends on a current basis without risk of forfeiture if the related awards do not vest. Performance-based awards granted subsequent to 2009 defer the payment of dividends accruing during the vesting period until vesting and if the related awards do not vest these accrued dividends will be forfeited. At June 30, 2012 dividends accrued pertaining to these awards totaled \$549,000 and are included in *Common stock dividend payable*. Unrecognized compensation expense for unvested stock awards totaled \$4.0 million as of June 30, 2012, to be expensed over a weighted average period of 1.6 years, assuming performance criteria, if applicable, are met for related initial measurement periods.

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

|  | <i>Number of<br/>Shares</i> | <i>Weighted Average<br/>Exercise Price</i> |
|--|-----------------------------|--|
| Option awards outstanding at December 31, 2011 | 256,250                     | \$10.71                                    |
| Exercises                                      | (36,250)                    | 10.06                                      |
| Option awards outstanding at June 30, 2012     | 220,000                     | 10.82                                      |

Exercisable option awards outstanding as of June 30, 2012 totaled 220,000 shares with a weighted average remaining contractual term of 5.0 years, an average exercise price of \$10.82 and an aggregate intrinsic value of \$686,000. The total intrinsic value of option awards exercised during the six months ended June 30, 2012 was \$125,000.

**Table of Contents****Other Benefit Programs**

Capstead sponsors a qualified defined contribution retirement plan for all employees and a nonqualified deferred compensation plan for certain of its officers. In general the Company matches up to 50% of a participant's voluntary contribution up to a maximum of 6% of a participant's compensation and makes discretionary contributions of up to another 3% of compensation regardless of participation in the plans. Company contributions are subject to certain vesting requirements. During the quarter and six months ended June 30, 2012, the Company recognized in *Salaries and benefits* \$117,000 and \$250,000 related to contributions to these plans, respectively.

**NOTE 10 NET INTEREST INCOME ANALYSIS**

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

|  | <i>Quarter Ended June 30</i> |                     |               |                     | <i>Related Changes in</i> |                |               |
|--|------------------------------|---------------------|---------------|---------------------|---------------------------|----------------|---------------|
|  | <i>2012</i>                  |                     | <i>2011</i>   |                     | <i>Rate*</i>              | <i>Volume*</i> | <i>Total*</i> |
|  | <i>Amount</i>                | <i>Average Rate</i> | <i>Amount</i> | <i>Average Rate</i> |                           |                |               |
| Interest income:                               |                              |                     |               |                     |                           |                |               |
| Residential mortgage investments               | \$ 65,787                    | 2.04%               | \$ 63,136     | 2.38%               | \$ (9,791)                | \$ 12,442      | \$ 2,651      |
| Other  | 176                          | 0.17                | 58            | 0.12                | 32                        | 86             | 118           |
|  | 65,963                       | 1.98                | 63,194        | 2.34                | (9,759)                   | 12,528         | 2,769         |
| Interest expense:                              |                              |                     |               |                     |                           |                |               |
| Repurchase arrangements and similar borrowings | (16,451)                     | 0.54                | (13,706)      | 0.55                | (250)                     | 2,995          | 2,745         |
| Unsecured borrowings                           | (2,187)                      | 8.49                | (2,187)       | 8.49                |                           |                |               |
| Other  |                              | 0.07                | (1)           | 0.10                |                           | (1)            | (1)           |
|  | (18,638)                     | 0.61                | (15,894)      | 0.64                | (250)                     | 2,994          | 2,744         |
|  | \$ 47,325                    | 1.37                | \$ 47,300     | 1.70                | \$ (9,509)                | \$ 9,534       | \$ 25         |

|  | <i>Six Months Ended June 30</i> |                     |               |                     | <i>Related Changes in</i> |                |               |
|--|---------------------------------|---------------------|---------------|---------------------|---------------------------|----------------|---------------|
|  | <i>2012</i>                     |                     | <i>2011</i>   |                     | <i>Rate*</i>              | <i>Volume*</i> | <i>Total*</i> |
|  | <i>Amount</i>                   | <i>Average Rate</i> | <i>Amount</i> | <i>Average Rate</i> |                           |                |               |
| Interest income:                               |                                 |                     |               |                     |                           |                |               |
| Residential mortgage investments               | \$ 131,520                      | 2.09%               | \$ 116,277    | 2.37%               | \$ (14,870)               | \$ 30,113      | \$ 15,243     |
| Other  | 326                             | 0.16                | 171           | 0.16                |                           | 155            | 155           |
|  | 131,846                         | 2.03                | 116,448       | 2.32                | (14,870)                  | 30,268         | 15,398        |
| Interest expense:                              |                                 |                     |               |                     |                           |                |               |
| Repurchase arrangements and similar borrowings | (30,554)                        | 0.52                | (26,028)      | 0.57                | (2,420)                   | 6,946          | 4,526         |
| Unsecured borrowings                           | (4,374)                         | 8.49                | (4,374)       | 8.49                |                           |                |               |
| Other  |                                 | 0.07                | (5)           | 0.14                | (2)                       | (3)            | (5)           |
|  | (34,928)                        | 0.58                | (30,407)      | 0.66                | (2,422)                   | 6,943          | 4,521         |
|  | \$ 96,918                       | 1.45                | \$ 86,041     | 1.66                | \$ (12,448)               | \$ 23,325      | \$ 10,877     |

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

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL**

**CONDITION AND RESULTS OF OPERATIONS**

**FINANCIAL CONDITION**

***Overview***

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

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

Capstead finances its investments with borrowings under repurchase arrangements with commercial banks and other financial institutions supported by its long-term investment capital, which as of June 30, 2012 totaled \$1.58 billion and consisted of \$1.29 billion of common and \$189 million of perpetual preferred stockholders' equity (recorded amounts) and \$100 million of long-term unsecured borrowings (net of related investments in statutory trusts). Long-term investment capital increased by \$188 million or 13% during the six months ended June 30, 2012 primarily as a result of raising \$121 million in common equity capital and higher portfolio pricing levels. Holdings of ARM Agency Securities increased by \$1.53 billion or 13% during 2012, to \$13.80 billion at June 30, 2012, while repurchase arrangements and similar borrowings increased \$1.38 billion or 12% during 2012 to \$12.73 billion. Portfolio leverage (repurchase arrangements and similar borrowings divided by long-term investment capital) decreased to 8.05 to one by June 30, 2012 from 8.15 to one at December 31, 2011. Management believes borrowing at current levels represents an appropriate and prudent use of leverage for a portfolio of Agency Securities under current market conditions, particularly a portfolio consisting almost entirely of short-duration ARM Agency Securities (duration is a common measure of market price sensitivity to interest rate movements). Provided capital can continue to be deployed at attractive levels and financing conditions remain favorable, management anticipates maintaining portfolio leverage near June 30, 2012 levels.

Capstead reported net income of \$43 million and \$89 million or \$0.40 and \$0.85 per diluted common share for the quarter and six months ended June 30, 2012, compared to \$43 million and \$77 million or \$0.48 and \$0.90 per diluted common share for the same periods in 2011. Total financing spreads (the difference between yields on interest-earning assets and rates on interest-bearing liabilities), averaged 137 and 145 basis points for the quarter and six months ended June 30, 2012, compared to 170 and 166 basis points during the same periods in 2011. Lower financing spreads during the second quarter of 2012 reflect (a) lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates underlying the portfolio resetting lower to more current rates and lower coupon interest rates on

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acquisitions, and (b) higher investment premium amortization primarily because of higher second quarter portfolio runoff and higher prices paid for portfolio acquisitions in recent years. The effect on financing spreads of lower portfolio yields was partially offset by lower borrowing rates attributable to the expiration of higher cost interest rate swap agreements that have largely been replaced with additional two-year term swap agreements at more favorable rates, even as unhedged borrowing rates have increased.

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

### ***Risk Factors and Critical Accounting Policies***

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

### ***Common and Preferred Equity Issuances***

During the second quarter of 2012 Capstead raised \$62 million in new common equity capital, after underwriting discounts and offering expenses, by issuing 4.5 million common shares at an average price of \$13.73 per share, after expenses, through the Company's at-the-market, continuous offering program. Year-to-date the Company has raised \$121 million by issuing 9.0 million common shares at an average price of \$13.45 per share under this program. Additionally, during the second quarter of 2012 the Company raised \$1 million in new preferred equity capital through the issuance of 78,000 Series B preferred shares at an average price of \$14.42 per share, after expenses. Year-to-date the Company has raised \$4 million by issuing 309,000 Series B preferred shares at an average price of \$14.50 per share under this program. As of quarter-end, 7.9 million common shares and 1.3 million Series B preferred shares are available for issuance under this program pursuant to supplements filed with the applicable registration statement on file with the Securities and Exchange Commission (the "SEC"). Subsequent to quarter-end and through the date of this filing, the Company used this program to issue an additional \$17 million in common equity capital. The Company may raise additional capital in future periods using this program or by other means, subject to market conditions and blackout periods associated with the dissemination of earnings and dividend announcements and other important company-specific news.

### ***Book Value per Common Share***

Nearly all of Capstead's residential mortgage investments and all of its interest rate swap agreements are reflected at fair value on the Company's balance sheet and included in the calculation of book value per common share (total stockholders' equity, less perpetual preferred share liquidation preferences, divided by common shares outstanding). The fair value of these positions is impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels. The Company's investment strategy attempts to mitigate these risks by focusing on investments in Agency Securities, which are considered to have little, if any, credit risk and are collateralized by ARM loans with interest rates that reset periodically to more current levels. Because of these characteristics, the fair value of Capstead's portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to portfolios containing a significant amount of non-agency and/or fixed-rate mortgage securities.

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The following table illustrates the progression of book value per common share for the quarter and six months ended June 30, 2012:

|   | <i>Quarter Ended</i> |                 | <i>Six Months Ended</i> |
|---|----------------------|-----------------|-------------------------|
|   | <i>June 30</i>       | <i>March 31</i> | <i>June 30</i>          |
| Book value per common share, beginning of period  | \$ 13.04             | \$ 12.52        | \$ 12.52                |
| Capital transactions:   |                      |                 |                         |
| Accretion from capital raises   | 0.03                 | 0.04            | 0.09                    |
| Increase related to stock awards  |                      | 0.01            | 0.01                    |
| Dividend distributions in excess of earnings  | (0.01)               |                 | (0.01)                  |
| Increase in fair value of mortgage securities classified as available-for-sale                        | 0.28                 | 0.44            | 0.69                    |
| Increase (decrease) in fair value of interest rate swap agreements designated as cash flow hedges of: |                      |                 |                         |
| Repurchase arrangements and similar borrowings  |                      | (0.05)          | (0.04)                  |
| Unsecured borrowings  | (0.11)               | 0.08            | (0.03)                  |
| Book value per common share, end of period  | \$ 13.23             | \$ 13.04        | \$ 13.23                |
| Increase in book value per common share during the indicated periods                                  | \$ 0.19              | \$ 0.52         | \$ 0.71                 |

**Residential Mortgage Investments**

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

|   | <i>Quarter Ended</i> | <i>Six Months Ended</i> |
|---|----------------------|-------------------------|
|   | <i>June 30, 2012</i> | <i>June 30, 2012</i>    |
| Residential mortgage investments, beginning of period   | \$ 13,012,459        | \$ 12,264,906           |
| Increase in unrealized gains on mortgage securities classified as available-for-sale              | 27,061               | 67,673                  |
| Portfolio acquisitions (principal amount) at average lifetime purchased yields of 2.19% and 2.29% | 1,354,777            | 2,580,552               |
| Investment premiums on acquisitions   | 54,442               | 104,237                 |
| Portfolio runoff (principal amount)   | (627,553)            | (1,177,686)             |
| Investment premium amortization   | (21,699)             | (40,195)                |
| Residential mortgage investments, end of period   | \$ 13,799,487        | \$ 13,799,487           |
| Average residential mortgage investments outstanding during the indicated periods                 | \$ 13,213,003        | \$ 12,876,008           |





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

| <i>ARM Type</i> <sup>(a)</sup>                           | <i>Amortized Cost Basis</i> <sup>(b)</sup> | <i>Net WAC</i> <sup>(c)</sup> | <i>Fully Indexed WAC</i> <sup>(c)</sup> | <i>Average Net Margins</i> <sup>(c)</sup> | <i>Average Periodic Caps</i> <sup>(c)</sup> | <i>Average Lifetime Caps</i> <sup>(c)</sup> | <i>Months To Roll</i> <sup>(a)</sup> |
|--|--|-------------------------------|---|---|---|---|--------------------------------------|
| <b>Current-reset ARMs:</b>                               |  |                               |   |   |   |   |                                      |
| Fannie Mae Agency Securities                             | \$ 5,620,970                               | 2.50%                         | 2.45%                                   | 1.70%                                     | 3.20%                                       | 10.17%                                      | 4.9                                  |
| Freddie Mac Agency Securities                            | 2,038,885                                  | 3.08                          | 2.60                                    | 1.84                                      | 2.32  | 10.66                                       | 5.8                                  |
| Ginnie Mae Agency Securities                             | 743,325                                    | 2.47                          | 1.74                                    | 1.51                                      | 1.01  | 9.33  | 7.5                                  |
| Residential mortgage loans                               | 5,269                                      | 3.51                          | 2.52                                    | 2.04                                      | 1.49  | 10.97                                       | 4.5                                  |
|  | 8,408,449                                  | 2.64                          | 2.43                                    | 1.72                                      | 2.79  | 10.21                                       | 5.4                                  |
| <b>Longer-to-reset ARMs:</b>                             |  |                               |   |   |   |   |                                      |
| Fannie Mae Agency Securities                             | 2,817,661                                  | 3.04                          | 2.84                                    | 1.77                                      | 4.78  | 8.10  | 46.1                                 |
| Freddie Mac Agency Securities                            | 1,430,898                                  | 3.08                          | 2.91                                    | 1.86                                      | 4.87  | 8.14  | 48.8                                 |
| Ginnie Mae Agency Securities                             | 830,212                                    | 3.22                          | 1.73                                    | 1.51                                      | 1.02  | 8.25  | 34.6                                 |
|  | 5,078,771                                  | 3.08                          | 2.68                                    | 1.75                                      | 4.19  | 8.14  | 45.0                                 |
|  | \$ 13,487,220                              | 2.80                          | 2.52                                    | 1.73                                      | 3.32  | 9.43  | 20.2                                 |
| <b>Gross WAC (rate paid by borrowers) <sup>(d)</sup></b> |  | <b>3.44</b>                   |   |   |   |   |                                      |

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

(b) Amortized cost basis represents the Company's investment (unpaid principal balance plus unamortized investment premiums) before unrealized gains and losses. As of June 30, 2012, the ratio of basis to related unpaid principal balance for the Company's ARM securities was 102.96. This table excludes \$4 million in fixed-rate Agency Securities, \$3 million in fixed-rate residential mortgage loans and \$3 million in private residential mortgage pass-through securities held as collateral for structured financings.

(c) Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments, net of servicing and other fees as of the indicated date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments. Fully indexed WAC represents the weighted average coupon upon one or more resets using interest rate indexes and net margins as of the indicated date. Average net margins represent the weighted average levels over the underlying indexes that the portfolio can adjust to upon reset, usually subject to initial, periodic and/or lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. ARM securities issued by the GSEs with initial fixed-rate periods of five years or longer typically have 500 basis point initial caps with 200 basis point periodic caps. Additionally, certain ARM securities held by the Company are subject only to lifetime caps. For presentation purposes, average periodic caps in the table above reflect initial caps until after an ARM security has reached its initial reset date and lifetime caps, less the current net WAC, for ARM securities subject only to lifetime caps. At quarter-end, 77% of current-reset ARMs were subject to periodic caps averaging 1.85%; 8% were subject to initial caps averaging 3.30%; and 15% were subject to lifetime caps, less the current net WAC, averaging 7.54%. All longer-to-reset ARM securities at June 30, 2012 were subject to initial caps.

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

ARM securities are backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities either (i) adjust annually based on specified margins over the one-year Constant Maturity U.S. Treasury Note Rate ( CMT ) or the one-year London interbank offered rate ( LIBOR ), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index,

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or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans.

After consideration of any applicable initial fixed-rate periods, at June 30, 2012 approximately 79%, 12% and 9% of the Company's ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly. Approximately 93% of the Company's current-reset ARM securities have reached an initial coupon reset date, while none of its longer-to-reset ARM securities have reached an initial

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coupon reset date. Additionally, at June 30, 2012 approximately 20% of the Company's ARM securities were backed by interest-only loans that have not reached an initial coupon reset date. All percentages are approximate and based on averages of the characteristics of mortgage loans underlying each security and calculated using unpaid principal balances as of the indicated balance sheet date.

ARM Agency Securities typically are acquired at a premium to the securities' unpaid principal balances and high levels of mortgage prepayments can put downward pressure on yields and financing spreads because the level of mortgage prepayments impacts how quickly investment premiums are written off against earnings as portfolio yield adjustments. Portfolio runoff during the quarter and six months ended June 30, 2012 averaging 18.3% and 17.7% on an annualized basis, respectively (a constant prepayment rate, or CPR, of 15.9% and 15.2%, respectively). Higher portfolio runoff in the second quarter reflects higher seasonal prepayment patterns as well as lower prevailing mortgage interest rates available to consumers. While the current low interest rate environment can be expected to persist for some time, certain characteristics of the Company's portfolio are expected to lessen the risk to earnings from sharply higher prepayment levels. A key differentiating factor of Capstead's investment strategy relative to the strategies implemented by peers in the mortgage REIT sector is the Company's focus on investing solely in ARM securities. At June 30, 2012 the portfolio was backed by mortgages requiring borrowers to make payments predicated on rates averaging a relatively low 3.44%, of which over 60% were originated prior to 2009. Mortgage prepayments on securities holding these more seasoned loans continue to be suppressed by low housing prices and credit problems being experienced by many of these borrowers, even as prepayments on newer originations remain somewhat elevated. As a result, most borrowers with mortgage loans underlying securities in the portfolio lack the ability to meaningfully lower their mortgage payments even if they can overcome all of these impediments to refinancing. For these reasons, management anticipates mortgage prepayments to remain somewhat elevated on newer origination securities (limited to a portion of the Company's longer-to-reset ARM securities) while further increases in prepayments on more seasoned longer-to-reset and current-reset ARM securities should be relatively modest during the third and fourth quarters of 2012.

Capstead generally pledges its residential mortgage investments as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis with commercial banks and other financial institutions, referred to as counterparties, when each borrowing is initiated or renewed. None of the Company's counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date, typically with terms of 30 to 90 days, and are accounted for as financings by the Company. The Company maintains the beneficial interest in the specific securities pledged during the term of the repurchase arrangement and receives the related principal and interest payments. The amount borrowed is generally equal to the fair value of the assets pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a haircut. Since early in 2009, haircut requirements for pledged Agency Securities have remained relatively stable and as of June 30, 2012, haircuts on outstanding borrowings averaged 4.6 percent and typically ranged from 3.0 to 5.0 percent of the fair value of the pledged securities. After considering related interest receivable, as well as interest payable on these borrowings, the Company had \$678 million of capital at risk with its lending counterparties as of June 30, 2012.

Interest rates charged on repurchase arrangements and similar borrowings are fixed based on prevailing rates corresponding to the terms of the borrowings, and interest is paid at the termination of the repurchase arrangement at which time the Company may enter into a new repurchase arrangement at prevailing market rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. When the fair value of pledged securities declines due to changes in market conditions or the publishing of monthly security pay down factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or establish cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls.

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Conversely, if fair values increase, lenders are required to release collateral back to the Company pursuant to Company-issued margin calls. The Company's borrowings under repurchase arrangements and similar borrowings at June 30, 2012 consisted of \$12.73 billion of primarily 30-day borrowings with 23 counterparties at average rates of 0.39%, before the effects of interest rate swap agreements held as cash flow hedges on a designated portion of 30- to 90-day borrowings (see below) and 0.56% including the effects of these derivative financial instruments.

To help mitigate exposure to higher short-term interest rates, Capstead uses currently-paying and forward-starting, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that typically require interest payments for two-year terms. Variable payments received by the Company under its swap agreements largely offset interest accruing on a like amount of the Company's 30- to 90-day borrowings, leaving the fixed-rate payments to be paid on the swap agreements as the Company's effective borrowing rate, subject to certain adjustments. These adjustments include the effects of measured hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and related actual borrowing rates. Under the terms of currently-paying interest rate swap agreements held at June 30, 2012, the Company is required to pay fixed rates of interest averaging 0.80% on notional amounts totaling \$3.7 billion with average remaining interest payment terms of 12 months. Additionally, as of quarter-end the Company had entered into forward-starting swap agreements with notional amounts totaling \$1.4 billion that will begin requiring interest payments at fixed rates averaging 0.55% for two-year periods that commence on various dates between July 2012 and March 2013, with an average expiration of 28 months. After consideration of all swap positions entered into as of quarter-end to hedge short-term borrowing rates, the Company's residential mortgage investments and related borrowings under repurchase arrangements had estimated durations at June 30, 2012 of 10 1/4 months and 6 3/4 months, respectively, for a net duration gap of 3 1/2 months. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-dated repurchase arrangements if available at attractive terms.

The following table progresses quarterly portfolio yields on residential mortgage investments and related borrowing rates over the past five quarters:

| <i>Quarter Ended</i> | <i>Yields *</i>   |                     |              | <i>Borrowing Rates *</i> |                |                  |
|----------------------|-------------------|---------------------|--------------|--------------------------|----------------|------------------|
|                      | <i>Investment</i> |                     |              | <i>Unhedged</i>          | <i>Overall</i> |                  |
|                      | <i>Cash</i>       | <i>Premium</i>      |              | <i>Borrowing</i>         | <i>Swap</i>    | <i>Borrowing</i> |
|                      | <i>Yields</i>     | <i>Amortization</i> | <i>Total</i> | <i>Rates</i>             | <i>Rates</i>   | <i>Rates</i>     |
| March 31, 2011       | 2.94%             | (0.58)%             | 2.36%        | 0.29%                    | 1.07%          | 0.59%            |
| June 30, 2011        | 2.97              | (0.59)              | 2.38         | 0.25                     | 1.02           | 0.55             |
| September 30, 2011   | 2.84              | (0.67)              | 2.17         | 0.25                     | 0.98           | 0.57             |
| December 31, 2011    | 2.77              | (0.66)              | 2.11         | 0.32                     | 0.90           | 0.54             |
| March 31, 2012       | 2.74              | (0.60)              | 2.14         | 0.32                     | 0.85           | 0.49             |
| June 30, 2012        | 2.71              | (0.67)              | 2.04         | 0.37                     | 0.80           | 0.54             |

\* Cash yields are based on the cash component of interest income. Investment premium amortization is determined using the interest method and incorporates actual and anticipated future mortgage prepayments. Both are expressed as a percentage calculated on an annualized basis on average amortized cost basis. Unhedged borrowing rates represent average rates on repurchase arrangements and similar borrowings. Swap Rates represent the average fixed rates on currently-paying interest rate swap agreements.

Declines on cash yields have moderated in recent quarters as the coupon interest rates of an increasing number of the mortgage loans underlying current-reset ARM securities approach fully-indexed levels. Investment premium amortization is influenced by investment premium levels and mortgage prepayments. Because of higher prices paid in recent years for acquisitions as well as continued runoff of older, lower-basis securities, the Company's cost basis in its portfolio has increased resulting in larger yield adjustments for investment premium amortization. Additionally, higher second quarter 2012 mortgage prepayment levels resulted in higher investment premium amortization. Unhedged borrowing

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rates have increased in recent quarters from the lower levels experienced last summer due to a variety of market factors; however, on an overall basis borrowing rates have tended to decline with the expiration of higher-rate interest rate swap agreements over the indicated periods.

**Commercial Investments**

In 2008 management curtailed its previous practice of periodically augmenting Capstead's residential mortgage investments with investments in credit-sensitive commercial real estate-related asset. The Company's remaining exposure to these non-core investments was eliminated by July 2012 through sales of the underlying collateral. The Company remains a subordinated participant in the lending group for the Four Seasons resort in Nevis, West Indies, which was foreclosed on in May 2010. The resort re-opened in December 2010 after having been closed since 2008 as a result of sustaining significant hurricane damage. The Company wrote off its \$39 million investment in 2009; a recovery on this investment of any amount would come from the eventual disposition of the resort by the lending group, which may not occur for several years.

**Utilization of Long-term Investment Capital and Potential Liquidity**

Capstead's investment strategy is to manage a conservatively leveraged portfolio of ARM Agency Securities that can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. Borrowings under repurchase arrangements generally can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Consequently, potential liquidity inherent in the Company's unencumbered residential mortgage investments portfolio is as important as the actual level of cash and cash equivalents carried on the balance sheet. Potential liquidity is affected by, among other things, current portfolio leverage levels; changes in market value of assets pledged and interest rate swap agreements held for hedging purposes as determined by lending and swap counterparties; principal prepayments; collateral requirements of lenders and swap counterparties; and general conditions in the commercial banking and mortgage finance industries. Future levels of portfolio leverage will be dependent upon many factors, including the size and composition of the Company's investment portfolio (see Liquidity and Capital Resources). Capstead's utilization of its long-term investment capital and its estimated potential liquidity were as follows as of June 30, 2012 in comparison with December 31, 2011 (in thousands):

|   | <i>Investments</i> <sup>(a)</sup> | <i>Related Borrowings</i> | <i>Capital Employed</i> | <i>Potential Liquidity</i> <sup>(b)</sup> | <i>Portfolio Leverage</i> <sup>(c)</sup> |
|---|-----------------------------------|---------------------------|-------------------------|---|--|
| <b>Balances as of June 30, 2012:</b>                                    |                                   |                           |                         |   |  |
| Residential mortgage investment portfolio                               | \$ 13,799,487                     | \$ 12,728,797             | \$ 1,070,690            | \$ 449,665                                |  |
| Cash collateral receivable from swap counterparties, net <sup>(d)</sup> |                                   |                           | 17,884                  |   |  |
| Other assets, net of other liabilities                                  |                                   |                           | 491,856                 | 433,241                                   |  |
|   |                                   |                           | \$ 1,580,430            | \$ 882,906                                | 8.05:1                                   |
| <b>Balances as of December 31, 2011</b>                                 |                                   |                           |                         |   |  |
|   | \$ 12,264,906                     | \$ 11,352,444             | \$ 1,392,685            | \$ 757,762                                | 8.15:1                                   |

(a) Investments are stated at balance sheet carrying amounts, which generally reflects estimated fair value as of the indicated date.

(b) Potential liquidity is based on maximum amounts of borrowings available under existing uncommitted repurchase arrangements considering management's estimate of the fair value of related collateral as of the indicated dates adjusted for other sources of liquidity such as cash and cash equivalents.

(c) Portfolio leverage is expressed as the ratio of repurchase agreements and similar borrowings (Related Borrowings in the table above) to long-term investment capital (total Capital Employed in the table above).

(d) Cash collateral receivable from swap counterparties is presented net of cash collateral payable to swap counterparties and the fair value of interest rate swap positions as of the indicated date.

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Because of relatively weak market conditions experienced in 2009 and 2010, including high levels of mortgage prepayments experienced in 2010 as a consequence of GSE programs to buy out seriously delinquent loans from their guarantee portfolios, increases in the Company's residential mortgage investments portfolio during these years were relatively modest, as were portfolio leverage levels. During the latter half of 2010, the Company began growing its holdings of ARM Agency Securities more aggressively in order to re-leverage its investment capital. By March 2011 this effort was largely completed and the Company had resumed raising new equity capital through its at-the-market continuous offering program. For the six months ended June 30, 2012, acquisitions of ARM agency securities totaled \$2.58 billion (principal amount) outpacing portfolio runoff and contributing to a \$1.53 billion increase in the portfolio. This portfolio growth has been funded largely with \$121 million in new common equity capital and additional borrowings. The Company has maintained portfolio leverage at approximately eight to one since March 2011 which management believes represents an appropriate and prudent use of leverage for a portfolio of Agency Securities under current market conditions, particularly a portfolio consisting almost entirely of short-duration ARM Agency Securities.

In order to prudently and efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund borrowing and interest rate swap program-related margin calls under stressed market conditions, including margin calls resulting from monthly principal payments (that are not remitted to the Company for 20 to 45 days after any given month-end), as well as reasonably possible declines in the market value of pledged assets and swap positions. Should market conditions deteriorate, management may reduce portfolio leverage and therefore increase liquidity by raising new equity capital, selling mortgage securities and/or curtailing the replacement of portfolio runoff. Additionally, the Company routinely does business with a large number of lending counterparties, which bolsters financial flexibility to address challenging market conditions and limits exposure to any individual counterparty.

**Table of Contents****RESULTS OF OPERATIONS**

|   | <i>Quarter Ended<br/>June 30</i> |             | <i>Six Months<br/>Ended June 30</i> |             |
|---|----------------------------------|-------------|-------------------------------------|-------------|
|   | <i>2012</i>                      | <i>2011</i> | <i>2012</i>                         | <i>2011</i> |
| <b>Income statement data: (dollars in thousands, except per share data)</b> |                                  |             |                                     |             |
| Interest income:  |                                  |             |                                     |             |
| Residential mortgage investments  | \$ 65,787                        | \$ 63,136   | \$ 131,520                          | \$ 116,277  |
| Other   | 176                              | 58          | 326                                 | 171         |
|   | 65,963                           | 63,194      | 131,846                             | 116,448     |
| Interest expense:   |                                  |             |                                     |             |
| Repurchase arrangements and similar borrowings                              | (16,451)                         | (13,706)    | (30,554)                            | (26,028)    |
| Unsecured borrowings  | (2,187)                          | (2,187)     | (4,374)                             | (4,374)     |
| Other   |                                  | (1)         |                                     | (5)         |
|   | (18,638)                         | (15,894)    | (34,928)                            | (30,407)    |
|   | 47,325                           | 47,300      | 96,918                              | 86,041      |
| Other revenue (expense):  |                                  |             |                                     |             |
| Miscellaneous other revenue (expense)                                       | 13                               | (599)       | (156)                               | (817)       |
| Incentive compensation  | (1,295)                          | (1,487)     | (2,833)                             | (2,720)     |
| Salaries and benefits   | (1,682)                          | (1,672)     | (3,509)                             | (3,373)     |
| Other general and administrative expense                                    | (1,091)                          | (1,066)     | (2,045)                             | (2,028)     |
|   | (4,055)                          | (4,824)     | (8,543)                             | (8,938)     |
| Equity in earnings of unconsolidated affiliates                             | 65                               | 65          | 130                                 | 130         |
| Net income  | \$ 43,335                        | \$ 42,541   | \$ 88,505                           | \$ 77,233   |
| Diluted earnings per common share   | \$ 0.40                          | \$ 0.48     | \$ 0.85                             | \$ 0.90     |
| Average diluted shares outstanding  | 94,286                           | 77,560      | 92,073                              | 74,575      |
| <b>Key operating statistics: (dollars in millions)</b>                      |                                  |             |                                     |             |
| Weighted average yields:  |                                  |             |                                     |             |
| Residential mortgage investments  | 2.04%                            | 2.38%       | 2.09%                               | 2.37%       |
| Other interest-earning assets   | 0.17                             | 0.12        | 0.16                                | 0.16        |
| Total weighted average yields   | 1.98                             | 2.34        | 2.03                                | 2.32        |
| Weighted average borrowing rates:   |                                  |             |                                     |             |
| Repurchase arrangements and similar borrowings:                             |                                  |             |                                     |             |
| Unhedged borrowing rates  | 0.37                             | 0.25        | 0.34                                | 0.27        |
| As adjusted for interest rate hedging transactions                          | 0.54                             | 0.55        | 0.52                                | 0.57        |
| Unsecured borrowings  | 8.49                             | 8.49        | 8.49                                | 8.49        |
| Other   | 0.07                             | 0.10        | 0.07                                | 0.14        |
| Total weighted average borrowing rates                                      | 0.61                             | 0.64        | 0.58                                | 0.66        |
| Total weighted average financing spreads                                    | 1.37                             | 1.70        | 1.45                                | 1.66        |
| Net yield on total interest-earning assets                                  | 1.43                             | 1.76        | 1.50                                | 1.73        |
| Average total runoff rate (scheduled payments and prepayments)              | 18.32                            | 17.06       | 17.67                               | 18.47       |



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|  |           |           |           |          |
|--|-----------|-----------|-----------|----------|
| Average balance information:   |           |           |           |          |
| Residential mortgage investments   | \$ 12,923 | \$ 10,602 | \$ 12,601 | \$ 9,802 |
| Other interest-earning assets  | 424       | 196       | 406       | 216      |
| Repurchase arrangements and similar borrowings   | 12,141    | 9,802     | 11,848    | 9,059    |
| Currently-paying swap agreements ( <i>notional amount</i> )  | 3,696     | 3,746     | 3,631     | 3,414    |
| Unsecured borrowings ( <i>included in long-term investment capital</i> )   | 103       | 103       | 103       | 103      |
| Other interest-bearing liabilities   |           | 3         |           | 7        |
| Long-term investment capital   | 1,544     | 1,254     | 1,499     | 1,206    |
| Portfolio leverage   | 7.86:1    | 7.82:1    | 7.90:1    | 7.51:1   |
| Incentive compensation, salaries and benefits and other general and administrative expense as a percentage of average long-term investment capital | 1.06%     | 1.35%     | 1.12%     | 1.36%    |
| Return on average long-term investment capital   | 11.84     | 14.29     | 12.44     | 13.62    |
| Return on average common equity capital  | 12.19     | 15.43     | 12.95     | 14.60    |

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Capstead's net income totaled \$43 million and \$89 million or \$0.40 and \$0.85 per diluted common share for the quarter and six months ended June 30, 2012, compared to \$43 million and \$77 million or \$0.48 and \$0.90 per diluted common share for the same periods in 2011. Total financing spreads averaged 1.37% and 1.45% during the quarter and six months ended June 30, 2012, which were 33 and 21 basis points lower than yields reported for the same periods in 2011. Lower financing spreads in 2012 reflect (a) lower cash yields on the portfolio because of the effects of ARM loan coupon interest rates underlying the portfolio resetting lower to more current rates and lower coupon interest rates on acquisitions, and (b) higher investment premium amortization primarily because of higher second quarter 2012 portfolio runoff and higher prices paid for portfolio acquisitions in recent years. The effect on financing spreads of lower portfolio yields was partially offset by lower borrowing rates attributable to the expiration of higher cost interest rate swap agreements that have largely been replaced with additional two-year term swap agreements at more favorable rates, even as unhedged borrowing rates have increased in recent quarters due to a variety of market factors.

Yields on residential mortgage securities averaged 2.04% and 2.09% during the quarter and six months ended June 30, 2012, which were 34 and 28 basis points lower than yields reported for the same periods in 2011. Cash yields averaged 2.71% and 2.73% during the quarter and six months ended June 30, 2012, which were 26 and 22 basis points lower than cash yields reported for the same periods in 2011. Investment premium amortization of \$22 million and \$40 million for the quarter and six months ended June 30, 2012 represented yield adjustments of 67 and 64 basis points, compared to amortization of \$16 million and \$28 million or 59 and 58 basis points for the same periods in 2011.

Borrowing rates on repurchase arrangements and similar borrowings averaged 0.54% and 0.52% during the quarter and six months ended June 30, 2012, which were 1 and 5 basis points lower than rates reported for the same periods in 2011. Borrowings under repurchase arrangements typically reset in rate every 30 to 90 days. Before adjustment for the effects of interest rate swap agreements held as cash flow hedges, rates on these borrowings averaged 0.37% and 0.34% during the quarter and six months ended June 30, 2012, which were 12 and 7 basis points higher than rates reported for the same periods in 2011. Rates on approximately \$3.70 billion and \$3.63 billion of the Company's average borrowings during the quarter and six months ended June 30, 2012 were effectively fixed through the use of interest rate swap agreements. The corresponding amounts were \$3.75 billion and \$3.41 billion for the same periods in 2011. Fixed-rate payment requirements on the Company's currently-paying swap positions, before certain adjustments including the effects of measured hedge ineffectiveness and changes in spreads between variable rates on the swap agreements and related actual borrowings, averaged 0.80% and 0.82% for the quarter and six months ended June 30, 2012, both of which were 22 basis points lower than rates reported for the same periods in 2011.

Miscellaneous other revenue (expense) includes \$108,000 and \$7,000 of gains on unit sales, net of operating costs related to Capstead's remaining commercial real estate investments which at quarter-end consisted of two completed unsold townhomes. These units were sold in July 2012. This activity lost \$570,000 and \$673,000 in the same periods in 2011, which included a \$470,000 impairment charge. Incentive compensation, salaries and benefits and other general and administrative expense (referred to as operating costs), as a percentage of average long-term investment capital declined 29 and 24 basis points to 1.06% and 1.12% for the quarter and six months ended June 30, 2012, compared to the same periods in 2011. This decline is attributable primarily to increases in average long-term investment capital. Additionally, incentive compensation declined 14 and 7 basis points to 0.34% and 0.38% for the quarter and six months ended June 30, 2012, compared to the same periods in 2011, reflecting lower relative accruals under a performance-based employee incentive compensation program that provides for a participation in annual earnings, in excess of a benchmark amount and caps annual incentive compensation at 50 basis points of average long-term investment capital. See NOTE 9 to the accompanying consolidated financial statements for additional information regarding the Company's compensation programs.

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**Table of Contents****LIQUIDITY AND CAPITAL RESOURCES**

Capstead's primary sources of funds are borrowings under repurchase arrangements and monthly principal and interest payments on its investments. Other sources of funds may include proceeds from debt and equity offerings and asset sales. The Company generally uses its liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage its long-term investment capital. Because the level of these borrowings can generally be adjusted on a daily basis, the Company's potential liquidity inherent in its unencumbered residential mortgage investments is as important as the level of cash and cash equivalents carried on the balance sheet. The table included under "Financial Condition - Utilization of Long-term Investment Capital and Potential Liquidity" and accompanying discussion illustrates management's estimate of additional funds potentially available to the Company as of June 30, 2012 and the Company's perspective on the appropriate level of portfolio leverage to employ under current market conditions. The Company currently believes that it has sufficient liquidity and capital resources available for the acquisition of additional investments when considered appropriate, repayments on borrowings and the payment of cash dividends as required for Capstead's continued qualification as a REIT. It is the Company's policy to remain strongly capitalized and conservatively leveraged.

In response to the financial market turmoil experienced in 2007 and 2008, Capstead expanded the number of lending counterparties it routinely does business with in order to support larger holdings of residential mortgage investments and to increase its financial flexibility and ability to withstand periods of contracting market liquidity. As of June 30, 2012, the Company had uncommitted repurchase facilities with a variety of lending counterparties to finance its portfolio, subject to certain conditions, and had borrowings outstanding with 23 of these counterparties. Interest rates on borrowings under repurchase arrangements are generally based on prevailing rates at inception corresponding to the terms of the borrowings. All terms and conditions are negotiated on a transaction-by-transaction basis. None of the Company's counterparties are obligated to renew or otherwise enter into new repurchase transactions at the conclusion of existing repurchase transactions. Amounts available to be borrowed under these arrangements are dependent upon the willingness of lenders to participate in the financing of Agency Securities, lender collateral requirements and the lenders' determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates and liquidity conditions within the commercial banking and mortgage finance industries. Borrowings under repurchase arrangements increased to \$12.73 billion at June 30, 2012, primarily with original maturities of 30 to 120 days. Total borrowings under repurchase arrangements began the year at \$11.35 billion and averaged \$12.14 billion and \$11.85 billion during the quarter and six months ended June 30, 2012. Average borrowings during the quarter were lower than at quarter-end primarily due to portfolio growth and differences in the timing of portfolio acquisitions relative to portfolio runoff.

To help mitigate exposure to higher short-term interest rates, Capstead uses currently-paying and forward-starting, one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements that typically require interest payments for two-year terms. At June 30, 2012 currently-paying swap agreements entered into by the Company had notional amounts totaling \$3.70 billion with average remaining interest payment terms of 12 months and were designated as cash flow hedges for accounting purposes of a like amount of the Company's 30- to 90-day borrowings under repurchase arrangements. Additionally, at June 30, 2012 the Company held forward-starting swap agreements for this purpose with notional amounts totaling \$1.4 billion that begin two-year interest payment terms on various dates between July 2012 and March 2013. Relative to the floating rate terms of the Company's \$100 million in unsecured borrowings that begin in 2015 and 2016, during 2010 the Company entered into forward-starting swap agreements to effectively lock in fixed rates averaging 7.56% (compared to current fixed rates of 8.49%) for the final 20 years of these borrowings that mature in 2035 and 2036. The Company intends to continue to manage interest rate risk by utilizing suitable derivative financial instruments such as interest rate swap agreements.

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During the second quarter of 2012 Capstead raised \$62 million in new common equity capital after expenses through its at-the-market, continuous offering program (\$121 million year-to-date). As of quarter-end, 7.9 million common shares were available for issuance under this program pursuant to a prospectus supplement filed with the applicable registration statement on file with the SEC. The Company may raise additional investment capital in future periods while maintaining a disciplined approach to augmenting its capital base, focusing on transactions that are accretive to existing common stockholders and providing the proceeds can be deployed at attractive levels. Rules promulgated under the Securities Act of 1933, as amended, permit these securities to be offered and sold only if not more than three years have elapsed since the initial effective date of the related registration statement. The Company's prior registration statement became effective on February 12, 2009. Consequently, shares issued after February 12, 2012 and prior to the effectiveness of a new registration statement on February 21, 2012 were not in full compliance with SEC rules. If these shares were held to be issued without registration in violation of the Securities Act, the Company could potentially be required to repurchase some or all of these shares, at the original purchase price (less than \$9 million, in aggregate), plus statutory interest and less dividends paid on the shares, subject to the statutory limitations period. Any such repurchase obligation would not be material to the Company's liquidity, earnings or financial condition.

**Interest Rate Sensitivity on Operating Results**

Capstead performs income sensitivity analyses using an income simulation model to estimate the effects that specific interest rate changes can reasonably be expected to have on future earnings. All investments, borrowings and derivative financial instruments held are included in these analyses. The sensitivity of components of other revenue (expense) to changes in interest rates is included as well, although no asset sales are assumed. The model incorporates management's assumptions regarding the level of mortgage prepayments for a given interest rate change using market-based estimates of prepayment speeds for the purpose of amortizing investment premiums. These assumptions are developed through a combination of historical analysis and expectations for future pricing behavior under normal market conditions unaffected by changes in market liquidity. Income simulation modeling is the primary tool used by management to assess the direction and magnitude of changes in earnings resulting solely from changes in interest rates. Key assumptions in the model include mortgage prepayment rates, adequate levels of market liquidity, changes in market conditions, portfolio leverage levels, and management's investment capital plans. These assumptions are inherently uncertain and, as a result, the model cannot precisely estimate the impact of higher or lower interest rates on earnings. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and other changes in market conditions, management strategies and other factors. Capstead had the following estimated income sensitivity profile at June 30, 2012 and December 31, 2011, respectively (dollars in thousands):

|                                   | <i>Federal</i> | <i>10-year U.S.</i> | <i>Immediate Change In Indicated Rates:*</i> |             |             |             |              |
|-----------------------------------|----------------|---------------------|--|-------------|-------------|-------------|--------------|
|                                   | <i>Funds</i>   | <i>Treasury</i>     | Up   | Up          | Up          | Up          |              |
|                                   | <i>Rate</i>    | <i>Rate</i>         |  |             |             |             |              |
| 30-day to one-year rates          |                | Flat                | 1.00%  | 1.00%       | 2.00%       | 3.00%       |              |
|                                   |                | Down                |  | Up          | Up          | Up          |              |
| 10-year U.S. Treasury rate        |                | 1.00%               | Flat   | 1.00%       | 2.00%       | 3.00%       |              |
| Projected 12-month income change: |                |                     |  |             |             |             |              |
| June 30, 2012 **                  | <0.25%         | 1.65%               | \$ (10,000)                                  | \$ (40,400) | \$ (31,500) | \$ (72,200) | \$ (134,600) |
| December 31, 2011                 | <0.25          | 1.88                | (8,600)                                      | (27,100)    | (23,200)    | (54,700)    | (105,800)    |

\* Sensitivity of income to changes in interest rates is determined relative to the actual rates at the applicable date. Note that the projected 12-month income change is predicated on acquisitions of similar assets sufficient to replace runoff. There can be no assurance that suitable investments will be available for purchase at attractive prices or if investments made will behave in the same fashion as assets currently held.

\*\* The greater sensitivity to earnings at June 30, 2012 compared to December 31, 2011 reflects increased holdings of longer duration longer-to-reset ARM securities.

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**Table of Contents****RISK FACTORS**

*An investment in securities issued by Capstead involves various risks. An investor should carefully consider the following risk factors in conjunction with the other information contained in this document before purchasing the Company's securities. The risks discussed herein can adversely affect the Company's business, liquidity, operating results, financial condition and future prospects, causing the market price of the Company's securities to decline, which could cause an investor to lose all or part of his/her investment. The risk factors described below are not the only risks that may affect the Company. Additional risks and uncertainties not presently known to the Company also may adversely affect its business, liquidity, operating results, prospects and financial condition.*

***Risks Related to Capstead's Business***

*Potential changes in the relationship between the federal government and the GSEs could negatively affect Capstead's liquidity, financial condition and earnings. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest on these securities are guaranteed by the GSEs, or by an agency of the federal government, Ginnie Mae. Only the guarantee by Ginnie Mae is explicitly backed by the full faith and credit of the federal government. The high actual or perceived credit quality of Agency Securities allows the Company to finance its portfolio using repurchase arrangements with relatively low interest rate terms and margin requirements that otherwise would not be available. As a result of deteriorating housing market conditions that began in 2007, the GSEs have incurred substantial losses due to high levels of mortgagor defaults, which are ongoing. In 2008 the Federal Housing Finance Agency placed the GSEs into conservatorship, allowing it to operate the GSEs without forcing them to liquidate. Additionally, the federal government, through the U.S. Treasury and the Federal Reserve, undertook other actions to provide financial support to these entities and the housing market including committing to ensure the GSEs maintain a positive net worth through 2012 through the purchase of preferred stock, the acquisition by early 2010 of \$1.25 trillion in Agency Securities and the subsequent reinvestment of related runoff into additional holdings of Agency Securities. These and other steps taken by the federal government were designed to support market stability and mortgage availability at favorable rates by providing additional confidence to investors in Agency Securities. There can be no assurance that the federal government's support for the GSEs and the market for Agency Securities will continue to be adequate to achieve these goals.*

It is anticipated that over the next several years U.S. policy makers will address what the long-term role of the federal government in general, and the GSEs in particular, will play in the housing markets. The actual or perceived credit quality of Agency Securities could be negatively affected by market uncertainty over any legislative or regulatory initiatives that impact the relationship between the GSEs and the federal government. A significantly reduced role by the federal government or other changes in the guarantees provided by Ginnie Mae, the GSEs or their successors could negatively affect the credit profile and pricing of existing holdings and/or future issuances of Agency Securities and whether the Company's strategy of holding a leveraged portfolio of Agency Securities remains viable, which could negatively affect earnings and book value per common share. In addition, the timing of any sales of Agency Securities held by the Federal Reserve or the GSEs could negatively affect pricing of these investments and limit the availability and/or terms and conditions of borrowings under repurchase arrangements which could negatively affect the Company's liquidity, earnings and book value per common share, as more fully described below.

*Failure of the federal government to reduce future federal budget deficits could negatively impact Capstead's liquidity, financial condition and earnings. Federal budget deficit concerns have increased the possibility of a decrease in the market's perception of the creditworthiness of debt securities issued by or guaranteed by the federal government and of further credit rating agency actions to downgrade the federal government's credit rating. Because the GSEs are relying on federal government support, the perception of credit risk associated with Agency Securities and, therefore, the pricing of existing holdings*

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of Agency Securities could be negatively affected. In addition, these circumstances could create broader financial turmoil and uncertainty, which may weigh heavily on the global banking system and limit the availability and/or terms and conditions of borrowings under repurchase arrangements which could negatively impact the Company's liquidity, earnings and book value per common share, as more fully described below.

*Legislative and regulatory actions could negatively affect the availability and/or terms and conditions of borrowings under repurchase arrangements and consequently, the Company's liquidity, financial condition and earnings.* In July 2010 the U.S. Congress enacted the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd Frank) in order to restrict certain business practices of systemically significant participants in the financial markets, which include most of the Company's lending counterparties. Additionally, changes in regulatory capital requirements are being implemented worldwide. It remains unclear how significant of an impact Dodd Frank and changes in regulatory capital requirements will have on the financial markets in general and on the Company's strategy of holding an appropriately hedged, leveraged portfolio of Agency Securities. However, it is possible that the availability and/or terms and conditions of borrowings under repurchase arrangements and related derivative financial instruments held for hedging purposes could be negatively affected which could negatively affect the Company's liquidity, earnings and book value per common share, as more fully described below.

*Government-supported mortgagor relief programs could negatively affect Capstead's liquidity, financial condition and earnings.* U.S. policy makers have established programs designed to provide qualified homeowners with assistance in avoiding foreclosure or in qualifying for the refinancing of their existing mortgages, which typically entails the pay off of existing mortgages with any losses absorbed by the GSEs. One of these programs, the Home Affordable Refinance Program (HARP), has been revised with the intent of increasing its availability to homeowners who are current on their mortgage payments but whose homes have lost significant value making it difficult to qualify for a new mortgage. A significant expansion of these mortgagor relief programs, as well as any future legislative or regulatory actions, could significantly reduce the expected life of the Company's residential mortgage investments; therefore, actual yields the Company realizes on these investments could be lower due to faster amortization of investment premiums which could negatively affect earnings. A significant expansion of these programs also could negatively affect book value per common share because of the elimination of any unrealized gains on that portion of the portfolio that prepays. Additionally, heightened prepayment exposure due to the real or perceived potential for government intervention could negatively affect pricing for Agency Securities and, as a result, liquidity and book value per common share could be adversely affected due to declines in the fair value of the Company's remaining portfolio.

*An increase in prepayments may negatively affect Capstead's liquidity, financial condition and earnings.* When short- and long-term interest rates are at nearly the same levels (i.e., a flat yield curve environment), or when long-term interest rates decrease, the rate of principal prepayments on mortgage loans underlying mortgage securities generally increases. Prolonged periods of high mortgage prepayments can significantly reduce the expected life of the Company's investments; therefore, actual yields the Company realizes can be lower due to faster amortization of investment premiums, which could negatively affect earnings. High levels of mortgage prepayments can lead to larger than anticipated demands on the Company's liquidity from its lending counterparties, as more fully described below. Additionally, periods of high prepayments can negatively affect pricing for Agency Securities and, as a result, book value per common share can be negatively affected due to declines in the fair value of the Company's remaining portfolio and the elimination of any unrealized gains on that portion of the portfolio that prepays.

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*Changes in interest rates, whether increases or decreases, may adversely affect Capstead's liquidity, financial condition and earnings.* Capstead's earnings depend primarily on the difference between the interest received on its residential mortgage investments and the interest paid on its related borrowings, net of the effect of derivatives held for hedging purposes. The Company typically finances its investments at 30- to 90-day interest rates. Coupon interest rates on only a portion of the ARM loans underlying the Company's securities reset each month and the terms of these ARM loans generally limit the amount of any increases during any single interest rate adjustment period and over the life of a loan. Consequently, interest rates on related borrowings not hedged through the use of interest rate swap agreements can rise to levels that may exceed yields on these securities in a rising short-term interest rate environment. This can contribute to lower, or in more extreme circumstances, negative financing spreads and negatively affect earnings. Because rising interest rates tend to put downward pressure on financial asset prices, Capstead may be presented with substantial margin calls during such periods negatively affecting the Company's liquidity. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of mortgage securities will lead to declines in book value per common share.

During periods of relatively low short-term interest rates, declines in the indices used to determine coupon interest rate resets for ARM loans may negatively affect yields on the Company's ARM securities as the underlying ARM loans reset at lower rates. If declines in these indices exceed declines in the Company's borrowing rates, earnings would be negatively affected.

*Periods of illiquidity in the mortgage markets may reduce amounts available to be borrowed under Capstead's repurchase arrangements due to declines in the perceived value of related collateral, which could negatively impact the Company's liquidity, financial condition and earnings.* Capstead generally finances its investments in mortgage securities by pledging them as collateral under uncommitted repurchase arrangements, the terms and conditions of which are negotiated on a transaction-by-transaction basis. The amount borrowed under a repurchase arrangement is limited to a percentage of the estimated market value of the pledged collateral and is specified at the inception of the transaction. The portion of the pledged collateral held by the lender that is not advanced under the repurchase arrangement is referred to as margin collateral and the resulting margin percentage is required to be maintained throughout the term of the borrowing. If the perceived market value of the pledged collateral as determined by the Company's lenders declines, the Company may be subject to margin calls wherein the lender requires the Company to pledge additional collateral to reestablish the agreed-upon margin percentage. Because market illiquidity tends to put downward pressure on asset prices, Capstead may be presented with substantial margin calls during such periods. If the Company is unable or unwilling to pledge additional collateral, the Company's lenders can liquidate the Company's collateral, potentially under adverse market conditions, resulting in losses. At such times the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses. In addition, lower pricing levels for remaining holdings of mortgage securities will lead to declines in book value per common share.

*Periods of illiquidity in the mortgage markets may reduce the number of counterparties willing to lend to the Company and/or the amounts individual counterparties are willing to lend via repurchase arrangements, which could negatively affect the Company's liquidity, financial condition and earnings.* For instance, a contraction in market liquidity is possible should Europe's sovereign debt problems deteriorate in a disorderly fashion, putting further financial pressures on large European and even domestic commercial banks, many of which are lending counterparties. Capstead enters into repurchase arrangements with numerous commercial banks and other financial institutions, both foreign and domestic, routinely with maturities of 30 to 90 days. The Company's ability to achieve its investment

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objectives depends on its ability to re-establish or roll maturing borrowings on a continuous basis and none of the Company's counterparties are obligated to enter into new repurchase transactions at the conclusion of existing transactions. If a counterparty chooses not to roll a maturing borrowing, the Company must pay off the borrowing, generally with cash available from another repurchase arrangement entered into with another counterparty. If the Company determines that it does not have sufficient borrowing capacity with its remaining counterparties, it could be forced to reduce its portfolio leverage by selling assets under potentially adverse market conditions, resulting in losses. This risk is increased if Capstead relies significantly on any single counterparty for a significant portion of its repurchase arrangements. An industry-wide reduction in the availability of borrowings under repurchase arrangements could negatively affect pricing levels for mortgage securities leading to further declines in the Company's liquidity and book value per common share. Under these conditions, the Company may determine that it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

*If Capstead is unable to negotiate favorable terms and conditions on future repurchase arrangements with one or more of the Company's lending counterparties, the Company's liquidity, financial condition and earnings could be negatively impacted.* The terms and conditions of each repurchase arrangement are negotiated on a transaction-by-transaction basis, and these borrowings generally are re-established, or rolled, at maturity. Key terms and conditions of each transaction include interest rates, maturity dates, asset pricing procedures and margin requirements. The Company cannot assure investors that it will be able to continue to negotiate favorable terms and conditions on its future repurchase arrangements. For instance, during periods of market illiquidity or due to perceived credit deterioration of the collateral pledged or the Company itself, a lender may require that less favorable asset pricing procedures be employed, margin requirements be increased and/or may choose to limit or completely curtail lending to the Company. Under these conditions, the Company may determine it is prudent to sell assets to improve its ability to pledge sufficient collateral to support its remaining borrowings, which could result in losses.

*Capstead's use of repurchase arrangements to finance its investments may expose the Company to losses if a lending counterparty seeks bankruptcy protection, or otherwise defaults on its obligation to deliver pledged collateral back to the Company.* Repurchase arrangements involve the sale and transfer of pledged collateral to the lending counterparty and a simultaneous agreement to repurchase the transferred assets at a future date. This may make it difficult for the Company to recover its pledged assets if a lender files for bankruptcy or otherwise fails to deliver pledged collateral back to the Company and subject the Company to losses to the extent of any margin amounts (pledged assets in excess of amounts borrowed) held by the lending counterparty.

*Capstead's use of repurchase arrangements to finance its investments may give the Company's lending counterparties greater rights if the Company seeks bankruptcy protection, exposing the Company to losses.* Borrowings made under repurchase arrangements may qualify for special treatment under the U.S. Bankruptcy Code. If the Company files for bankruptcy, its lending counterparties could avoid the automatic stay provisions of the U.S. Bankruptcy Code and liquidate pledged collateral without delay, which could result in losses.

*Capstead may sell assets for various reasons, including a change in the Company's investment focus, which could increase earnings volatility.* Capstead may periodically sell assets to enhance its liquidity during periods of market illiquidity or rising interest rates or the Company may change its investment focus requiring it to sell some portion of its existing investments. Gains or losses resulting from any such asset sales, or from terminating any related longer-dated repurchase arrangements or interest rate swap agreements, will likely increase the Company's earnings volatility.



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*Capstead may invest in derivative financial instruments such as interest rate swap agreements to mitigate or hedge the Company's interest rate risk, which may negatively affect the Company's liquidity, financial condition or earnings.* The Company may invest in such instruments from time to time with the goal of achieving more stable borrowing costs over an extended period. However, these activities may not have the desired beneficial impact on the Company's liquidity, financial condition or earnings. For instance, the pricing of residential mortgage investments and the pricing of related derivatives may deteriorate at the same time leading to margin calls by counterparties to both the borrowings supporting these investments and the derivatives, negatively impacting the Company's liquidity and financial condition. In addition, counterparties could fail to honor their commitments under the terms of the derivatives or have their credit quality downgraded impairing the value of the derivatives. In the event of any defaults by counterparties, the Company may have difficulty recovering its cash collateral receivable from its counterparties and may not receive payments provided for under the terms of the derivatives and as a result, the Company may incur losses. No such hedging activity can completely insulate the Company from the risks associated with changes in interest rates and prepayment rates.

*Derivative financial instruments held may fail to qualify for hedge accounting introducing potential volatility to Capstead's earnings.* The Company typically qualifies derivative financial instruments held as cash flow hedges for accounting purposes in order to record the effective portion of the change in fair value of derivatives as a component of stockholders' equity rather than in earnings. If the hedging relationship for any derivative held ceases to qualify for hedge accounting treatment for any reason, including failing to meet documentation and ongoing hedge effectiveness requirements, the Company would be required to record in earnings the total change in fair value of any such derivative. In addition the Company could elect to no longer avail itself of cash flow hedge accounting for its derivative positions. Such changes could introduce a potentially significant amount of volatility to earnings reported by the Company.

*The lack of availability of suitable investments at attractive pricing may adversely affect Capstead's earnings.* Pricing of investments is determined by a number of factors including interest rate levels and expectations, market liquidity conditions, and competition among investors for these investments, many of whom have greater financial resources and lower return requirements than Capstead. Additionally, in recent years the federal government, primarily through the Federal Reserve, has been an active buyer of Agency Securities which has had the effect of supporting, if not increasing, pricing for these securities. To the extent the proceeds from prepayments on Capstead's mortgage investments are not reinvested or cannot be reinvested at rates of return at least equal to the rates previously earned on those investments, the Company's earnings may be adversely affected. Similarly, if proceeds from capital raising activities are not deployed or cannot be deployed at rates of return being earned on existing capital, earnings may be adversely affected. Capstead cannot assure investors that the Company will be able to acquire suitable investments at attractive pricing and in a timely manner to replace portfolio runoff as it occurs or to deploy new capital as it is raised. Neither can the Company assure investors that it will maintain the current composition of its investments, consisting primarily of ARM Agency Securities.

*Capstead is dependent on its executives and employees and the loss of one or more of its executive officers could harm the Company's business and its prospects.* As a self-managed REIT with 15 employees, Capstead is dependent on the efforts of its key officers and employees, most of whom have significant experience in the mortgage industry. Although the Company's named executive officers and some of its other employees are parties to severance agreements, the Company's key officers and employees are not subject to employment agreements with non-compete clauses, nor has Capstead acquired key man life insurance policies on any of these individuals. The loss of any of their services could have an adverse effect on the Company's operations.

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***Risks Related to Capstead's Status as a REIT and Other Tax Matters***

*If Capstead does not qualify as a REIT, the Company will be subject to tax as a regular corporation and face substantial tax liability.* Capstead has elected to be taxed as a REIT for federal income tax purposes and intends to continue to so qualify. Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could jeopardize the Company's REIT status. Furthermore, new tax legislation, administrative guidance or court decisions, in each instance potentially with retroactive effect, could make it more difficult or impossible for the Company to qualify as a REIT.

If Capstead fails to qualify as a REIT in any tax year, then:

the Company would be taxed as a regular domestic corporation, which, among other things, means that the Company would be unable to deduct dividends paid to its stockholders in computing taxable income and would be subject to federal income tax on its taxable income at regular corporate rates;

any resulting tax liability could be substantial and would reduce the cash available for distribution to stockholders, and the Company would not be required to make income distributions; and

unless Capstead were entitled to relief under applicable statutory provisions, the Company would be disqualified from treatment as a REIT for the subsequent four taxable years and, as a result, the Company's cash available for distribution to stockholders would be reduced during these years.

*Even if Capstead remains qualified as a REIT, the Company may face other tax liabilities that reduce its earnings.* Even if Capstead remains qualified for taxation as a REIT, the Company may be subject to certain federal, state and local taxes on its income and assets. For example, the Company:

will be required to pay tax on any undistributed REIT taxable income,

may be subject to the alternative minimum tax on any tax preference items, and

may operate taxable REIT subsidiaries subject to tax on any taxable income earned.

*Complying with REIT requirements may limit Capstead's ability to hedge effectively.* The REIT provisions of the Code may limit Capstead's ability to hedge mortgage securities and related borrowings by requiring it to limit its income in each year from unqualified hedges together with any other income not generated from qualified real estate assets, to no more than 25% of gross income. In addition, the Company must limit its aggregate income from nonqualified hedging transactions, from providing certain services, and from other non-qualifying sources to not more than 5% of annual gross income. As a result, the Company may have to limit its use of advantageous hedging techniques. This could result in greater risks associated with changes in interest rates than the Company would otherwise incur. If the Company were to violate the 25% or 5% limitations, it may have to pay a penalty tax equal to the amount of gross income in excess of those limitations, multiplied by a fraction intended to reflect the profitability of these transactions or activities. If the Company fails to satisfy the REIT gross income tests it could lose its REIT status for federal income tax purposes unless the failure was due to reasonable cause and not due to willful neglect.

*Complying with REIT requirements may cause Capstead to forego otherwise attractive opportunities.* To qualify as a REIT for federal income tax purposes, Capstead must continually satisfy tests concerning, among other things, the sources of its income, the nature and diversification of its assets, the amounts that it distributes to its stockholders, and the ownership of its stock. The Company may be required to make



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distributions to stockholders at disadvantageous times or when it does not have funds readily available for distribution. As a result, compliance with the REIT requirements may hinder the Company's ability to operate solely on the basis of maximizing profits.

*Complying with REIT requirements may force Capstead to liquidate otherwise attractive investments.* To qualify as a REIT, Capstead must also ensure that at the end of each calendar quarter at least 75% of the value of its assets consists of cash, cash items, United States government securities and qualified REIT real estate assets. The remainder of the Company's investments in securities (other than government securities and qualified real estate assets) generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of the Company's assets (other than government securities and qualified real estate assets) can consist of the securities of any one issuer, and no more than 25% of the value of its total securities can be represented by securities of one or more taxable REIT subsidiaries. If the Company fails to comply with these requirements at the end of any calendar quarter, it must correct such failure within 30 days after the end of the calendar quarter to avoid losing its REIT status and suffering adverse tax consequences. As a result, the Company may be required to liquidate otherwise attractive investments.

*Complying with REIT requirements may force Capstead to borrow to make distributions to stockholders.* As a REIT, Capstead must distribute at least 90% of its annual taxable income (subject to certain adjustments) to its stockholders. To the extent that the Company satisfies the distribution requirement, but distributes less than 100% of its taxable income, the Company will be subject to federal corporate income tax on its undistributed taxable income. In addition, the Company will be subject to a 4% nondeductible excise tax if the actual amount that it pays out to its stockholders in a calendar year is less than a minimum amount specified under the federal tax laws. From time to time, the Company may generate taxable income greater than its net income for financial reporting purposes or its taxable income may be greater than the Company's cash flow available for distribution to stockholders. If the Company does not have other funds available in these situations, it could be required to borrow funds, sell investments at disadvantageous prices or find another alternative source of funds to make distributions sufficient to enable it to pay out enough of its taxable income to satisfy the distribution requirement and to avoid corporate income tax or the 4% excise tax in a particular year. These alternatives could increase the Company's costs and reduce its long-term investment capital.

*Capstead may be subject to adverse legislative or regulatory tax changes that could reduce the market price of the Company's securities.* Federal income tax laws governing REITs or the administrative interpretations of those laws may change at any time. Any such changes in laws or interpretations thereof may apply retroactively and could adversely affect Capstead or its stockholders. Capstead cannot predict any impact on the value of its securities from adverse legislative or regulatory tax changes.

*An investment in Capstead's securities has various federal, state and local income tax risks that could affect the value of an investor's investment.* The Company strongly urges investors to consult their own tax advisor concerning the effects of federal, state and local income tax law on an investment in the Company's securities, because of the complex nature of the tax rules applicable to REITs and their stockholders.

***Risk Factors Related to Capstead's Corporate Structure***

*There are no assurances of Capstead's ability to pay dividends in the future.* Capstead intends to continue paying quarterly dividends and to make distributions to its stockholders in amounts such that all or substantially all of the Company's taxable income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable the Company to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. However, the Company's ability to pay dividends

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may be adversely affected by the risk factors described in this filing. All distributions will be made at the discretion of the Company's board of directors and will depend upon the Company's earnings, its financial condition, maintenance of its REIT status and such other factors as the board may deem relevant from time to time. There are no assurances of the Company's ability to pay dividends in the future.

*Failure to maintain an exemption from the Investment Company Act of 1940 would adversely affect Capstead's results of operations.* The Investment Company Act of 1940 (the "40 Act") exempts from regulation as an investment company any entity that is primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on, and interests in, real estate. Capstead believes that it conducts its business in a manner that allows the Company to avoid registration as an investment company under the 40 Act. For over 30 years, the staff of the SEC has interpreted the provisions of the 40 Act to require, among other things, a REIT to maintain at least 55% of its assets directly in qualifying real estate interests and at least 80% of its assets in real estate-related assets in order to be exempt from regulation as an investment company. Critical to Capstead's exemption from regulation as an investment company is the long-standing SEC staff interpretation that so-called whole loan mortgage securities, in which an investor holds all issued certificates with respect to an underlying pool of mortgage loans, constitutes a qualifying real estate interest for purposes of the staff's 55% qualifying real estate interest requirement. Conversely, so-called partial pool mortgage securities presently do not qualify for purposes of meeting the 55% requirement, although they are considered by the staff to be real estate-related assets for purposes of meeting the staff's 80% real estate-related asset requirement.

In August 2011, the SEC staff issued a request for information (Concept Release No. IC-29778) from industry participants and investors regarding, among other things, its past interpretations of the 40 Act real estate exemption, including the interpretations described above, raising concerns that the SEC may issue a proposal for rulemaking that could overturn some of the staff's past interpretations regarding the real estate exemption. If the SEC or its staff adopts contrary interpretations of the 40 Act and the Company becomes subject to regulation as an investment company, the Company would be unable to conduct business as described in this filing because its ability to use leverage would be substantially reduced. Absent a restructuring of the Company's business operations to avoid such regulation, this could require the sale of most of the Company's portfolio of Agency Securities under potentially adverse market conditions resulting in losses.

*Pursuant to Capstead's charter, its board of directors has the ability to limit ownership of the Company's capital stock, to the extent necessary to preserve its REIT qualification.* For the purpose of preserving Capstead's REIT qualification, the Company's charter gives the board the ability to repurchase outstanding shares of capital stock from existing stockholders if the directors determine in good faith that the concentration of ownership by such individuals, directly or indirectly, would cause the Company to fail to qualify or be disqualified as a REIT. Constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of outstanding stock by an individual or entity could cause that individual or entity to own constructively a greater concentration of the Company's outstanding stock than is acceptable for REIT purposes, thereby giving the board the ability to repurchase any excess shares.

*Because provisions contained in Maryland law and Capstead's charter may have an anti-takeover effect, investors may be prevented from receiving a control premium for their shares.* Provisions contained in Capstead's charter and Maryland general corporation law can delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a control premium for their shares. For example, these provisions may defer or prevent tender offers for the Company's common stock or purchases of large blocks of the Company's common stock, thereby limiting the opportunities for its stockholders to receive a premium over then-prevailing market prices. These provisions include the following:

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*Repurchase rights:* Repurchase rights granted to Capstead's board in its charter limit related investors, including, among other things, any voting group, from owning common stock if the concentration owned would jeopardize the Company's REIT status.

*Classification of preferred stock:* Capstead's charter authorizes the board to issue preferred stock and establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval and could have the effect of delaying or preventing someone from taking control of the Company.

*Statutory provisions:* Capstead is subject to provisions of Maryland statutory law that restrict business combinations with interested stockholders and restrict voting rights of certain shares acquired in control share acquisitions. The board has not taken any action to exempt the Company from these provisions.

Maryland statutory law provides that an act of a director relating to or affecting an acquisition or a potential acquisition of control of a corporation may not be subject to a higher duty or greater scrutiny than is applied to any other act of a director. Hence, directors of Maryland corporations may not be required to act in takeover situations under the same standards as apply in Delaware and certain other corporate jurisdictions.

*There are risks associated with ownership of Capstead's Series A and B Preferred Stock.* Risks associated with ownership of the Company's preferred shares include:

*Redemption rights:* The Company's preferred shares are redeemable by the Company, in whole or in part, at any time at cash redemption prices (\$16.40 and \$12.50 per share, respectively, for the Series A and B preferred shares) plus all accrued and unpaid dividends to the date of redemption, which may be less than prevailing market prices for these securities.

*Limited conversion rights:* Holders of the Company's existing preferred shares may convert into common shares at any time; however, it may not be economically advantageous to do so given existing conversion ratios and current trading levels of the Company's common shares.

*Subordination:* The Company's preferred shares are subordinate to all of the Company's existing and future debt. None of the provisions relating to existing preferred shares limit the Company's ability to incur future debt. Future debt may include restrictions on the Company's ability to pay dividends on, redeem, or pay the liquidation preference on, existing preferred shares.

*Dilution through issuance of additional preferred shares:* The Company's charter currently authorizes the issuance of up to 100 million shares of preferred stock in one or more series. The issuance of additional preferred stock on parity with or senior to existing preferred shares would dilute the interests of the existing preferred stockholders, and could affect the Company's ability to pay dividends on, redeem, or pay the liquidation preference on, existing preferred shares. None of the provisions relating to existing preferred shares limit the Company's ability to issue additional preferred stock on parity with existing preferred shares.

*Limited voting rights:* Voting rights as a holder of existing preferred shares are limited. The Company's common stock is currently the only class of stock carrying full voting rights. Voting rights for holders of existing preferred shares exist primarily with respect to (i) adverse changes in the terms of existing preferred shares, (ii) the creation of additional classes or series of preferred

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stock that are senior to existing preferred shares, (iii) any failure to pay dividends on existing preferred shares, and (iv) for the Series B Preferred Stock only and provided at least 5.9 million of these preferred shares remain outstanding, the sale of all or substantially all of the Company's assets, or the Company's participation in any merger or consolidation.

*Capstead may change its policies without stockholder approval.* Capstead's board and management determine all of its policies, including its investment, financing and distribution policies and may amend or revise these policies at any time without a vote of the Company's stockholders. Policy changes could adversely affect the Company's financial condition, results of operations, the market price of its common and preferred stock or the Company's ability to pay dividends or distributions.

**CRITICAL ACCOUNTING POLICIES**

Management's discussion and analysis of financial condition and results of operations is based upon Capstead's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the use of estimates and judgments that can affect the reported amounts of assets, liabilities (including contingencies), revenues and expenses, as well as related disclosures. These estimates are based on available internal and market information and appropriate valuation methodologies believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the expected useful lives and carrying values of assets and liabilities which can materially affect the determination of net income and book value per common share. Actual results may differ from these estimates under different assumptions or conditions.

Management believes the following are critical accounting policies in the preparation of Capstead's consolidated financial statements that involve the use of estimates requiring considerable judgment:

*Amortization of investment premiums on financial assets* Investment premiums on financial assets are recognized in earnings as adjustments to interest income by the interest method over the estimated lives of the related assets. For most of Capstead's residential mortgage investments, estimates and judgments related to future levels of mortgage prepayments are critical to this determination. Mortgage prepayment expectations can change based on how current and projected changes in interest rates impact the economic attractiveness of mortgage refinance opportunities, if available, and other factors such as portfolio composition. In recent years, the ability of mortgagors to refinance has also been impacted by more stringent loan underwriting practices and lending industry capacity restraints, low housing prices and credit problems being experienced by many of these borrowers. Management estimates mortgage prepayments based on past experiences with specific investments within the portfolio in addition to the factors mentioned above. Should actual prepayment rates differ materially from these estimates, investment premiums would be expensed at a different pace.

*Fair value and impairment accounting for financial assets* Most of Capstead's investments are financial assets held in the form of mortgage securities that are classified as available-for-sale and recorded at fair value on the balance sheet with unrealized gains and losses recorded in Stockholders' equity as a component of Accumulated other comprehensive income. As such, these unrealized gains and losses enter into the calculation of book value per common share, a key financial metric used by investors in evaluating the Company. Fair values fluctuate with current and projected changes in interest rates, prepayment expectations and other factors such as market liquidity conditions. Considerable judgment is required to interpret market data and develop estimated fair values, particularly in circumstances of deteriorating credit quality and market liquidity. See NOTE 8 to the consolidated financial statements (included under ITEM 1 of this report) for discussion of how Capstead values its financial assets. Generally, gains or losses are

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recognized in earnings only if sold; however, if a decline in fair value of a mortgage security below its amortized cost occurs that is determined to be other-than-temporary, the difference between amortized cost and fair value would be recognized in earnings as a component of Other revenue (expense) if the decline was credit-related or it was determined to be more likely than not that the Company will incur a loss via an asset sale. Other-than-temporary impairment of a mortgage security due to other factors would be recognized in Accumulated other comprehensive income and amortized to earnings as a yield adjustment.

*Accounting for derivative financial instruments* The Company uses derivatives for risk management purposes. Derivatives are recorded as assets or liabilities and carried at fair value and consequently, changes in value of these instruments enter into the calculation of book value per common share. Fair values fluctuate with current and projected changes in interest rates and other factors such as the Company's and its counterparties' nonperformance risk. Judgment is required to develop estimated fair values. The accounting for changes in fair value of each derivative held depends on whether it has been designated as an accounting hedge, as well as the type of hedging relationship identified. To qualify as cash flow hedges for accounting purposes, at the inception of the hedge relationship the Company must anticipate and document that the hedge relationship will be highly effective and must monitor ongoing effectiveness on at least a quarterly basis. As long as the hedge relationship remains effective, the effective portion of changes in fair value of the derivative are recorded in *Accumulated other comprehensive income* and the ineffective portion is recorded in earnings as a component of *Interest expense*. Changes in fair value of derivatives not held as accounting hedges, or for which the hedge relationship is deemed to no longer be highly effective and as a result hedge accounting is terminated, are recorded in earnings as a component of *Other revenue (expense)*.

The Company currently uses interest rate swap agreements in hedge relationships accounted for as cash flow hedges in order to hedge variability in borrowing rates due to changes in the underlying benchmark interest rate related to a designated portion of its current and anticipated future 30- and 90-day borrowings and the 20-year floating-rate periods of the Company's long-term unsecured borrowings. Variable-rate payments to be received on the swap agreements and any measured hedge ineffectiveness are recorded in interest expense as an offset to interest owed on the hedged borrowings that reset to market rates generally on a monthly basis while fixed rate swap payments to be made are also recorded in interest expense resulting in an effectively fixed borrowing rate on these borrowings, subject to certain adjustments. See NOTE 6 to the consolidated financial statements (included under ITEM 1 of this report) and Financial Condition Residential Mortgage Investments for additional information regarding the Company's current use of derivatives and its related risk management policies.



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**CAUTIONARY STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS**

This document contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements include, without limitation, any statement that may predict, forecast, indicate or imply future results, performance or achievements, and may contain the words believe, anticipate, expect, estimate, intend, will be, will likely continue, will likely result, phrases of similar meaning. Forward-looking statements are based largely on the expectations of management and are subject to a number of risks and uncertainties including, but not limited to, the following:

changes in general economic conditions;

fluctuations in interest rates and levels of mortgage prepayments;

the effectiveness of risk management strategies;

the impact of differing levels of leverage employed;

liquidity of secondary markets and credit markets;

the availability of financing at reasonable levels and terms to support investing on a leveraged basis;

the availability of new investment capital;

the availability of suitable qualifying investments from both an investment return and regulatory perspective;

changes in legislation or regulation affecting exemptions for mortgage REITs from regulation under the Investment Company Act of 1940;

changes in legislation or regulation affecting the GSEs and similar federal government agencies and related guarantees;

deterioration in credit quality and ratings of existing or future issuances of GSE or Ginnie Mae securities; and

increases in costs and other general competitive factors.

In addition to the above considerations, actual results and liquidity are affected by other risks and uncertainties which could cause actual results to be significantly different from those expressed or implied by any forward-looking statements included herein. It is not possible to identify all of the risks, uncertainties and other factors that may affect future results. In light of these risks and uncertainties, the forward-looking events and circumstances discussed herein may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. Forward-looking statements speak only as of the date the statement is made and the Company undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, readers of this document are cautioned not to place undue reliance on any forward-looking statements included herein.



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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURE OF MARKET RISKS**

The information required by this Item is incorporated by reference to the information included in Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

**ITEM 4. CONTROLS AND PROCEDURES**

As of June 30, 2012, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's management, including the CEO and CFO, concluded that the Company's disclosure controls and procedures were effective as of June 30, 2012. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to June 30, 2012.

**PART II. OTHER INFORMATION**

**ITEM 6. EXHIBITS**

| <b>Exhibit</b> |   |
|----------------|---|
| <b>Number</b>  | <b>DESCRIPTION</b>  |
| 3.1            | Charter, including Articles of Incorporation, Articles Supplementary for each series of preferred shares and all other amendments to such Articles of Incorporation. <sup>(1)</sup>                                 |
| 3.2            | Amended and Restated Bylaws. <sup>(2)</sup>   |
| 3.3            | Articles of Amendment of Articles of Incorporation dated as of May 29, 2008. <sup>(3)</sup>   |
| 4.1            | Junior Subordinated Indenture dated September 26, 2005, pertaining to the issuance of Capstead Mortgage Trust I preferred securities. <sup>(2)</sup>  |
| 4.2            | Amended and Restated Trust Agreement dated September 26, 2005, pertaining to the issuance of Capstead Mortgage Trust I preferred securities. <sup>(2)</sup>   |
| 4.3            | Indenture dated December 15, 2005, regarding junior subordinated debentures due 2035, including a form of debenture pertaining to the issuance of Capstead Mortgage Trust II preferred securities. <sup>(2)</sup>   |
| 4.4            | Amended and Restated Declaration of Trust dated December 15, 2005, including forms of capital security certificates pertaining to the issuance of Capstead Mortgage Trust II preferred securities. <sup>(2)</sup>   |
| 4.5            | Indenture dated September 11, 2006, regarding junior subordinated debentures due 2036, including a form of debenture pertaining to the issuance of Capstead Mortgage Trust III preferred securities. <sup>(2)</sup> |
| 4.6            | Amended and Restated Declaration of Trust dated September 11, 2006, including forms of capital security certificates pertaining to the issuance of Capstead Mortgage Trust III preferred securities. <sup>(2)</sup> |
| 10.01          | Amended and Restated Deferred Compensation Plan. <sup>(2)</sup>   |
| 10.02          | Amended and Restated 2004 Flexible Long-Term Incentive Plan. <sup>(4)</sup>   |
| 10.03          | Second Amended and Restated Incentive Bonus Plan. <sup>(5)</sup>  |
| 10.04          | Form of nonqualified stock option and stock award agreements for non-employee directors. <sup>(2)</sup>   |
| 10.05          | Form of nonqualified stock option and stock award agreements for employees with service conditions. <sup>(2)</sup>  |
| 10.06          | Form of stock award agreements for employees with performance conditions. <sup>(6)</sup>  |
| 10.07          | Form of stock award agreements for employees with performance conditions and deferral of dividends. <sup>(7)</sup>  |

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|         |   |
|---------|---|
| 10.08   | Purchase Agreements dated September 23, 2005, pertaining to the issuance of Capstead Mortgage Trust I preferred securities. <sup>(2)</sup>  |
| 10.09   | Placement Agreement dated December 6, 2005, pertaining to the issuance of Capstead Mortgage Trust II preferred securities. <sup>(2)</sup>   |
| 10.10   | Placement Agreement dated September 8, 2006, pertaining to the issuance of Capstead Mortgage Trust III preferred securities. <sup>(2)</sup> |
| 12      | Computation of ratio of net income to fixed charges and ratio of net income to combined fixed charges and preferred stock dividends.*       |
| 31.1    | Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*   |
| 31.2    | Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002*   |
| 32      | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*  |
| 101.INS | XBRL Instance Document**  |
| 101.SCH | XBRL Taxonomy Extension Schema**  |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase**  |
| 101.DEF | XBRL Additional Taxonomy Extension Definition Linkbase**  |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase**  |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase**   |

(1) Incorporated by reference to the Registrant's Registration Statement on Form S-3 (No. 333-63358) dated June 19, 2001.

(2) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2011.

(3) Incorporated by reference to the Registrant's Current Report on Form 8-K dated May 30, 2008.

(4) Incorporated by reference to the Registrant's Registration Statement on Form S-8 (No. 333-142861) dated May 9, 2007.

(5) Incorporated by reference to the Registrant's Current Report on Form 8-K dated May 4, 2011.

(6) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2008.

(7) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended December 31, 2010.

\*Filed herewith

\*\*Furnished electronically herewith

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**CAPSTEAD MORTGAGE CORPORATION**  
**Registrant**

Date: August 3, 2012

By: /s/ ANDREW F. JACOBS  
Andrew F. Jacobs  
President and Chief Executive Officer

Date: August 3, 2012

By: /s/ PHILLIP A. REINSCH  
Phillip A. Reinsch  
Executive Vice President and  
Chief Financial Officer

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