

Edgar Filing: ANNALY CAPITAL MANAGEMENT INC - Form 10-Q

ANNALY CAPITAL MANAGEMENT INC  
Form 10-Q  
November 08, 2006

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: SEPTEMBER 30, 2006

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: 1-13447

ANNALY CAPITAL MANAGEMENT, INC.  
(Exact name of Registrant as specified in its Charter)

MARYLAND  
(State or other jurisdiction of  
incorporation or organization)

22-3479661  
(IRS Employer  
Identification No.)

1211 AVENUE OF THE AMERICAS, SUITE 2902  
NEW YORK, NEW YORK  
(Address of principal executive offices)

10036  
(Zip Code)

(212) 696-0100  
(Registrant's telephone number,  
including area code)

Indicate by check mark whether the Registrant (1) has filed all documents and 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

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## APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Class	Outstanding at November 8, 2006
Common Stock, \$.01 par value	204,845,591

## ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES

### FORM 10-Q

#### TABLE OF CONTENTS

Part I.	FINANCIAL INFORMATION	
Item 1.	Financial Statements:	
	Consolidated Statements of Financial Condition-September 30, 2006 (Unaudited) and December 31, 2005 (Derived from the audited consolidated financial statement at December 31, 2005)	1
	Consolidated Statements of Operations and Comprehensive Income (Unaudited) for the quarters and nine months ended September 30, 2006 and 2005	2
	Consolidated Statement of Stockholders' Equity (Unaudited) for the nine months ended September 30, 2006	3
	Consolidated Statements of Cash Flows (Unaudited) for the quarters and nine months ended September 30, 2006 and 2005	4
	Notes to Consolidated Financial Statements (Unaudited)	5
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	18
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	35
Item 4.	Controls and Procedures	36
Part II.	OTHER INFORMATION	
Item 1.	Legal Proceedings	37
Item 1A.	Risk Factors	37
Item 6.	Exhibits	37
	SIGNATURES	39

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PART I.  
ITEM 1. FINANCIAL STATEMENTS

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION  
(dollars in thousands, except for share data)

	September 30, 2006 (UNAUDITED)	DECEMBER 31, 2005 (1)
-----		
ASSETS		
Cash and cash equivalents	\$66,844	\$4,808
Mortgage-Backed Securities, at fair value	28,348,027	15,929,864
Trading securities, at fair value	23,409	-
Receivable for Mortgage-Backed Securities sold	5,325	13,449
Accrued interest receivable	130,348	71,340
Receivable for advisory and service fees	3,124	3,497
Intangible for customer relationships	11,662	15,183
Goodwill	22,966	23,122
Other assets	2,679	2,159
-----		
Total assets	\$28,614,384	\$16,063,422
=====		
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Repurchase agreements	\$24,901,420	\$13,576,301
Payable for Mortgage-Backed Securities purchased	942,871	933,051
Trading securities sold, net yet purchased, at fair value	29,740	-
Accrued interest payable	66,547	27,994
Dividends payable	30,403	12,368
Other liabilities	-	305
Accounts payable and accrued liabilities	13,367	8,837
Interest rate swaps, at fair value	30,333	543
-----		
Total liabilities	26,014,681	14,559,399
-----		
Minority interest in equity of consolidated affiliate	5,028	-
-----		
6.00% Series B Cumulative Convertible Preferred Stock; 4,600,000 and 0 shares authorized, issued and outstanding, respectively	111,466	-
-----		
Stockholders' Equity:		
7.875% Series A Cumulative Redeemable Preferred Stock: 7,637,500 authorized, 7,412,500 shares issued and outstanding	177,088	177,088
Common stock: par value \$.01 per share; 500,000,000 authorized; 204,845,591 and		

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123,684,931 outstanding, respectively	2,048	1,237
Additional paid-in capital	2,607,995	1,679,452
Accumulated other comprehensive loss	(119,973)	(207,117)
Accumulated deficit	(183,949)	(146,637)
	-----	-----
Total stockholders' equity	2,483,209	1,504,023
	-----	-----
Total liabilities, minority interest, series B cumulative redeemable preferred stock and stockholders' equity	\$28,614,384	\$16,063,422
	=====	=====

(1) Derived from the audited consolidated financial statements at December 31, 2005.

See notes to consolidated financial statements

1

PART I.

ITEM 1. FINANCIAL STATEMENTS

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)  
(UNAUDITED)  
(dollars in thousands, except per share amounts)

	For the Quarter Ended September 30, 2006	For the Quarter Ended September 30, 2005	For the nine Months Ended September 30, 2006	For the nine Months Ended September 30, 2005
	-----	-----	-----	-----
Interest income	\$339,737	\$177,474	\$814,790	\$525,358
Interest expense	295,726	155,043	705,711	402,794
	-----	-----	-----	-----
Net interest income	44,011	22,431	109,079	122,564
	-----	-----	-----	-----
Other income				
Investment advisory and service fees	4,978	10,945	17,185	26,923
(Loss) gain on sale of Mortgage-Backed Securities	(446)	32	(8,691)	12,047
Gain on termination of interest rate swaps	8,414	-	8,414	-
Income from trading securities	432	-	432	-
	-----	-----	-----	-----
Total other income	13,378	10,977	17,340	38,970
	-----	-----	-----	-----
Expenses				
Distribution fees	724	2,414	2,649	6,151
General and administrative expenses	11,542	6,455	27,704	19,919

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Total expenses	12,266	8,869	30,353	26,070
Impairment of intangible for customer relationships	-		2,493	
Loss on other-than-temporarily impaired securities	-		46,844	
Income before income taxes	45,123	24,539	46,729	135,464
Income taxes	2,273	3,353	6,250	7,952
Net income	42,850	21,186	40,479	127,512
Dividends on preferred stock	5,373	3,648	14,184	10,945
Net income available to common shareholders	\$37,477	\$17,538	\$26,295	\$116,567
Net income per share available to common shareholders:				
Basic	\$0.21	\$0.14	\$0.17	\$0.95
Diluted	\$0.20	\$0.14	\$0.16	\$0.95
Weighted average number of common shares outstanding:				
Basic	181,767,106	123,169,910	155,054,308	122,067,300
Diluted	189,952,159	123,330,645	160,211,191	122,265,351
Net income	\$42,850	\$21,186	\$40,479	\$127,512
Comprehensive income (loss):				
Unrealized gain (loss) on available-for-sale securities	400,261	(159,670)	61,399	(171,709)
Unrealized loss on interest rate swaps	(127,354)	-	(21,376)	-
Reclassification adjustment for net (gains) losses included in net income	(7,968)	(32)	47,121	(12,047)
Other comprehensive income (loss)	264,939	(159,702)	87,144	(183,756)
Comprehensive income (loss)	\$307,789	(\$138,516)	\$127,623	(\$56,244)

See notes to consolidated financial statements.

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2

PART I  
ITEM 1.

FINANCIAL STATEMENTS

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2006  
(dollars in thousands, except per share data)  
(UNAUDITED)

	7.875% Series A Preferred Stock	Common Stock Par Value	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Ac
BALANCE, JANUARY 1, 2006	\$177,088	\$1,237	\$1,679,452	(\$207,117)	(
Net loss					
Other comprehensive loss				(42,342)	
Comprehensive loss					
Stock option expense			293		
Exercise of stock options			159		
Series A preferred dividend declared, \$0.492188 per share					
Common dividend declared, \$0.11 per share					
BALANCE, MARCH 31, 2006	177,088	1,237	1,679,904	(249,459)	
Net income					
Other comprehensive loss				(135,453)	
Comprehensive income					
Proceeds from common stock follow-on offering		392	436,956		
Stock option expense			322		
Proceeds from equity shelf offering		11	14,176		
Series A preferred dividend declared and, \$0.492188 per share					
Series B preferred dividend declared, \$0.32916 per share					
Common dividend declared, \$0.13 per share					
BALANCE, JUNE 30, 2006	177,088	1,640	2,131,358	(384,912)	
Net income					
Other comprehensive income				264,939	
Comprehensive income					
Net proceeds from common stock follow-on offering		408	476,267		
Exercise of stock options			46		

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Stock option expense	324
Series A preferred dividend declared, \$0.492188 per share	
Series B preferred dividend declared, \$0.375 per share	
Common dividend declared, \$0.14 per share	

BALANCE, SEPTEMBER 30, 2006	\$177,088	\$2,048	\$2,607,995	(\$119,973)	(
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See notes to consolidated financial statements.

3

PART I  
ITEM 1.

FINANCIAL STATEMENTS  
ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(dollars in thousands)  
(UNAUDITED)

	For the Quarter Ended September 30, 2006	For the Quarter Ended September 30, 2005	For the Nine Months Ended September 30, 2006
Cash flows from operating activities:			
Net income	\$42,850	\$21,186	\$40,479
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of Mortgage-Backed Securities premiums and discounts, net	14,941	43,722	48,677
Amortization of intangibles	564	194	1,090
Loss (gain) on sale of Mortgage-Backed Securities	446	(32)	8,691
Gain on Sale of interest rate swaps	(8,414)	-	(8,414)
Loss on other-than-temporarily impaired securities	-	-	46,843
Stock option expense	324	-	961
Market value adjustment on long-term repurchase agreement	-	(616)	(149)
Impairment of intangible for customer relationships	-	-	2,493
(Increase) decrease in accrued interest receivable, net of purchased interest	(20,236)	4,032	(59,857)
(Increase) Decrease in other assets	(1,133)	147	(583)
(Decrease) increase in advisory and service fees receivable	(10)	(245)	374
Increase (decrease) in accrued interest payable	24,447	4,517	38,553
Decrease in accounts payable	6,388	2,069	4,530
Loss on trading securities	19	-	19
Proceeds from sale of trading securities	43,448	-	43,448

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Purchase of trading securities	(36,995)	-	(36,995)
Principal payments on trading securities	51	-	51
Accretion of discounts on trading securities	(4)	-	(4)
Unrealized gain on trading securities	(187)	-	(187)
<hr/>			
Net cash provided by operating activities	66,499	74,974	130,020
<hr/>			
-			
Cash flows from investing activities:			
Purchase of Mortgage-Backed Securities	(5,944,272)	(2,035,744)	(18,536,593)
Proceeds from sale of Mortgage Backed Securities	482,108	21,632	2,534,044
Proceeds from sale of interest rate swaps	8,414	-	8,414
Proceeds from called agency debentures	-	130,000	-
Principal payments on Mortgage-Backed Securities	1,303,756	2,051,163	3,615,902
<hr/>			
Net cash (used in) provided by investing activities	(4,149,994)	167,051	(12,378,233)
<hr/>			
Cash flows from financing activities:			
Proceeds from repurchase agreements	76,940,538	65,581,331	205,009,542
Principal payments on repurchase agreements	(73,295,822)	(65,794,700)	(193,684,423)
Proceeds from exercise of stock options	46	-	183
Proceeds from dividend reinvestment	-	114	-
Net proceeds from common stock follow-on offering	476,675	-	914,023
Net proceeds from equity shelf program	-	17,002	14,187
Net proceeds from Series B preferred stock offering	(5)	-	111,466
Dividends paid	(24,970)	(47,768)	(59,757)
Proceeds from minority interest	28	-	5,028
<hr/>			
Net cash provided by (used in) financing activities	4,096,490	(244,010)	12,310,249
<hr/>			
Net increase (decrease) in cash and cash equivalents	12,995	(1,985)	62,036
Cash and cash equivalents, beginning of period	53,849	3,669	4,808
<hr/>			
Cash and cash equivalents, end of period	\$66,844	\$1,684	\$66,844
<hr/>			
Supplemental disclosure of cash flow information:			
Interest paid	\$271,279	\$150,526	\$667,158
<hr/>			
Income taxes paid	\$2,320	\$2,842	\$5,917
<hr/>			
Noncash investing activities:			
Net change in unrealized loss on available-for-sale securities and			



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interest rate swaps, net of reclassification adjustment due to sales or terminations of securities	\$264,939	(\$159,702)	\$87,144
=====			
Noncash financing activity:			
Dividends declared, not yet paid	\$30,403	\$16,079	\$30,403
=====			

See notes to consolidated financial statements.

4

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
FOR THE QUARTER AND NINE MONTHS ENDED SEPTEMBER 30, 2006 AND 2005  
(UNAUDITED)

-----  
1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Annaly Capital Management, Inc. (the "Company") was incorporated in Maryland on November 25, 1996. The Company changed its name from Annaly Mortgage Management, Inc. to Annaly Capital Management, Inc. effective August 2, 2006. The Company commenced its operations of purchasing and managing an investment portfolio of mortgage-backed securities on February 18, 1997, upon receipt of the net proceeds from the private placement of equity capital. An initial public offering was completed on October 14, 1997. The Company is a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended. The Company acquired Fixed Income Discount Advisory Company ("FIDAC") on June 4, 2004. FIDAC is a registered investment advisor and is a taxable REIT subsidiary of the Company. On June 27, 2006, the Company made a majority equity investment in an affiliated investment fund (the "Fund"). At September 30, 2006, the Fund was invested 100% in equity investments.

A summary of the Company's significant accounting policies follows:

**Basis of Presentation** - The accompanying unaudited consolidated financial statements have been prepared in conformity with the instructions to Form 10-Q and Article 10, Rule 10-01 of Regulation S-X for interim financial statements. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America ("GAAP"). The interim financial statements are unaudited; however, in the opinion of the Company's management, all adjustments, consisting only of normal recurring accruals, necessary for a fair statement of the financial positions, results of operations, and cash flows have been included. These unaudited financial statements should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. The nature of the Company's business is such that the results of any interim period are not necessarily indicative of results for a full year.

The consolidated financial statements include the accounts of the Company, FIDAC and the Fund. All material intercompany balances and transactions have been eliminated. The minority shareholder in the Fund is reflected as minority interest in the consolidated statement of financial condition.

**Cash and Cash Equivalents** - Cash and cash equivalents include cash on hand and money market funds.

**Mortgage-Backed Securities** - The Company invests in mortgage

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pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans (collectively, "Mortgage-Backed Securities" or "Investment Securities").

Statement of Financial Accounting Standards ("SFAS") No. 115, Accounting for Certain Investments in Debt and Equity Securities, requires the Company to classify its Investment Securities as either trading investments, available-for-sale investments or held-to-maturity investments. Although the Company generally intends to hold most of its Investment Securities until maturity, it may, from time to time, sell any of its Investment Securities as part of its overall management of its portfolio. Accordingly, SFAS No. 115 requires the Company to classify all of its Investment Securities as available-for-sale. All assets classified as available-for-sale are reported at estimated fair value, based on market prices provided by certain dealers who make markets in these financial instruments, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been lower than carrying value, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for recovery in fair value. Unrealized losses on Investment Securities that are considered other than temporary, as measured by the amount of decline in fair value attributable to factors other than temporary, are recognized in income and the cost basis of the Investment Securities is adjusted. The loss on other-than-temporarily impaired securities was \$46.8 million for the nine months ended September 30, 2006. There were no impairment losses recognized during the quarter ended September 30, 2006 and the nine months ended September 30, 2005.

5

SFAS No. 107, Disclosure About Fair Value of Financial Instruments, requires disclosure of the fair value of financial instruments for which it is practicable to estimate that value. The fair value of Mortgage-Backed Securities available-for-sale and hedging instruments is equal to their carrying value presented in the consolidated statements of financial condition. The fair value of cash and cash equivalents, accrued interest receivable, receivable for mortgage-backed securities sold, receivable for advisory and service fees, repurchase agreements, payable for mortgage-backed securities purchased, dividends payable, accounts payable, and accrued interest payable generally approximates cost as of September 30, 2006 and December 31, 2005, due to the short term nature of these financial instruments.

Interest income is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment Securities are amortized and accreted, respectively, into interest income over the projected lives of the securities using the effective interest method. The Company's policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, consensus prepayment speeds, and current market conditions.

Investment Securities transactions are recorded on the trade date. Purchases of newly issued securities are recorded when all significant uncertainties regarding the characteristics of the securities are removed,

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generally shortly before settlement date. Realized gain and losses on sale of Investment Securities are determined on the specific identification basis.

Derivative Financial Instruments/Hedging Activity- The Company hedges interest rate risk through the use of derivative financial instruments, including interest rate caps and swaps ("Hedging Instruments"). Hedging Instruments may in the future include inverse floating rate securities (or inverse floaters). The Company accounts for Hedging Instruments in accordance with SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities ("SFAS 133") as amended and interpreted. The Company carries all Hedging Instruments at their fair value, as assets, if their fair value is positive, or as liabilities, if their fair value is negative. As the Company's interest rate swaps are designated as "cash flow hedges," the change in their fair values is recorded in other comprehensive income or loss for hedges that qualify as effective. The ineffective amount of all Hedging Instruments, if any, is recognized in earnings each quarter. To date, the Company has not recognized any change in the value of its interest rate swaps in earnings as a result of the hedge or a portion thereof being ineffective.

Upon entering into hedging transactions, the Company documents the relationship between the Hedging Instruments and the hedged liability. The Company also documents its risk-management policies, including objectives and strategies, as they relate to its hedging activities. The Company assesses, both at inception of a hedge and on an on-going basis, whether or not the hedge is "highly effective," as defined by SFAS 133. The Company discontinues hedge accounting on a prospective basis with changes in the estimated fair value reflected in earnings when (i) it is determined that the derivative is no longer effective in offsetting cash flows of a hedged item (including hedged items such as forecasted transactions); (ii) it is no longer probable that the forecasted transaction will occur; or (iii) it is determined that designating the derivative as a Hedging Instrument is no longer appropriate.

When the Company enters into an interest rate swap, it agrees to pay a fixed rate of interest and to receive a variable interest rate, generally based on the London Interbank Offered Rate ("LIBOR"). The Company's interest rate swaps are designated as cash flow hedges against the benchmark interest rate risk associated with the Company's borrowings.

All changes in the unrealized gains/losses on any interest rate swap are recorded in accumulated other comprehensive income or loss and are reclassified to earnings as interest expense is recognized on the Company's hedged borrowings. If it becomes probable that the forecasted transaction, which in this case refers to interest payments to be made under the Company's short-term borrowing agreements, will not occur by the end of the originally specified time period, as documented at the inception of the hedging relationship, then the related gain or loss in accumulated other comprehensive income or loss would be reclassified to income or loss.

Realized gains and losses resulting from the termination of an interest rate swap are initially recorded in accumulated other comprehensive income or loss as a separate component of stockholders' equity. The gain or loss from a terminated interest rate swap remains in accumulated other comprehensive income or loss until the forecasted interest payments affect earnings. If it becomes probable that the forecasted interest payments will not occur, then the entire gain or loss is recognized in earnings. During the quarter ended September 30, 2006, interest rate swaps and the corresponding repurchase agreements were terminated; therefore resulting in the forecasted interest payments not occurring and the gain being reflected in earnings.

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Credit Risk - The Company has limited its exposure to credit losses on its portfolio of Mortgage-Backed Securities by only purchasing securities issued by FHLMC, FNMA, or GNMA. The payment of principal and interest on the FHLMC and FNMA Mortgage-Backed Securities are guaranteed by those respective agencies, and the payment of principal and interest on the GNMA Mortgage-Backed Securities are backed by the full faith and credit of the U.S. government. All of the Company's Investment Securities have an actual or implied "AAA" rating.

Trading Securities and Trading Securities sold, not yet purchased

Trading securities and trading securities sold, not yet purchased are included in the balance sheet as a result of consolidating the financial statements of an affiliated investment fund.

Trading securities owned and trading account securities sold, not yet purchased consisted of securities at fair value as of September 30, 2006. The resulting realized and unrealized gains and losses are reflected in principal transactions in the statements of operations.

Trading account securities sold, not yet purchased represent obligations of the investment fund to deliver the specified security at the contracted price, and thereby, create a liability to purchase the security in the market at prevailing prices.

Repurchase Agreements - The Company finances the acquisition of its Investment Securities through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

Convertible Cumulative Preferred Stock- The Company classifies its Series B Cumulative Convertible Preferred Stock on the consolidated statements of financial condition using the guidance in SEC Accounting Series Release No. 268, Presentation in Financial Statements of "Redeemable Preferred Stocks," and Emerging Issues Task Force ("EITF") Topic D-98, Classification and Measurement of Redeemable Securities. The Series B Cumulative Convertible Preferred Stock contains fundamental change provisions that allow the holder to redeem the preferred stock for cash if certain events occur. As redemption under these provisions is not solely within the Company's control, the Company has classified the Series B Cumulative Convertible Preferred Stock as temporary equity in the accompanying consolidated statement of financial condition.

The Company has analyzed whether the embedded conversion option should be bifurcated under the guidance in SFAS133 and EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock, and has determined that bifurcation is not necessary.

Income Taxes - The Company has elected to be taxed as a REIT and intends to comply with the provisions of the Internal Revenue Code of 1986, as amended (the "Code"), with respect thereto. Accordingly, the Company will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. The Company and FIDAC have made a joint election to treat FIDAC as a taxable REIT subsidiary. As such, FIDAC is taxable as a domestic C corporation and subject to federal and state and local income taxes based upon its taxable income.

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Use of Estimates - The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Intangible assets - The Company's acquisition of FIDAC was accounted for using the purchase method. Under the purchase method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. In addition, the cost of FIDAC was allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of cost over the fair value of the net assets acquired was recognized as goodwill. Intangible assets are periodically reviewed for potential impairment. During the nine months ended September 30, 2006, the Company recognized \$2.5 million in impairment losses on intangible assets relating to customer relationships. During the quarter ended September 30, 2006 and the nine months ended September 30, 2005, the Company did not have impairment losses.

Recent Accounting Pronouncements - On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (Revised 2004) - Share-Based Payment ("SFAS No. 123R"). SFAS No. 123R, which replaces SFAS No. 123, requires the Company to measure and recognize in the financial statements the compensation cost relating to share-based payment transactions. The compensation cost should be reassessed based on the fair value of the equity instruments issued. We adopted SFAS No. 123R effective January 1, 2006 under the modified prospective transition method. Accordingly, prior period amounts have not been restated. Under this application, the Company is required to record compensation expense for all awards granted or modified on or after January 1, 2006 and for the unvested portion of all outstanding awards that remain outstanding at the date of adoption. The adoption of SFAS No. 123R resulted in incremental stock-based compensation expense of \$324,000 and \$961,000 for the quarter and nine months ended September 30, 2006, respectively.

We elected to recognize compensation expense on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). We estimate fair value using the Black-Scholes valuation model. The assumptions used to value the options granted during the nine months ended September 30, 2006 are as follows: Expected volatility 26.50%, expected dividends 5.57%, expected term in years, 6.8, and risk free rate 4.7%. Assumptions used to estimate the compensation expense are determined as follows:

- o Expected term (estimated time of outstanding) is estimated using the historical exercise behavior of employees
- o Expected volatility is measured using the weighted average of historical daily changes in the market price of our common stock over the expected term of the award
- o Expected dividend yield is based on projected dividend yield over the expected term of the award
- o Risk-free interest rate is equivalent to the implied yield on zero-coupon U.S. Treasury bonds with a remaining maturity equal to the expected term of the awards; and,
- o Forfeitures are based substantially on the history of cancellations of similar awards granted by the Company in prior years.

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Prior to the adoption of SFAS No. 123R, we used the intrinsic value method prescribed in APB 25 and also followed the disclosure requirements of SFAS No. 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure ("SFAS No. 148") which required certain disclosures on a pro forma basis as if the fair value method had been followed for accounting for such compensation.

8

	For the Quarter Ended September 30, 2005	For the Nine Months September 30, 2005
Net income available to common shareholders, as reported	\$17,538	\$116,567
Deduct: Total stock-based employee compensation expense determined under fair value based method	(36)	(107)
Pro-forma net income available to common shareholders	\$17,502	\$116,460
Net income per share available to common shareholders, as reported:		
Basic	\$0.14	\$0.95
Diluted	\$0.14	\$0.95
Pro-forma net income per share available to common shareholders:		
Basic	\$0.14	\$0.95
Diluted	\$0.14	\$0.95

Proposed Accounting Pronouncements- The FASB has added an item to its current proposed amendment relating to the accounting treatment under SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities of transactions where assets purchased from a particular counterparty are financed via a repurchase agreement with the same counterparty. Currently, the Company records such assets and the related financing in the consolidated statement of financial condition, and the corresponding interest income and interest expense in the Company's consolidated statement of operations and comprehensive (loss) income. For assets representing available-for-sale investment securities, as in the Company's case, any change in fair value is reported through other comprehensive income under SFAS No. 115, with the exception of impairment losses, which are recorded in the consolidated statement of operations and comprehensive (loss) income as realized losses.

However, a transaction where assets are acquired from and financed under a repurchase agreement with the same counterparty may not qualify for a sale treatment by a seller under an interpretation of SFAS 140, which would require the seller to continue to carry such sold assets on their books based on their "continuing involvement" with such assets. Depending on the ultimate outcome of the FASB deliberations, the result may be that the Company would be precluded from recording the assets purchased in the transaction described above as well as the related financing in the Company's consolidated statement of financial

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condition and would instead be treating the Company's net investment in such assets as a derivative.

This potential change in accounting treatment would not affect the economic substance of the transactions but would affect how the transactions would be reported in the Company's financial statements. The Company's cash flows, liquidity and ability to pay a dividend would be unchanged, and the Company does not believe the Company's taxable income or net equity would be affected.

SEC Staff Accounting Bulletin No. 108 -- In September 2006 the SEC issued Staff Accounting Bulletin (SAB) No. 108 Quantifying Financial Misstatements, which expresses the Staff's views regarding the process of quantifying financial statement misstatements. Registrants are required to quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The techniques most commonly used in practice to accumulate and quantify misstatements are generally referred to as the "rollover" (current year income statement perspective) and "iron curtain" (year-end balance perspective) approaches. The financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors. Management does not expect this guidance to have a material effect on our financial condition and results of operations.

In April 2006, the FASB issued FSP FIN 46(R)-6, "Determining the Variability to be Considered When Applying FASB Interpretation No. 46(R)" ("FIN 46(R)-6"). FIN 46(R)-6 addresses the approach to determine the variability to consider when applying FIN 46(R). The variability that is considered in applying Interpretation 46(R) may affect (i) the determination as to whether an entity is a variable interest entity ("VIE"), (ii) the determination of which interests are variable in the entity, (iii) if necessary, the calculation of expected losses and residual returns on the entity, and (iv) the determination of which party is the primary beneficiary of the VIE. Thus, determining the variability to be considered is necessary to apply the provisions of Interpretation 46(R). FIN 46(R)-6 is required to be prospectively applied to entities in which the Company first become involved after July 1, 2006 and would be applied to all existing entities with which the Company is involved if and when a "reconsideration event" (as described in FIN 46) occurs. Management does not expect that FIN 46(R)-6 will have a material impact on the consolidated financial statements.

9

In February 2006, the FASB issued FAS No. 155, "Accounting for Certain Hybrid Instruments" ("FAS 155"), an amendment to FAS 133 and FAS 140. Among other things, FAS 155: (i) permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; (ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of FAS 133; (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and (v) amends FAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. FAS 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year beginning after September 15, 2006.

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On September 25, 2006, the FASB met and determined to propose a scope exception under FAS 155 for securitized interests that only contain an embedded derivative that is tied to the prepayment risk of the underlying pre-payable financial assets, and for which the investor does not control the right to accelerate the settlement. If a securitized interest contains any other embedded derivative (for example, an inverse floater), then it would be subject to the bifurcation tests in FAS 133, as would securities purchased at a significant premium. The FASB plans to: (i) expose the proposed guidance for a 30-day comment period in the form of a FAS 133 Derivatives Implementation Issue in early November; (ii) re-deliberate the issue in December 2006 following the completion of the 30-day comment period; and (iii) issue their final position in early 2007.

The Company does not expect that the January 1, 2007 anticipated adoption of FAS 155 will have a material impact on the Company's consolidated financial position or results of operations. However, to the extent that certain of the Company's future investments in securitized financial assets do not meet the scope exception ultimately adopted by the FASB, the Company's future results of operations may exhibit volatility as certain of its future investments may be marked to market value in their entirety through the income statement. Under the current accounting rules, changes in the market value of the Company's investment securities are made through other comprehensive income, a component of stockholders' equity.

In July 2006, the FASB issued FASB Interpretation ("FIN") No. 48, Accounting for Uncertainty in Income taxes and Related Implementation Issues. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the Company's financial statements in accordance with AFAS No. 109, Accounting for Income Taxes. FIN 48 prescribes a threshold and measurement attribute for recognition in the financial statements of an asset or liability resulting from a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective as of the beginning of fiscal years that begin after December 15, 2006. The Company is currently evaluating the effects of implementing this new standard.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS No. 157 requires companies to disclose the fair value of its financial instruments according to a fair value hierarchy (i.e., levels 1, 2, and 3, as defined). Additionally, companies are required to provide enhanced disclosure regarding instruments in the level 3 category (which require significant management judgment), including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and all interim periods within those fiscal years. The Company is currently evaluating the impact adoption may have on the consolidated financial statements.

## 2. MORTGAGE-BACKED SECURITIES

The following table presents the Company's Mortgage-Backed Securities classified as available-for-sale as of September 30, 2006 and December 31, 2005, which are carried at their fair value:



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	Federal Home Loan Mortgage Corporation	Federal National Mortgage Association	Government National Mortg Association
September 30, 2006			
	(dollars in thousands)		
Mortgage-Backed Securities, gross	\$10,336,368	\$17,679,224	\$282,000,000
Unamortized discount	(19,189)	(59,573)	(3,000,000)
Unamortized premium	84,081	130,781	3,000,000
Amortized cost	10,401,260	17,750,432	285,000,000
Gross unrealized gains	33,764	66,163	3,000,000
Gross unrealized losses	(76,218)	(109,968)	(3,000,000)
Estimated fair value	\$10,358,806	\$17,706,627	\$282,000,000
	Amortized Cost	Gross Unrealized Gains	Gross Unreal Loss
	(dollars in thousands)		
Adjustable rate	\$8,400,036	\$9,249	(\$76,000,000)
Fixed rate	20,037,631	90,980	(113,000,000)
Total	\$28,437,667	\$100,229	(\$189,000,000)
December 31, 2005			
	(dollars in thousands)		
Mortgage-Backed Securities, gross	\$5,689,898	\$9,881,672	\$344,000,000
Unamortized discount	(4,043)	(17,345)	(5,000,000)
Unamortized premium	92,228	144,726	5,000,000
Amortized cost	5,778,083	10,009,053	349,000,000
Gross unrealized gains	3,174	1,853	6,000,000
Gross unrealized losses	(80,733)	(124,330)	(6,000,000)
Estimated fair value	\$5,700,524	\$9,886,576	\$342,000,000
	Amortized Cost	Gross Unrealized Gains	Gross Unreal Loss
	(dollars in thousands)		
Adjustable rate	\$9,844,261	\$3,973	(\$120,000,000)
Fixed rate	6,292,177	1,054	(91,000,000)
Total	\$16,136,438	\$5,027	(\$211,000,000)

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11

Actual maturities of Mortgage-Backed Securities are generally shorter than stated contractual maturities. Actual maturities of the Company's Mortgage-Backed Securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal, and prepayments of principal. The following table summarizes the Company's Mortgage-Backed Securities on September 30, 2006 and December 31, 2005 according to their estimated weighted-average life classifications:

	September 30, 2006		December
	Fair Value	Amortized Cost (dollars in thousands)	Fair Value
Less than one year	\$230,188	\$232,146	\$ 508,851
Greater than one year and less than five years	12,194,077	12,306,297	12,648,106
Greater than or equal to five years	15,923,762	15,899,224	2,772,907
Total	\$28,348,027	\$28,437,667	\$15,929,864

The weighted-average lives of the Mortgage-Backed Securities at September 30, 2006 and December 31, 2005 in the table above are based upon data provided through subscription-based financial information services, assuming constant principal prepayment rates to the reset date of each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rates of the outstanding loans, loan age, margin and volatility.

Mortgage-Backed Securities with a carrying value of \$7.6 billion were in a continuous unrealized loss position over 12 months at September 30, 2006 in the amount of \$156.8 million. Mortgage-Backed Securities with a carrying value of \$5.5 billion were in a continuous unrealized loss position for less than 12 months at September 30, 2006 in the amount of \$33.1 million. Mortgage-Backed Securities with a carrying value of \$4.6 billion were in a continuous unrealized loss position over 12 months at December 31, 2005 in the amount of \$111.1 million. Mortgage-Backed Securities with a carrying value of \$8.4 billion were in a continuous unrealized loss position for less than 12 months at December 31, 2005 in the amount of \$100.5 million. The decline in value of these securities is solely due to increases in interest rates. All of the Mortgage-Backed Securities are "AAA" rated or carry an implied "AAA" rating. Also, the Company is guaranteed payment on the par value of the securities.

With the continued increase in the Federal Funds rate during the fourth quarter of 2005 and first and second quarters of 2006, management determined that it did not intend to hold certain of its securities until maturity and would reposition a portion of its assets. The Company recorded an impairment charge of \$20.1 million, \$26.7 million and \$83.1 million for these securities during the second quarter of 2006, first quarter of 2006 and fourth quarter of 2005 respectively. The remaining investments are not considered other-than-temporarily impaired since the Company currently has the ability and intent to hold the investments for a period of time or to maturity, if necessary, sufficient for a forecasted market price recovery up to or beyond the

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cost of the investments.

The adjustable rate Mortgage-Backed Securities are limited by periodic caps (generally interest rate adjustments are limited to no more than 1% every nine months) and lifetime caps. The weighted average lifetime cap was 9.7% at September 30, 2006 and 10.3% December 31, 2005.

During the quarter and nine months ended September 30, 2006, the Company realized \$446,000 and \$8.7 million in net loss from sales of Mortgage-Backed Securities, respectively. In addition the Company had an \$8.4 million gain on the termination of interest rate swaps with a notional value of \$895 million. During the quarter and nine months ended September 30, 2005 the Company realized \$32,000 and \$12.0 million in net gains from sales of Mortgage-Backed Securities, respectively.

12

### 3. REPURCHASE AGREEMENTS

The Company had outstanding \$24.9 billion and \$13.6 billion of repurchase agreements with weighted average borrowing rates of 5.12% and 4.16%, including the impact of the interest rate swaps, and weighted average remaining maturities of 35 days and 79 days as of September 30, 2006 and December 31, 2005, respectively. Mortgage-Backed Securities pledged as collateral under these repurchase agreements had an estimated fair value of \$26.2 billion and \$14.3 billion at September 30, 2006 and December 31, 2005, respectively.

At September 30, 2006 and December 31, 2005, the repurchase agreements had the following remaining maturities:

	September 30, 2006	December 31, 2005
	(dollars in thousands)	
Within 30 days	\$19,917,334	\$10,000,000
30 to 59 days	2,934,086	1,000,000
60 to 89 days	250,000	
90 to 119 days	300,000	
Over 120 days	1,500,000	1,000,000
Total	\$24,901,420	\$13,000,000

The Company did not have an amount at risk greater than 10% of the equity of the Company with any counterparties as of September 30, 2006.

The Company has entered into two structured repurchase agreements, which provide the buyer with the right to extend their maturity dates. The repurchase agreements totaled \$400 million and the market value of the option to extend is \$2.5 million.

### 4. INTEREST RATE SWAPS

In connection with the Company's interest rate risk management strategy, the Company hedges a portion of its interest rate risk by entering into derivative financial instrument contracts. To date, such instruments are comprised of interest rate swaps, which in effect modify the cash flows on

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repurchase agreements. The use of interest rate swaps creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the contracts. In the event of a default by the counterparty, the Company could have difficulty obtaining its Mortgage-Backed Securities pledged as collateral for swaps. The Company does not anticipate any defaults by its counterparties.

The Company's swaps are used to lock-in the fixed rate related to a portion of its current and anticipated future 30-day term repurchase agreements.

The table below presents information about the Company's swaps outstanding at September 30, 2006.

Notional Amount (dollars in thousands)	Weighted Average Pay Rate	Weighted Average Receive Rate	Estimated Fair Value/Carrying Value (dollars in thousands)
\$9,183,000	5.19%	5.33%	(\$30,333)

During the quarter ended September 30, 2006, the Company recorded an \$8.4 million gain on the termination of interest rate swaps with a notional value of \$895 million.

13

### 5. PREFERRED STOCK AND COMMON STOCK

On August 16, 2006, the Company entered into an underwriting agreement pursuant to which it sold 40,825,000 shares of its common stock for net proceeds before expenses of approximately \$476.7 million. This transaction settled on August 22, 2006.

On April 6, 2006, the Company entered into an underwriting agreement pursuant to which it sold 39,215,000 shares of its common stock for net proceeds before expenses of approximately \$437.7 million. On April 6, 2006, the Company entered into a second underwriting agreement pursuant to which it sold 4,600,000 shares of its 6% Series B Cumulative Convertible Preferred Stock for net proceeds before expenses of approximately \$111.5 million. Both of these transactions settled on April 12, 2006.

On August 3, 2006, the Company entered into an ATM Equity Offering (sm) Sales Agreement with Merrill Lynch & Co. and Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), relating to the sale of shares of its common stock from time to time through Merrill Lynch. Sales of the shares, if any, will be made by means of ordinary brokers' transaction on the New York Stock Exchange. During the quarter ended September 30, 2006, no shares of the Company's common stock were issued pursuant to this program.

On August 3, 2006, the Company entered into an ATM Equity Sales Agreement with UBS Securities LLC ("UBS Securities"), relating to the sale of shares of its common stock from time to time through UBS Securities. Sales of the shares, if any, will be made by means of ordinary brokers' transaction on the New York Stock Exchange. During the quarter ended September 30, 2006, no shares of the Company's common stock were issued pursuant to this program.

No shares of the Company's common stock were issued through the Company's previously existing equity shelf program during the quarter ended September 30, 2006.

During the quarter ended September 30, 2006, the Company declared

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dividends to common shareholders totaling \$28.7 million or \$0.14 per share, which were paid on October 27, 2006. During the quarter ended September 30, 2006, the Company declared dividends to Series A Preferred shareholders totaling \$3.6 million or \$0.492188 per share, and Series B shareholders totaling \$1.7 million or \$0.375 per share which were paid on October 2, 2006.

### 6. NET INCOME PER COMMON SHARE

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for the quarters ended September 30, 2006 and 2005.

	For the Quarters Ended September 30, 2006	September 30, 2005	For the Nine M September 30, 2006
	(dollars and shares in thousands)		
Net income	\$42,850	\$21,186	\$40,479
Less: Series A and Series B Preferred stock dividend	5,373	3,648	14,184
Net income available to common shareholders	\$37,477	\$17,538	\$26,295
Weighted average shares of common stock outstanding	181,767	123,170	155,054
Add: Effect of dilutive stock options	-	161	-
	181,767	123,331	155,054
Effect of converted Series B preferred stock	8,185	-	5,157
Weighted average shares of common stock outstanding-diluted	189,952	123,331	160,211
Basic Earnings per share	\$0.21	\$0.14	\$0.17
Diluted Earnings per share	\$0.20	\$0.14	\$0.16

14

### 7. LONG-TERM STOCK INCENTIVE PLAN

The Company has adopted a long term stock incentive plan for executive officers, key employees and non-employee directors (the "Incentive Plan"). The Incentive Plan authorizes the Compensation Committee of the board of directors to grant awards, including non-qualified options as well as incentive stock options as defined under Section 422 of the Code. The Incentive Plan authorizes the granting of options or other awards for an aggregate of the greater of 500,000 shares or 9.5% of the diluted outstanding shares of the Company's common stock, up to ceiling of 8,932,921 shares. Stock options are issued at the current market price on the date of grant, subject to an immediate or four year

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vesting in four equal installments with a contractual term of 5 or 10 years. The grant date fair value is calculated using the Black-Scholes option valuation model.

The following table sets forth activity relating to the Company's stock options awards:

	For the Nine Months Ended September 2006		
	Number of Shares	Weighted Average Exercise Price	Number of Shares
Options outstanding at the beginning of period	2,333,593	\$16.10	1,645,721
Granted	737,250	11.72	6,250
Exercised	(22,160)	8.25	(16,128)
Forfeited	(60,000)	15.39	-
Expired	(3,688)	13.69	(33,750)
Options outstanding at the end of period	2,984,995	\$15.10	1,602,093
Options exercisable at the end of period	1,298,496	\$15.28	1,602,093

15

The weighted average remaining contractual term was approximately 7.6 years for stock options outstanding and approximately 6.2 years for stock options exercisable as of September 30, 2006. The amount of cash received from the exercise of stock options was \$47,000 and \$206,000 for the quarter and nine months ended September 30, 2006. As of September 30, 2006, there was approximately \$3.2 million of total unrecognized compensation cost related to nonvested share-based compensation awards. That cost is expected to be recognized over a weighted average period of 3.5 years. As of September 30, 2006 the aggregate intrinsic value of options outstanding was approximately \$2.6 million and the aggregate intrinsic value of options currently exercisable was \$1.6 million.

The following table summarizes information about stock options outstanding at September 30, 2006:

Range of Exercise Prices	Total Options Outstanding	Weighted Average Exercise Price on Total Outstanding	Weighted Average Remaining Contractual Life (Years) on Total Outstanding	Total Options Exercisable	Weighted Average Exercise Price Exercisable
\$7.94-\$19.99	2,974,995	\$15.08	7.59	1,288,496	
\$20.00-\$29.99	10,000	20.53	1.24	10,000	\$

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2,984,995	\$15.10	7.57	1,298,496	\$
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8. INCOME TAXES

As a REIT, the Company is not subject to federal income tax on earnings distributed to its shareholders. Most states recognize REIT status as well. The Company has decided to distribute the majority of its income and retain a portion of the permanent difference between book and taxable income arising from Section 162(m) of the Code pertaining to employee remuneration.

During the quarter and nine months ended September 30, 2006, the Company recorded \$517,000 and \$2.9 million of income tax expense for income attributable to FIDAC, its taxable REIT subsidiary, and the portion of earnings retained based on Code Section 162(m) limitations, respectively. During the quarter and nine months ended September 30, 2006, the Company recorded \$1.8 million and \$3.3 million of income tax expense attributable to Annaly for a portion of earnings retained based on Section 162(m) limitations, respectively.

During the quarter and nine months ended September 30, 2005, the Company recorded \$2.9 million and \$438,000 of income tax expense for income attributable to FIDAC, its taxable REIT subsidiary, and the portion of earnings retained based on Code Section 162(m) limitations, respectively. During the quarter and nine months ended September 30, 2005, the Company recorded \$438,000 and \$1.5 million of income tax expense attributable to Annaly for a portion of earnings retained based on Section 162(m) limitations.

9. LEASE COMMITMENTS

The Company has a noncancelable lease for office space, which commenced in May 2002 and expires in December 2009. The Company's aggregate future minimum lease payments are as follows:

	Total (dollars in millions)
2006 (remainder)	
2007	
2008	
2009	
Total remaining lease payments	

10. INTEREST RATE RISK

The primary market risk to the Company is interest rate risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond the Company's control. Changes in the general level of interest rates can affect net interest income, which is the difference between

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the interest income earned on interest-earning assets and the interest expense incurred in connection with the interest-bearing liabilities, by affecting the spread between the interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of the Investment Securities and the Company's ability to realize gains from the sale of these assets. A decline in the value of the Investment Securities pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels.

The Company seeks to manage the extent to which net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. The Company may seek to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in the portfolio of Investment Securities by entering into interest rate agreements such as interest rate caps and interest rate swaps, and investing in inverse floaters. As of September 30, 2006 and December 31, 2005, the Company entered into interest rate swaps to pay a fixed rate and receive a floating rate of interest, with total notional amounts of \$9.2 billion and \$479.0 million, respectively.

Changes in interest rates may also have an effect on the rate of mortgage principal prepayments and, as a result, prepayments on Mortgage-Backed Securities. The Company will seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets purchased at a premium with assets purchased at a discount. To date, the aggregate premium exceeds the aggregate discount on the Mortgage-Backed Securities. As a result, prepayments, which result in the expensing of unamortized premium, will reduce net income compared to what net income would be absent such prepayments.

### 11. CONTINGENCIES

From time to time, the Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Company's consolidated financial statements.

17

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

### Special Note Regarding Forward-Looking Statements

Certain statements contained in this quarterly report, and certain statements contained in our future filings with the Securities and Exchange Commission (the "SEC" or the "Commission"), in our press releases or in our other public or shareholder communications may not be based on historical facts and are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements which are based on various assumptions, (some of which are beyond our control) may be identified by reference to a future period or periods, or by the use of forward-looking terminology, such as "may," "will," "believe," "expect," "anticipate," "continue," or similar terms or variations on those terms, or the negative of those terms. Actual results could differ materially from those set forth in forward-looking statements due to a variety of factors, including, but not limited to, changes in interest rates, changes in yield curve, changes in prepayment rates, the availability of mortgage backed securities for purchase, the availability of financing, and, if available, the terms of any financings,



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changes in the market value of our assets, changes in business conditions and the general economy, and risks associated with the investment advisory business of FIDAC, including the removal by FIDAC's clients of assets FIDAC manages, FIDAC's regulatory requirements, and competition in the investment advisory business, changes in governmental regulations affecting our business, and our ability to maintain our classification as a REIT for federal income tax purposes. For a discussion of the risks and uncertainties which could cause actual results to differ from those contained in the forward-looking statements, see our most recent Annual Report on Form 10-K and any subsequent Quarterly Reports on Form 10-Q. We do not undertake, and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

### Overview

We are a real estate investment trust (REIT) that owns and manages a portfolio of mortgage-backed securities. Our principal business objective is to generate net income for distribution to our stockholders from the spread between the interest income on our investment securities and the costs of borrowing to finance our acquisition of investment securities and from dividends we receive from FIDAC. FIDAC is our wholly-owned taxable REIT subsidiary, and is a registered investment advisor that generates advisory and service fee income. The Company also has a majority interest in an investment fund.

We are primarily engaged in the business of investing, on a leveraged basis, in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans (collectively, "Mortgage-Backed Securities").

Under our capital investment policy, at least 75% of our total assets must be comprised of high-quality mortgage-backed securities and short-term investments. High quality securities means securities that (1) are rated within one of the two highest rating categories by at least one of the nationally recognized rating agencies, (2) are unrated but are guaranteed by the United States government or an agency of the United States government, or (3) are unrated but are determined by us to be of comparable quality to rated high-quality Mortgage-Backed Securities.

The remainder of our assets, comprising not more than 25% of our total assets, may consist of other qualified REIT real estate assets which are unrated or rated less than high quality, but which are at least "investment grade" (rated "BBB" or better by Standard & Poor's Corporation ("S&P") or the equivalent by another nationally recognized rating agency) or, if not rated, determined by us to be of comparable credit quality to an investment which is rated "BBB" or better. In addition, we may directly or indirectly invest part of this remaining 25% of our assets in other types of securities, including without limitation, unrated debt, equity or derivative securities, to the extent consistent with our REIT qualification requirements. The derivative securities in which we invest may include securities representing the right to receive interest only or a disproportionately large amount of interest, as well as inverse floaters, which may have imbedded leverage as part of their structural characteristics.

We may acquire Mortgage-Backed Securities backed by single-family residential mortgage loans as well as securities backed by loans on multi-family, commercial or other real estate-related properties. To date, all of the Mortgage-Backed Securities that we have acquired have been backed by

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single-family residential mortgage loans.

We have elected to be taxed as a REIT for federal income tax purposes. Pursuant to the current federal tax regulations, one of the requirements of maintaining our status as a REIT is that we must distribute at least 90% of our REIT taxable income (determined without regard to the deduction for dividends paid and by excluding any net capital gain) to our stockholders, subject to certain adjustments.

The results of our operations are affected by various factors, many of which are beyond our control. Our results of operations primarily depend on, among other things, the level of our net interest income, the market value of our assets and the supply of and demand for such assets. Our net interest income, which reflects the amortization of purchase premiums and accretion of discounts, varies primarily as a result of changes in interest rates, borrowing costs and prepayment speeds, the behavior of which involves various risks and uncertainties. Prepayment speeds, as reflected by the Constant Prepayment Rate, or CPR, and interest rates vary according to the type of investment, conditions in financial markets, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment speeds on our Mortgage-Backed Securities portfolio increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. The CPR on our Mortgage Backed Securities portfolio averaged 16% and 28% for the quarters ended September 30, 2006 and 2005, respectively. Since changes in interest rates may significantly affect our activities, our operating results depend, in large part, upon our ability to effectively manage interest rate risks and prepayment risks while maintaining our status as a REIT.

During the fourth quarter of 2005, the Company sold certain assets and began purchasing assets in the current rate environment. This continued during 2006. With the federal funds interest rate continuing to rise through the first and second quarter of 2006, the Company sold lower yielding assets and replaced them with higher yielding assets. The Company took these actions because it determined that certain assets that were purchased in the much lower interest rate environment of 2003 and 2004 were unlikely to recover to their amortized cost basis and were not providing attractive returns on a cash flow basis.

We have shortened contractual maturities on our borrowings during the third quarter of 2006, such that our weighted average contractual maturity on our repurchase agreements was 108 days at September 30, 2006, as compared to 137 days at September 30, 2005.

The table below provides quarterly information regarding our average balances, interest income, interest expense, yield on assets, cost of funds and net interest income for the following quarterly periods presented.

	Average Investment Securities Held (1)	Total Interest Income	Yield on Average Interest Earning Assets	Average Balance of Repurchase Agreements	Total Interest Expense
	-----	-----	-----	-----	-----
Quarter Ended September 30, 2006	\$24,976,876	\$339,737	5.44%	\$23,120,247	\$295,726
Quarter Ended June 30, 2006	\$21,660,089	\$280,171	5.17%	\$20,060,978	\$242,473
Quarter Ended March 31, 2006	\$16,590,859	\$194,882	4.70%	\$15,296,893	\$167,512

(ratios for the quarters have been annualized, dollars in

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Quarter Ended December 31, 2005	\$17,551,868	\$179,688	4.10%	\$16,547,972	\$165,766
Quarter Ended September 30, 2005	\$18,906,350	\$177,474	3.75%	\$17,672,690	\$155,043
Quarter Ended June 30, 2005	\$18,918,577	\$171,595	3.63%	\$17,658,408	\$133,758
Quarter Ended March 31, 2005	\$18,798,200	\$176,289	3.75%	\$17,756,241	\$113,993

(1) Does not reflect unrealized gains/(losses).

19

The following table presents the CPR experienced on our Mortgage-Backed Securities portfolio, on an annualized basis, for the following quarterly periods:

Quarter Ended	CPR
-----	---
September 30, 2006	16%
June 30, 2006	19%
March 31, 2006	18%
December 31, 2005	28%
September 30, 2005	28%
June 30, 2005	27%
March 31, 2005	25%

We believe that the CPR in future periods will depend, in part, on changes in and the level of market interest rates across the yield curve, with higher CPRs expected during periods of declining interest rates and lower CPRs expected during periods of rising interest rates.

We continue to explore alternative business strategies, alternative investments and other strategic initiatives to complement our core business strategy of investing, on a leveraged basis, in high quality Investment Securities. No assurance, however, can be provided that any such strategic initiative will or will not be implemented in the future.

For the purposes of computing ratios relating to equity measures, throughout this document, equity includes Series B cumulative Convertible Preferred Stock, which has been treated under GAAP as temporary equity.

### Critical Accounting Policies

Management's discussion and analysis of financial condition and results of operations is based on the amounts reported in our financial statements. These financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. In preparing the financial statements, management is required to make various judgments, estimates and assumptions that affect the reported amounts. Changes in these estimates and assumptions could have a material effect on our financial statements. The following is a summary of our policies most affected by management's judgments, estimates and assumptions; the policies have not changed during 2006.

**Market Valuation and Impairment of Investment Securities:** All assets classified as available-for-sale are reported at fair value, based on market prices. Although we generally intend to hold most of our Investment Securities until maturity, we may, from time to time, sell any of our Investment Securities as part our overall management of our portfolio. Accordingly, we are required to classify all of our Investment Securities as available-for-sale. Our policy is to obtain market values from independent sources. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation.

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Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Investments with unrealized losses are not considered other-than-temporarily impaired if the Company has the ability and intent to hold the investments for a period of time, to maturity if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments. Unrealized losses on Investment Securities that are considered other than temporary, as measured by the amount of decline in fair value attributable to factors other than temporary, are recognized in income and the cost basis of the Investment Securities is adjusted. Losses on other-than-temporarily impaired securities totaled \$46.7 million for the nine months ended September 30, 2006. There were no such adjustments for the quarter ended September 30, 2006 or for the quarter and nine months ended September 30, 2005. Unrealized losses at September 30, 2006 on Investment Securities that are not deemed impaired totaled \$190.0 million.

**Interest income:** Interest income is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment Securities are amortized or accreted into interest income over the projected lives of the securities using the interest method. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, street consensus prepayment speeds, and current market conditions. If our estimate of prepayments is incorrect, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

20

**Repurchase Agreements:** We finance the acquisition of our Investment Securities through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

**Income Taxes:** We have elected to be taxed as a Real Estate Investment Trust (or REIT) and intend to comply with the provisions of the Internal Revenue Code of 1986, as amended (or the Code), with respect thereto. Accordingly, the Company will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. The Company and FIDAC have made a joint election to treat FIDAC as a taxable REIT subsidiary. As such, FIDAC is taxable as a domestic C corporation and subject to federal and state and local income taxes based upon its taxable income.

**Impairment of Intangibles:** The Company's acquisition of FIDAC was accounted for using the purchase method. The cost of FIDAC was allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of cost over the fair value of the net assets acquired was recognized as goodwill. Intangible assets are periodically reviewed for potential impairment. This evaluation requires significant judgment. During 2006, we recognized impairment charges totaling \$2.5 million on intangible assets relating to customer relationships.

**Results of Operations:** For the Quarters and Nine Months Ended September 30, 2006 and 2005

Net Income Summary

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For the quarter ended September 30, 2006, our net income was \$42.9 million, or \$0.21 basic net income per average share available to common shareholders, as compared to net income of \$21.2 million, or \$0.14 net income per average share available to common shareholders, for the quarter ended September 30, 2005. We attribute the increase in total net income for the quarter ended September 30, 2006 from the quarter ended September 30, 2005 to the increased asset base, the increase in interest rate spread, and gains on the termination of interest rate swaps. The increase in total net income per share was primarily due to the increase in the interest rate spread from 0.24% to 0.32%. The increase in yield on investment securities to 5.44% for the quarter ended September 30, 2006 from 3.75% for the quarter ended September 30, 2005 was only partially offset by the increase in cost of funding to 5.12% for the quarter ended September 30, 2006 from 3.51% for the quarter ended September 30, 2005. For the quarter ended September 30, 2006, the net gain on sale of Mortgage-Backed Securities and termination of interest rate swaps was \$7.9 million as compared to \$32,000 gain on sale of Mortgage-Backed Securities for the quarter ended September 30, 2005. For the quarter ended September 30, 2006, net investment advisory and service fees totaled \$4.3 million, as compared to \$8.5 million for the quarter ended September 30, 2005. For the quarter ended September 30, 2006, general and administrative expenses totaled \$11.5 million, as compared to \$6.4 million for the quarter ended September 30, 2005. Dividends for the quarter ended September 30, 2006 were \$0.14 per share of common stock, or \$28.7 million in total, and \$0.492188 per share of Series A preferred stock, or \$3.6 million in total, and \$0.375 per share of Series B preferred stock or \$1.7 million in total. Dividends per share for the quarter ended September 30, 2005 were \$0.13 per share of common stock, or \$16.0 million in total and \$0.492188 per share of Series A preferred stock, or \$3.7 million in total. The Series B Cumulative preferred stock has been treated under GAAP as temporary equity. For the purpose of computing ratios relating to equity measures, the Series B Preferred Stock has been included in equity. Our return on average equity was 7.72% for the quarter ended September 30, 2006 compared to 5.20% for the quarter ended September 30, 2005.

For the nine months ended September 30, 2006, our net income was \$40.5 million, or \$0.17 net income per average share related to common shareholders, as compared to net income of \$127.5 million, or \$0.95 basic net income per average share available to common shareholders, for the nine months ended September 30, 2005. We attribute the majority of the decrease in net income for the nine months ended September 30, 2006, compared to the nine months ended September 30, 2005 to the decrease in net interest spread, realized and unrealized losses, and the reduction in net investment advisory fees. For the nine months ended September 30, 2006, net interest income was \$109.1 million, as compared to \$122.5 million for the nine months ended September 30, 2005. For the nine months ended September 30, 2006, loss on sale of Mortgage-Backed Securities and loss on other-than-temporary impaired securities, net of gain on termination of interest rate swaps, was \$47.1 million, as compared to a \$12.0 million gain for the quarter ended September 30, 2005. For the nine months ended September 30, 2006, net investment advisory and service fees totaled \$14.5 million, as compared to \$20.7 million for the nine months ended September 30, 2005. Dividends per share for the nine months ended September 30, 2006, were \$0.38 per share of common stock, or \$63.6 million in total and \$1.476566 per share of preferred stock or \$10.9 million in total and \$0.704167 per share of Series B Preferred stock, or \$3.2 million in total. Dividends per share for the nine months ended September 30, 2005 were \$0.94 per share, or \$114.8 million in total and \$1.476564 per share of preferred stock or \$10.9 million in total. Our return on average equity was 2.93% for the nine months ended September 30, 2006 and 10.35% for the nine months ended September 30, 2005.

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Net Income Summary			
(ratios for the quarter have been annualized, dollars in the thousands, except			
	Quarter Ended September 30, 2006	Quarter Ended September 30, 2005	Nine Months Ended September 30, 2006
Interest income	\$339,737	\$177,474	\$814,790
Interest expense	295,726	155,043	705,711
Net interest income	44,011	22,431	109,079
Investment advisory and service fees	4,978	10,945	17,185
(Loss) gain on sale of Mortgage-Backed Securities	(446)	32	(8,691)
Gain on termination of interest rate swaps	8,414	-	8,414
Income from equity investment	432	-	432
Distribution fees	(724)	(2,414)	(2,649)
General and administrative expenses	(11,542)	(6,455)	(27,704)
Impairment of intangible for customer relationships	-	-	(2,493)
Loss on other-than-temporarily impaired securities	-	-	(46,844)
Income before income taxes	45,123	24,539	46,729
Income taxes	2,273	3,353	6,250
Net income	42,850	21,186	40,479
Dividends on preferred stock	5,373	3,648	14,184
Net income available to common shareholders	\$37,477	\$17,538	\$26,295
Weighted average number of basic common shares outstanding	181,767,106	123,169,910	155,054,308
Weighted average number of diluted common shares outstanding	189,952,159	123,330,645	160,211,191
Basic net income per share available to common shareholders	\$0.21	\$0.14	\$0.17
Diluted net income per share available to common shareholders	\$0.20	\$0.14	\$0.16
Average total assets	\$26,199,087	\$19,389,755	\$21,226,016
Average total equity	\$2,219,286	\$1,629,724	\$1,844,131
Annualized return on average assets	0.65%	0.44%	0.25%
Annualized return on average equity	7.72%	5.20%	2.93%

22

Interest Income and Average Earning Asset Yield

We had average earning assets of \$25.0 billion and \$18.9 billion for the quarters ended September 30, 2006 and 2005, respectively. Our primary source

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of income for the quarters ended September 30, 2006 and 2005 was interest income. Our interest income was \$339.7 million for the quarter ended September 30, 2006 and \$177.5 million for the quarter ended September 30, 2005. The yield on average investment securities increased from 3.75% for the quarter ended September 30, 2005 to 5.44% for the quarter ended September 30, 2006. Our average earning asset balance increased by \$6.1 billion and interest income increased by \$162.2 million for the quarter ended September 30, 2006 as compared to the quarter ended September 30, 2005. The average coupon rate at September 30, 2006 was 5.74% as compared to 4.79% at September 30, 2005. The prepayment speeds decreased to 16% CPR for the quarter ended September 30, 2006 from 28% CPR for the quarter ended September 30, 2005. The increase in coupon rates and reduction in prepayment speeds resulted in an increase in weighted average yield.

We had average earning assets of \$21.1 billion and \$18.9 billion for the nine months ended September 30, 2006 and 2005, respectively. Our interest income was \$815.0 million for the nine months ended September 30, 2006 and \$525.4 million for the nine months ended September 30, 2005. The yield on average investment securities increased from 3.71% for the nine months ended September 30, 2005, to 5.15% for the nine months ended September 30, 2006. Our average earning asset balance increased by \$2.2 billion and interest income increased by \$289.6 million for the nine months ended September 30, 2006 as compared to the nine months ended September 30, 2005. The average prepayment speeds decreased to 18% CPR for the nine months ended September 30, 2006 from 28% CPR for the nine months ended September 30, 2005. The increase in interest income for the nine months ended September 30, 2006, when compared to the nine months ended September 30, 2005, resulted from the increased asset base and the increase in weighted average yield.

### Interest Expense and the Cost of Funds

We anticipate that our largest expense will be the cost of borrowed funds. We had average borrowed funds of \$23.1 billion and total interest expense of \$295.7 million for the quarter ended September 30, 2006. We had average borrowed funds of \$17.7 billion and total interest expense of \$155.0 million for the quarter ended September 30, 2005. Our average cost of funds was 5.12% for the quarter ended September 30, 2006 and 3.51% for the quarter ended September 30, 2005. The cost of funds rate increased by 161 basis points and the average borrowed funds increased by \$5.4 billion for the quarter ended September 30, 2006 when compared to the quarter ended September 30, 2005. Interest expense for the quarter increased by \$140.7 million due to the substantial increase in the cost of funds interest rate and the average borrowed funds balance. Our average cost of funds was 0.17% below average one-month LIBOR and 0.31% below average six-month LIBOR for the quarter ended September 30, 2006. Our average cost of funds was 0.03% below average one-month LIBOR and 0.40% below average six-month LIBOR for the quarter ended September 30, 2005.

The table below shows our average borrowed funds and average cost of funds, including the effect of the interest rate swaps, as compared to average one-month and average six-month LIBOR for the quarters ended September 30, 2006, June 30, 2006, March 31, 2006, the year ended December 31, 2005 and the four quarters in 2005.

23

### Average Cost of Funds

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(ratios for the quarters have been annualized, dollars in thousands)

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	Average Borrowed Funds	Interest Expense	Average Cost of Funds	Average One-Month LIBOR	Average Six-Month LIBOR	Average One-Month LIBOR Relative to Average Six-Month LIBOR	Relative to Average Six-Month LIBOR
Quarter Ended September 30, 2006	\$23,120,247	\$295,726	5.12%	5.29%	5.43%	(0.14%)	
Quarter Ended June 30, 2006	\$20,060,978	\$242,473	4.83%	5.03%	5.27%	(0.24%)	
Quarter Ended March 31, 2006	\$15,296,893	\$167,512	4.38%	4.55%	4.84%	(0.29%)	
Year Ended December 31, 2005	\$17,408,828	\$568,560	3.27%	3.33%	3.72%	(0.39%)	
Quarter Ended December 31, 2005	\$16,547,972	\$165,766	4.01%	4.10%	4.46%	(0.36%)	
Quarter Ended September 30, 2005	\$17,672,690	\$155,043	3.51%	3.54%	3.91%	(0.37%)	
Quarter Ended June 30, 2005	\$17,658,408	\$133,758	3.03%	3.05%	3.43%	(0.38%)	
Quarter Ended March 31, 2005	\$17,756,241	\$113,993	2.57%	2.58%	3.02%	(0.44%)	

Net Interest Income

Our net interest income, which equals interest income less interest expense, totaled \$44.0 million for the quarter ended September 30, 2006 and \$22.4 million for the quarter ended September 30, 2005. Our net interest income increased because of the increase in average investment securities and interest rate spread. Our net interest spread, which equals the yield on our average assets for the period less the average cost of funds for the period, was 0.32% for the quarter ended September 30, 2006 as compared to 0.24% for the quarter ended September 30, 2005. This 8 basis point increase was a result of the yield increasing for the quarter ended September 30, 2006 to 5.44% from 3.75% for the quarter ended September 30, 2005. The increase in yield was only partially offset by the increase in cost of funds, which increased to 5.12% for the quarter ended September 30, 2006, as compared to 3.51% for the quarter ended September 30, 2005.

Our net interest income totaled \$109.1 million for the nine months ended September 30, 2006 and \$122.6 million for the nine months ended September 30, 2005. Our net interest income decreased because of the decrease in interest rate spread. Our net interest spread, which equals the yield on our average assets for the period less the average cost of funds for the period, was 0.32% for the nine months ended September 30, 2006 as compared to 0.68% for the quarter ended September 30, 2005.

The table below shows our interest income by average investment securities held, total interest income, yield on average interest earning assets, average repurchase agreements, interest expense, average cost of funds, net interest income, and net interest rate spread for the quarters ended September 30, 2006, June 30, 2006, March 31, 2006 the year ended December 31, 2005, and the four quarters in 2005.

Net Interest Income

(ratios for the quarters have been annualized, dollars in thousand)



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	Average Investment Securities Held -----	Total Interest Income -----	Yield on Average Interest Earning Assets -----	Average Balance of Repurchase Agreements -----	Interest Expense -----	Average Cost of Funds -----
Quarter Ended September 30, 2006	\$24,976,876	\$339,737	5.44%	\$23,120,247	\$295,726	5.12%
Quarter Ended June 30, 2006	\$21,660,089	\$280,171	5.17%	\$20,060,978	\$242,473	4.83%
Quarter Ended March 31, 2006	\$16,590,859	\$194,882	4.70%	\$15,296,893	\$167,512	4.38%
Year Ended December 31, 2005	\$18,543,749	\$705,046	3.80%	\$17,408,827	\$568,560	3.27%
Quarter Ended December 31, 2005	\$17,551,868	\$179,688	4.10%	\$16,547,972	\$165,766	4.01%
Quarter Ended September 30, 2005	\$18,906,350	\$177,474	3.75%	\$17,672,690	\$155,043	3.51%
Quarter Ended June 30, 2005	\$18,918,577	\$171,595	3.63%	\$17,658,408	\$133,758	3.03%
Quarter Ended March 31, 2005	\$18,798,200	\$176,289	3.75%	\$17,756,241	\$113,993	2.57%

24

Investment Advisory and Service Fees

FIDAC is a registered investment advisor which specializes in managing fixed income securities. FIDAC recently expanded its line of business to include the management of equity securities, initially for us and an affiliated person and collateralized debt obligations. FIDAC generally receives annual net investment advisory fees of approximately 10 to 20 basis points of the gross assets it manages, assists in managing or supervises. At September 30, 2006, FIDAC had under management approximately \$2.6 billion in net assets and \$14.6 billion in gross assets, compared to \$2.9 billion in net assets and \$26.8 billion in gross assets at September 30, 2005. Investment advisory and service fees for the quarters ended September 30, 2006 and 2005 totaled \$4.3 million and \$8.5 million respectively, net of fees paid to third parties pursuant to distribution agreements for facilitating and promoting distribution of shares of FIDAC's clients. Gross assets under management will vary from time to time because of changes in the amount of net assets FIDAC manages as well as changes in the amount of leverage used by the various funds and accounts FIDAC manages. At September 30, 2006, net assets under management decreased by \$300 million and gross assets under management decreased by \$12.2 billion, when compared to September 30, 2005. Since the net advisory fees are based on assets under management, the decline in fees is a result of redemptions, reductions in the market value of the assets, and lower leverage in the funds.

Gains and Losses on Sales of Mortgage-Backed Securities

For the quarter ended September 30, 2006, we sold Mortgage-Backed Securities with a carrying value of \$483.5 million for an aggregate loss of \$446,000 and terminated interest rates swap agreements with a notional amount of \$895 million for a gain of \$8.4 million. For the quarter ended September 30, 2005, we sold Mortgage-Backed Securities with an aggregate historical amortized cost of \$151.6 million for an aggregate gain of \$32,000.

For the nine months ended September 30, 2006, we sold Mortgage-Backed Securities with an aggregate historical amortized cost of \$2.5 billion for an aggregate loss of \$8.7 million and terminated interest rate swap agreements with a notional amount of \$895 million for a gain of \$8.4 million. For the nine months ended September 30, 2005, we sold Mortgage-Backed Securities with an

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aggregate historical amortized cost of \$1.1 billion for an aggregate gain of \$12.0 million. The difference between the sale price and the carrying value of our Mortgage-Backed Securities will be a realized gain or a realized loss, and will increase or decrease income accordingly. We do not expect to sell assets on a frequent basis, but may from time to time sell existing assets to acquire new assets, which our management believes might have higher risk-adjusted returns as part of our asset/liability management strategy.

### Impairment of Intangible for Customer Relationships

During the nine months ended September 30, 2006, intangibles were evaluated for possible impairment. It was determined that an impairment charge of \$1.4 million was necessary based on the decline in expected future cash flows on one customer relationship. We also terminated an investment advisory agreement during the nine months ended September 30, 2006. The expected cash flows from the contract were valued as a component of the intangible for customer relationships on June 4, 2004, the date of the acquisition of FIDAC. The value of \$1.1 million was deemed to be impaired. The total impairment of intangible assets relating to customer relationships is \$2.5 million for the nine months ended September 30, 2006. There were no impairment charges during the quarter ended September 30, 2006 and the nine months ended September 30, 2005.

### Loss on Other-Than-Temporarily Impaired Securities

During the third quarter of 2006, the Company reviewed each of its securities to determine if an other-than-temporary impairment charge would be necessary. It was determined that none of the securities that were in an unrealized loss position would be other-than-temporarily impaired. The Company intends to hold them for a period of time, to maturity if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments.

During the first two quarters of 2006, the total loss on other-than-temporarily impaired securities totaled \$46.8 million. For the nine months ended September 30, 2005, there were no charges for other-than-temporarily impaired securities.

25

### General and Administrative Expense

General and administrative ("G&A") expenses were \$11.5 million for the quarter ended September 30, 2006 and \$6.5 million for the quarter ended September 30, 2005. G&A expenses as a percentage of average assets were 0.18% and 0.13% for the quarters ended September 30, 2006 and September 30, 2005, respectively. G&A expenses as a percentage of average equity were 2.08% and 1.58% on an annualized basis for the quarters ended September 30, 2006 and September 30, 2005 respectively. The increase in G&A expenses of \$5.0 million for the quarter ended September 30, 2006 was the primary result of an increase in compensation expense from new and existing employment contracts.

G&A expenses were \$27.7 million for the nine months ended September 30, 2006 and \$20.0 million for the nine months ended September 30, 2005. G&A expenses as a percentage of average assets was 0.17% and 0.14% on an annualized basis for the nine months ended September 30, 2006 and 2005, respectively. G&A expenses as a percentage of average equity were 2.0% and 1.62% on an annualized basis for the nine months ended September 30, 2006 and 2005, respectively.

The table below shows our total G&A expenses as compared to average total assets and average equity for the quarters ended September 30, 2006, June

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30, 2006, March 31, 2006, the year ended December 31, 2005, and the four quarters in 2005.

### G&A Expenses and Operating Expense Ratios

(ratios for the quarters have been annualized, dollars in thousand)

	Total G&A Expenses	Total G&A Expenses/Average Assets (annualized)	Total Expenses Equity (an
Quarter Ended September 30, 2006	\$11,542	0.18%	2.0
Quarter Ended June 30, 2006	\$8,985	0.18%	2.1
Quarter Ended March 31, 2006	\$7,177	0.18%	1.9
Year Ended December 31, 2005	\$26,278	0.14%	1.6
Quarter Ended December 31, 2005	\$6,359	0.14%	1.6
Quarter Ended September 30, 2005	\$6,455	0.13%	1.5
Quarter Ended June 30, 2005	\$6,800	0.14%	1.6
Quarter Ended March 31, 2005	\$6,664	0.14%	1.6

#### Net Income and Return on Average Equity

Our net income was \$42.9 million for the quarter ended September 30, 2006 and \$21.2 million for the quarter ended September 30, 2005. Our annualized return on average equity was 7.72% for the quarter ended September 30, 2006 and 5.20% for the quarter ended September 30, 2005. We attribute the increase in net income and return on average equity to the interest rate spread appreciation for the quarter, net gains on sale of Mortgage-Backed Securities and the termination of interest rate swaps, which were only partially offset by the reduction in net investment advisory fees, and an increase in general and administrative expenses. The increase in spread income for the quarter ended September 30, 2006, as compared to the quarter ended September 30, 2005, totaled \$21.7 million. Net gains on sales of Mortgage-Backed Securities and the termination of interest rate swaps totaled \$7.9 million for the quarter ended September 30, 2006, as compared to \$32,000 for the quarter ended September 30, 2005.

Our net income was \$40.5 million for the nine months ended September 30, 2006 and our net income was \$127.5 million for the nine months ended September 30, 2005. Our annualized net income on average equity was 2.93% for the nine months ended September 30, 2006 and our return was 10.35% for the nine months ended September 30, 2005. We attribute the decrease in net income for the nine months ended September 30, 2006 from the quarter and nine months ended September 30, 2005 to the decline in net interest income, realized losses, impairment charges related to certain securities and intangibles, reduction in net investment advisory fees, and an increase in general and administrative expenses. The table below shows our net interest income, net investment advisory and service fees, gain (loss) on sale of Mortgage-Backed Securities and interest rate swaps, loss on other than temporarily impaired securities, G&A expenses, income from equity investment, income taxes each as a percentage of average equity, impairment of intangibles and the return on average equity for the quarters ended September June 30, 2006, March 31, 2006, the year ended December 31, 2005, and the four quarters in 2005.

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Components of Return on Average Equity

(Ratios for the quarterly periods been annualized)

	Net Interest Income/ Average Equity	Net Investment Advisory and Service Fees/Average Equity	Gain/Loss on Sale of Mortgage -Backed Securities and Interest Rate Swaps/ Average Equity	Loss on other-than- temporarily impaired securities	Income from equity investment	G&A Expense Average Equity
For the Quarter Ended September 30, 2006	7.93%	0.76%	1.44%	-	0.08%	(2.08%)
For the Quarter Ended June 30, 2006	9.20%	1.08%	(0.30%)	(4.91%)	-	(2.19%)
For the Quarter Ended March 31, 2006	7.45%	1.59%	(1.91%)	(7.28%)	-	(1.95%)
For the Year Ended December 31, 2005	8.45%	1.71%	(3.30%)	(5.15%)	-	1.63%
For the Quarter Ended December 31, 2005	3.64%	1.79%	(17.05%)	(21.70%)	-	1.66%
For the Quarter Ended September 30, 2005	5.50%	2.09%	0.01%	-	-	1.58%
For the Quarter Ended June 30, 2005	9.15%	1.82%	2.76%	-	-	1.64%
For the Quarter Ended March 31, 2005	15.06%	1.13%	0.14%	-	-	1.61%

Financial Condition

Investment Securities, Available for Sale

All of our Mortgage-Backed Securities at September 30, 2006 were adjustable-rate or fixed-rate Mortgage-Backed Securities backed by single-family mortgage loans. All of the mortgage assets underlying these Mortgage-Backed Securities were secured with a first lien position on the underlying single-family properties. All of our Mortgage-Backed Securities were FHLMC, FNMA or GNMA mortgage pass-through certificates or collateralized mortgage obligations, which carry an actual or implied "AAA" rating. We mark-to-market all of our Mortgage Backed Securities to fair value.

We accrete discount balances as an increase in interest income over the life of Investment Securities purchased at a discount and we amortize premium balances as a decrease in interest income over the life of the Investment Securities purchased at a premium. At September 30, 2006 and December 31, 2005, we had in our statement of financial condition a total of \$78.8 million and \$21.5 million, respectively, of unamortized discount and a total of \$218.5 million and \$242.1 million, respectively, of unamortized premium.

We received mortgage principal repayments of \$1.3 billion for the

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quarter ended September 30, 2006 and \$2.1 billion for the quarter ended September 30, 2005. The overall prepayment speed for the quarter ended September 30, 2006 decreased to 16%, as compared to 28% for the quarter ended September 30, 2005, due to the decline in refinancing activity. We received mortgage principal repayments of \$3.6 billion for the nine months ended September 30, 2006 and \$5.3 billion for the nine months ended September 30, 2005. The overall prepayment speed for the nine months ended September 30, 2006 decreased to 18%, as compared to 27% for the nine months ended September 30, 2005, due to the decline in refinancing activity. Given our current portfolio composition, if mortgage principal prepayment rates were to increase over the life of our Mortgage-Backed Securities, all other factors being equal, our net interest income would decrease during the life of these Mortgage-Backed Securities as we would be required to amortize our net premium balance over a shorter time period. Similarly, if mortgage principal prepayment rates were to decrease over the life of our Mortgage-Backed Securities, all other factors being equal, our net interest income would increase during the life of these Mortgage-Backed Securities, as we would amortize our net premium balance over a longer time period.

The table below summarizes our Investment Securities, which include Mortgage-Backed Securities and agency debentures, at September 30, 2006, June 30, 2006, March 31, 2006, December 31, 2005, September 30, 2005, June 30, 2005, and March 31, 2005.

27

### Investment Securities

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(dollars in thousands)  
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	Principal Amount	Net Premium	Amortized Cost	Amortized Cost/Principal Amount	Fair Value	Value/P Amo
At September 30, 2006	\$28,297,950	\$139,717	\$28,437,667	100.49%	\$28,348,027	10
At June 30, 2006	\$23,822,683	\$141,671	\$23,964,354	100.59%	\$23,474,006	9
At March 31, 2006	\$16,288,848	\$173,428	\$16,462,276	101.06%	\$16,176,348	9
At December 31, 2005	\$15,915,801	\$220,637	\$16,136,438	101.39%	\$15,929,864	10
At September 30, 2005	\$18,884,571	\$375,985	\$19,260,557	101.99%	\$18,956,001	10
At June 30, 2005	\$19,300,333	\$401,356	\$19,701,690	102.08%	\$19,556,836	10
At March 31, 2005	\$18,887,801	\$416,542	\$19,304,343	102.21%	\$19,091,063	10

The tables below set forth certain characteristics of our Investment Securities. The index level for adjustable-rate Investment Securities is the weighted average rate of the various short-term interest rate indices, which determine the coupon rate of securities.

### Adjustable-Rate Investment Securities Characteristics

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(dollars in thousands)  
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Weighted                      Principal  
Amount at

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	Principal Amount	Weighted Average Coupon Rate	Weighted Average Term to Next Adjustment	Weighted Average Lifetime Cap	Average Asset Yield (annualized)	Period End as of Total Investment Securities
At September 30, 2006	\$8,291,239	5.57%	17 months	9.64%	5.47%	29.30%
At June 30, 2006	\$7,964,221	5.36%	16 months	9.75%	5.26%	33.43%
At March 31, 2006	\$7,785,082	4.99%	20 months	10.27%	5.07%	47.79%
At December 31, 2005	\$9,699,133	4.76%	22 months	10.26%	4.74%	60.94%
At September 30, 2005	\$12,437,763	4.56%	23 months	10.26%	3.91%	65.86%
At June 30, 2005	\$12,934,382	4.43%	24 months	10.30%	3.69%	67.02%
At March 31, 2005	\$13,464,087	4.29%	22 months	10.06%	3.46%	71.28%

Fixed-Rate Investment Securities Characteristics

(dollars in thousands)

	Principal Amount	Weighted Average Coupon Rate (annualized)	Weighted Average Asset Yield (annualized)	Principal Amount at Period End as % of Total Investment Securities
At September 30, 2006	\$20,006,711	5.82%	5.62%	70.70%
At June 30, 2006	\$15,858,461	5.73%	5.50%	66.57%
At March 31, 2006	\$8,503,766	5.43%	4.99%	52.21%
At December 31, 2005	\$6,216,668	5.37%	4.60%	39.06%
At September 30, 2005	\$6,446,808	5.23%	4.06%	34.14%
At June 30, 2005	\$6,365,952	5.22%	3.96%	32.98%
At March 31, 2005	\$5,423,714	5.31%	3.99%	28.72%

28

The following tables provide information on adjustable-rate Investment Securities by index at September 30, 2006, and December 31, 2005.

Adjustable-Rate Investment Securities by Index

September 30, 2006

One- Month Libor	Six- Month Libor	Twelve Month Libor	Six- Month Auction Average	12-Month Moving Average	11th District Cost of Funds	National Average Mortgage Rate	Six- Month CD	1-Year Treasury Index	2-Year Treasury Index	3-Year Treasury Index
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Weighted Average Term to Next Adjustment	1 mo.	39 mo.	33 mo.	6 mo.	1 mo.	1 mo.	9 mo.	4 mo.	13 mo.	14 mo.	18 mo.
Weighted Average Annual Period Cap	6.71%	2.00%	2.00%	1.00%	0.21%	0.00%	2.00%	1.00%	1.89%	2.00%	2.03%
Weighted Average Lifetime Cap at September 30, 2006	7.32%	11.02%	10.49%	12.95%	10.57%	12.08%	10.90%	10.96%	10.76%	11.93%	13.17%
Investment Principal Amount as Percentage of Investment Securities at June 30, 2006	9.48%	2.87%	8.77%	0.00%	0.08%	0.46%	0.04%	0.01%	7.10%	0.00%	0.12%

Adjustable-Rate Investment Securities by Index

December 31, 2005

	One- Month Libor	Six- Month Libor	Twelve Month Libor	Six- Month Auction Average	12-Month Moving Average	11th District Cost of Funds	National Average Mortgage Rate	Six- Month CD Rate	1-Year Treasury Index	2-Year Treasury Index	3- Year Treasury Index
Weighted Average Term to Next Adjustment	1 mo.	42 mo.	22 mo.	2 mo.	2 mo.	1 mo.	17mo.	3 mo.	18 mo.	14 mo.	
Weighted Average Annual Period Cap	7.29%	2.00%	2.00%	1.00%	0.16%	0.00%	2.00%	1.00%	1.90%	2.00%	
Weighted Average Lifetime Cap at December 31, 2005	7.98%	10.78%	10.33%	13.03%	10.61%	12.07%	10.90%	11.74%	10.54%	11.93%	
Investment Principal Value as Percentage of Investment Securities at December 31, 2005	6.33%	6.42%	24.46%	0.01%	0.19%	0.94%	0.01%	0.03%	21.55%	0.01%	

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### Trading securities and Trading Securities Sold, not yet purchased

Trading securities and trading securities sold, not yet purchased are included in the balance sheet as a result of consolidating the financial statements of an affiliated investment fund. Trading securities owned and trading account securities sold, not yet purchased consisted of securities at fair values as of September 30, 2006. The resulting realized and unrealized gains and losses are reflected in principal transactions in the statements of operations. The fair value of the trading securities was \$23.4 million and the trading securities sold, not yet purchased was \$29.7 million at September 30, 2006. The notional value of the swaps entered into by the investment fund are not included in either the trading securities or trading securities sold. The net market value is reflected in trading securities. In the third quarter earnings release, the trading securities and trading securities sold were shown on a gross basis, which included the notional value of the swaps. The presentation of the notional value of the swaps had no effect on a net basis because the notional value was included in both the assets and liabilities of the Company on a consolidated basis.

29

### Borrowings

To date, our debt has consisted entirely of borrowings collateralized by a pledge of our Investment Securities. These borrowings appear on our balance sheet as repurchase agreements. At September 30, 2006, we had established uncommitted borrowing facilities in this market with 35 lenders in amounts which we believe are in excess of our needs. All of our Investment Securities are currently accepted as collateral for these borrowings. However, we limit our borrowings, and thus our potential asset growth, in order to maintain unused borrowing capacity and thus increase the liquidity and strength of our financial condition.

For the quarter ended September 30, 2006, the term to maturity of our borrowings ranged from one day to three years, with a weighted average original term to maturity of 108 days. For the quarter ended September 30, 2005, the term to maturity of our borrowings ranged from one day to three years, with a weighted average original term to maturity of 137 days. At September 30, 2006, the weighted average cost of funds for all of our borrowings was 5.12% and the weighted average term to next rate adjustment was 35 days. At September 30, 2005, the weighted average cost of funds for all of our borrowings was 3.69% and the weighted average term to next rate adjustment was 74 days.

### Liquidity

Liquidity, which is our ability to turn non-cash assets into cash, allows us to purchase additional investment securities and to pledge additional assets to secure existing borrowings should the value of our pledged assets decline. Our potential immediate sources of liquidity include cash balances and unused borrowing capacity. Unused borrowing capacity will vary over time as the market value of our investment securities varies. Liquidity is also generated on an on-going basis through mortgage principal repayments and net earnings retained prior to payment as dividends to our shareholders. Should our needs ever exceed these on-going sources of liquidity plus the immediate sources of liquidity discussed above, we believe that in most circumstances our investment securities could be sold to raise cash. The maintenance of liquidity is one of the goals of our capital investment policy. Under this policy, we limit asset growth in order to preserve unused borrowing capacity for liquidity management purposes.



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Borrowings under our repurchase agreements increased by \$11.3 billion to \$24.9 billion at September 30, 2006 from \$13.6 billion at December 31, 2005. The increase in our repurchase agreements was a direct result of the increase in our equity base from common stock offerings and a Series B Preferred offering during the second and third quarters of 2006.

We anticipate that, upon repayment of each borrowing under a repurchase agreement, we will use the collateral immediately for borrowing under a new repurchase agreement. We have not at the present time entered into any commitment agreements under which the lender would be required to enter into a new repurchase agreement during a specified period of time, nor do we presently plan to have liquidity facilities with commercial banks.

Under our repurchase agreements, we may be required to pledge additional assets to our repurchase agreement counterparties (i.e., lenders) in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (a "margin call"), which may take the form of additional securities or cash. Similarly, if the estimated fair value of the Mortgage-Backed Securities increases due to changes in market interest rates or market factors, lenders may release collateral back to us. Specifically, margin calls result from a decline in the value of the our Mortgage-Backed Securities securing our repurchase agreements, prepayments on the mortgages securing such Mortgage-Backed Securities and to changes in the estimated fair value of such Mortgage-Backed Securities generally due to principal reduction of such Mortgage-Backed Securities from scheduled amortization and resulting from changes in market interest rates and other market factors. Through September 30, 2006, we did not have any margin calls on our repurchase agreements that we were not able to satisfy with either cash or additional pledged collateral. However, should prepayment speeds on the mortgages underlying our Mortgage-Backed Securities and/or market interest rates suddenly increase, margin calls on our repurchase agreements could result, causing an adverse change in our liquidity position.

30

The following table summarizes the effect on our liquidity and cash flows from contractual obligations at September 30, 2006.

	Within One Year	One to Three Years	Three to Five Years	More than Five Years	
	----- (dollars in thousands) -----				
Repurchase agreements	\$24,601,420	\$300,000	-	-	\$
Interest expense on repurchase agreements	89,519	12,727			
Long-term operating lease obligations	528	1,056	132	-	
Employment contracts	18,614	1,036			
	-----				
Total	\$24,710,081	\$314,819	-	-	\$
	=====				

Stockholders' Equity

During the quarter ended September 30, 2006 the Company declared

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dividends to common shareholders totaling \$28.7 million or \$0.14 per share, which were paid on October 27, 2006. During the quarter ended September 30, 2006, the Company declared dividends to Series A Preferred shareholders totaling \$3.6 million or \$0.492188 per share, and Series B Preferred shareholders totaling \$1.7 million or \$0.375 per share which were paid September 30, 2006.

On August 16, 2006, the Company entered into an underwriting agreement pursuant to which it sold 40,825,000 shares of its common stock for net proceeds before expenses of approximately \$476.7 million. This transaction settled on August 22, 2006.

On April 6, 2006, the Company entered into an underwriting agreement pursuant to which it sold 39,215,000 shares of its common stock for net proceeds before expenses of approximately \$437.7 million. On April 6, 2006, the Company entered into a second underwriting agreement pursuant to which it sold 4,600,000 shares of its 6% Series B Cumulative Convertible Preferred Stock for net proceeds before expenses of approximately \$111.5 million. Each of these transactions settled on April 12, 2006. The 6% Series B Cumulative Preferred Stock has been treated under GAAP as temporary equity. For the purpose of computing ratios relating to equity measures, the Series B Preferred Stock has been included in equity. During the quarter ended September 30, 2005, the Company declared dividends to common shareholders totaling \$16.1 million or \$0.13 per share, which was paid on October 27, 2005.

On August 3, 2006, the Company entered into an ATM Equity Offering (sm) Sales Agreement with Merrill Lynch & Co. and Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), relating to the sale of shares of its common stock from time to time through Merrill Lynch. Sales of the shares, if any, will be made by means of ordinary brokers' transaction on the New York Stock Exchange. During the quarter ended September 30, 2006, no shares of the Company's common stock were issued pursuant to this program.

On August 3, 2006, the Company entered into an ATM Equity Sales Agreement with UBS Securities LLC ("UBS Securities"), relating to the sale of shares of its common stock from time to time through UBS Securities. Sales of the shares, if any, will be made by means of ordinary brokers' transaction on the New York Stock Exchange. During the quarter ended September 30, 2006, no shares of the Company's common stock were issued pursuant to this program.

No shares of the Company's common stock were issued through the Company's previously existing equity shelf program during the quarter ended September 30, 2006.

During the quarter ended September 30, 2005, the Company declared dividends to Series A preferred shareholders totaling \$3.6 million or \$0.492218 per share, which were paid on September 30, 2005. In addition, the Company sold 7,153 common shares through the dividend reinvestment and direct purchase program for \$114,000 during the quarter ended September 30, 2005. During the quarter ended September 30, 2005, the Company raised \$17.0 million in the equity shelf program by issuing 1,122,947 common shares.

With our "available-for-sale" accounting treatment, unrealized fluctuations in market values of assets do not impact our GAAP or taxable income but rather are reflected on our balance sheet by changing the carrying value of the asset and stockholders' equity under "Accumulated Other Comprehensive Income (Loss)."

The table below shows unrealized gains and losses on the Investment Securities and interest rate swaps in our portfolio.

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	Unrealized Gains and Losses				
	(dollars in thousands)				
	At September 30, 2006	At June 30, 2006	At March 31, 2006	At December, 31 2005	At Septembe 200
Unrealized gain	\$100,229	\$110,755	\$41,470	\$5,027	\$6,1
Unrealized loss	(220,202)	(495,667)	(290,929)	(212,145)	(310,6
Net Unrealized loss	(\$119,973)	(\$384,912)	(\$249,459)	(\$206,118)	(\$304,5
Net unrealized loss as % of Investment Securities' principal amount	(0.42%)	(1.62%)	(1.53%)	(1.30%)	(1.6
Net unrealized loss as % of Investment Securities' Amortized Cost	(0.42%)	(1.61%)	(1.52%)	(1.28%)	(1.5

Unrealized changes in the estimated net market value of Investment Securities and interest rate swaps have a direct effect on our potential earnings and dividends: positive mark-to-market changes increase our equity base and allow us to increase our borrowing capacity while negative changes tend to limit borrowing capacity under our capital investment policy. A very large negative change in the net market value of our Investment Securities and interest rate swaps may impair our liquidity position, requiring us to sell assets with the likely result of realized losses upon sale. The net unrealized loss on available for sale securities was \$220.2 million, or (0.42%) of the amortized cost of our Investment Securities and interest rate swaps as of September 30, 2006 and \$206.6 million, or (1.28%) of the amortized cost of our Investment Securities and interest rate swaps as of December 31, 2005.

Mortgage-Backed Securities with a carrying value of \$7.6 billion were in a continuous unrealized loss position over 12 months at September 30, 2006 in the amount of \$156.8 million. Mortgage-Backed Securities with a carrying value of \$5.5 billion were in a continuous unrealized loss position for less than 12 months at September 30, 2006 in the amount of \$33.1 million. Mortgage-Backed Securities with a carrying value of \$4.6 billion were in a continuous unrealized loss position over 12 months at December 31, 2005 in the amount of \$111.1 million. Mortgage-Backed Securities with a carrying value of \$8.4 billion were in a continuous unrealized loss position for less than 12 months at December 31, 2005 in the amount of \$100.5 million. The decline in value of these securities is solely due to increases in interest rates. All of the Mortgage-Backed Securities are "AAA" rated or carry an implied "AAA" rating. Also, the Company is guaranteed payment on the par value of the securities.

With the continued increase in the Federal Funds rate during the fourth quarter of 2005 and first and second quarter of 2006, management determined that it did not intend to hold certain of its securities until maturity and would reposition a portion of its assets. The Company recorded an impairment charge of \$20.1 million, \$26.7 million and \$83.1 million for these securities during the second quarter of 2006, first quarter of 2006 and fourth quarter of 2005 respectively. The remaining investments are not considered other-than-temporarily impaired since the Company currently has the ability and

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intent to hold the investments for a period of time or to maturity, if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments.

### Leverage

Our debt-to-equity ratio at September 30, 2006 and September 30, 2005 was 9.6:1 and 10.9:1 respectively. We generally expect to maintain a ratio of debt-to-equity of between 8:1 and 12:1, although the ratio may vary from this range from time to time based upon various factors, including our management's opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity and over-collateralization levels required by lenders when we pledge assets to secure borrowings.

Our target debt-to-equity ratio is determined under our capital investment policy. Should our actual debt-to-equity ratio increase above the target level due to asset acquisition or market value fluctuations in assets, we will cease to acquire new assets. Our management will, at that time, present a plan to our Board of Directors to bring us back to our target debt-to-equity ratio; in many circumstances, this would be accomplished over time by the monthly reduction of the balance of our Mortgage-Backed Securities through principal repayments.

32

### Asset/Liability Management and Effect of Changes in Interest Rates

We continually review our asset/liability management strategy with respect to interest rate risk, mortgage prepayment risk, credit risk and the related issues of capital adequacy and liquidity. We seek attractive risk-adjusted stockholder returns while maintaining a strong balance sheet.

We seek to manage the extent to which our net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. In addition, we may seek to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in our portfolio of Investment Securities by entering into interest rate agreements such as interest rate caps and interest rate swaps, and investing in inverse floaters. At September 30, 2006, we entered into swap agreements with a total notional amount of \$9.2 billion. Pursuant to these swaps, we are required to pay a weighted average pay rate of 5.19% and receive a floating rate based on one month LIBOR. At December 31, 2005, we entered into swap agreements with a total notional amount of \$479.0 million. Pursuant to these swaps, we are required to pay a weighted average pay rate of 4.88% and receive a floating rate based on one month LIBOR. We may enter into similar derivative transactions by entering into interest rate collars, caps or floors, and by investing in inverse floaters.

Changes in interest rates may also have an effect on the rate of mortgage principal prepayments and, as a result, prepayments on Mortgage-Backed Securities. We will seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets we purchase at a premium with assets we purchase at a discount. To date, the aggregate premium exceeds the aggregate discount on our Mortgage-Backed Securities. As a result, prepayments, which result in the expensing of unamortized premium, will reduce our net income compared to what net income would be absent such prepayments.

### Off-Balance Sheet Arrangements

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance

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or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities nor do we have any commitment or intent to provide funding to any such entities. As such, we are not materially exposed to any market, credit, liquidity or financing risk that could arise if we had engaged in such relationships.

### Capital Resources

At September 30, 2006, we had no material commitments for capital expenditures.

### Inflation

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates and other factors drive our performance far more than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our dividends based upon our net income as calculated for tax purposes; in each case, our activities and balance sheet are measured with reference to historical cost or fair market value without considering inflation.

### Other Matters

We calculate that our qualified REIT assets, as defined in the Code, were almost 99% of our total assets at September 30, 2006 and December 31, 2005 as compared to the Code requirement that at least 75% of our total assets be qualified REIT assets. We also calculate that 98% and 99% of our revenue qualifies for the 75% source of income test, and 100% of our revenue qualifies for the 95% source of income test, under the REIT rules for the quarters ended September 30, 2006 and September 30, 2005 respectively. We also met all REIT requirements regarding the ownership of our common stock and the distribution of our net income. Therefore, as of September 30, 2006 and December 31, 2005 we believe that we qualified as a REIT under the Code.

33

We at all times intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act. If we were to become regulated as an investment company, then our use of leverage would be substantially reduced. The Investment Company Act exempts entities that are "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" (qualifying interests). Under current interpretation of the staff of the SEC, in order to qualify for this exemption, we must maintain at least 55% of our assets directly in qualifying interests and at least 80% of our assets in qualifying interests plus other real estate related assets. In addition, unless certain mortgage securitites represent all the certificates issued with respect to an underlying pool of mortgages, the Mortgage-Backed Securities may be treated as securities separate from the underlying mortgage loans and, thus, may not be considered qualifying interests for purposes of the 55% requirement. We calculate that as of September 30, 2006 and December 31, 2005 we were in compliance with this requirement.

34

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### MARKET RISK

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risk to which we are exposed is interest rate risk, which is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities, by affecting the spread between our interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of our Mortgage-Backed Securities and our ability to realize gains from the sale of these assets. We may utilize a variety of financial instruments, including interest rate swaps, caps, floors, inverse floaters and other interest rate exchange contracts, in order to limit the effects of interest rates on our operations. When we use these types of derivatives to hedge the risk of interest-earning assets or interest-bearing liabilities, we may be subject to certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of securities and that the losses may exceed the amount we invested in the instruments.

Our profitability and the value of our portfolio (including interest rate swaps) may be adversely affected during any period as a result of changing interest rates. The following table quantifies the potential changes in net interest income and portfolio value should interest rates go up or down 25, 50, and 75 basis points, assuming the yield curves of the rate shocks will be parallel to each other and the current yield curve. All changes in income and value are measured as percentage changes from the projected net interest income and portfolio value at the base interest rate scenario. The base interest rate scenario assumes interest rates at September 30, 2006 and various estimates regarding prepayment and all activities are made at each level of rate shock. Actual results could differ significantly from these estimates.

Change in Interest Rate	Projected Percentage Change in Net Interest Income	Projected Percentage Portfolio Value
-75 Basis Points	22.83%	1.76%
-50 Basis Points	14.41%	1.37%
-25 Basis Points	6.82%	0.88%
Base Interest Rate	-	-
+25 Basis Points	(6.96%)	(0.37%)
+50 Basis Points	(14.04%)	(1.14%)
+75 Basis Points	(21.22%)	(2.00%)

### ASSET AND LIABILITY MANAGEMENT

Asset and liability management is concerned with the timing and magnitude of the repricing of assets and liabilities. We attempt to control risks associated with interest rate movements. Methods for evaluating interest rate risk include an analysis of our interest rate sensitivity "gap", which is the difference between interest-earning assets and interest-bearing liabilities maturing or repricing within a given time period. A gap is considered positive when the amount of interest-rate sensitive assets exceeds the amount of interest-rate sensitive liabilities. A gap is considered negative when the

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amount of interest-rate sensitive liabilities exceeds interest-rate sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall market rates or conditions, changes in interest rates may affect net interest income positively or negatively even if an institution were perfectly matched in each maturity category.

35

The following table sets forth the estimated maturity or repricing of our interest-earning assets and interest-bearing liabilities at September 30, 2006. The amounts of assets and liabilities shown within a particular period were determined in accordance with the contractual terms of the assets and liabilities, except adjustable-rate loans, and securities are included in the period in which their interest rates are first scheduled to adjust and not in the period in which they mature and does not include the affect of the interest rate swaps. The interest rate sensitivity of our assets and liabilities in the table could vary substantially if based on actual prepayment experience.

	Within 3 Months	4-12 Months	More than 1 Year to 3 Years	3 Years Over
	-----			
	(dollars in thousands)			
Rate Sensitive Assets:				
Investment Securities	\$3,305,327	\$1,622,633	\$3,860,281	\$19,
Rate Sensitive Liabilities:				
Repurchase Agreements	23,401,420	1,200,000	300,000	
	-----			
Interest rate sensitivity gap	(\$20,096,093)	\$422,633	\$3,560,281	\$19,
	=====			
Cumulative rate sensitivity gap	(\$20,096,093)	(\$19,673,460)	(\$16,113,179)	\$3,
	=====			
Cumulative interest rate sensitivity gap as a percentage of total rate-sensitive assets	(71%)	(70%)	(57%)	

Our analysis of risks is based on management's experience, estimates, models and assumptions. These analyses rely on models which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of investment decisions by our management may produce results that differ significantly from the estimates and assumptions used in our models and the projected results shown in the above tables and in this report. These analyses contain certain forward-looking statements and are subject to the safe harbor statement set forth under the heading, "Special Note Regarding Forward-Looking Statements."

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### ITEM 4. CONTROLS AND PROCEDURES

Our management, including our Chief Executive Officer (the "CEO") and Chief Financial Officer (the "CFO"), reviewed and evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) of the Securities Exchange Act) as of the end of the period covered by this quarterly report. Based on that review and evaluation, the CEO and CFO have concluded that our current disclosure controls and procedures, as designed and implemented, (1) were effective in ensuring that information regarding the Company and its subsidiaries is made known to our management, including our CEO and CFO, by our employees, as appropriate to allow timely decisions regarding required disclosure and (2) were effective in providing reasonable assurance that information the Company must disclose in its periodic reports under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods prescribed by the SEC's rules and forms. There have been no changes in our internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonable likely to materially affect our internal control over financial reporting.

36

### PART II. OTHER INFORMATION

#### Item 1. LEGAL PROCEEDINGS

From time to time, we are involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on our consolidated financial statements.

#### Item 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2005, which could materially affect our business, financial condition or future results. The information presented below updates and should be read in conjunction with the risk factors and information disclosed in that Form 10-K.

We may face risks of investing in inverse floating rate securities.

We may also invest in inverse floaters. The returns on inverse floaters are inversely related to changes in an interest rate. Generally, income on inverse floaters will decrease when interest rates increase and increase when interest rates decrease. Investments in inverse floaters may subject us to the risks of reduced or eliminated interest payments and losses of principal. In addition, certain indexed securities and inverse floaters may increase or decrease in value at a greater rate than the underlying interest rate, which effectively leverages our investment in such securities. As a result, the market value of such securities will generally be more volatile than that of fixed rate securities.

Our operations may be adversely affected if we are subject to the Investment Company Act.



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We rely on the exclusion provided by Section 3(c)(5)(C) of the Investment Company Act of 1940, as amended (or Investment Company Act). Section 3(c)(5)(C), as interpreted by the staff of the SEC, requires us to invest at least 55% of our assets in "mortgages and other liens on and interests in real estate" (or Qualifying Real Estate Assets) and at least 80% of our assets in Qualifying Real Estate Assets plus real estate related assets. The assets that we acquire, therefore, are limited by the provisions of the Investment Company Act and the rules and regulations promulgated under the Investment Company Act. If the Securities and Exchange Commission determines that any of these securities are not qualifying interests in real estate or real estate related assets, adopts a contrary interpretation with respect to these securities or otherwise believes we do not satisfy the above exceptions, we could be required to restructure our activities or sell certain of our assets. We may be required at times to adopt less efficient methods of financing certain of our mortgage assets and we may be precluded from acquiring certain types of higher-yielding mortgage assets. The net effect of these factors will be to lower our net interest income. If we fail to qualify for exemption from registration as an investment company, our ability to use leverage would be substantially reduced, and we would not be able to conduct our business as described. Our business will be materially and adversely affected if we fail to qualify for this exemption.

### ITEM 6. EXHIBITS

#### Exhibits

The exhibits required by this item are set forth on the Exhibit Index attached hereto.

Exhibit Number	Exhibit Description
3.1	Articles of Amendment and Restatement of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.2 to the Registrant's Registration Statement on Form S-11 (Registration No. 333-32913) filed with the Securities and Exchange Commission on August 5, 1997).
3.2	Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant's Registration Statement on Form S-3 (Registration Statement 333-74618) filed with the Securities and Exchange Commission on June 12, 2002).
3.3	Articles of Amendment of the Articles of Incorporation of the Registrant (incorporated by reference to Exhibit 3.1 of the Registrant's Form 8-K (filed with the Securities and Exchange Commission on August 3, 2006).
3.4	Form of Articles Supplementary designating the Registrant's 7.875% Series A Cumulative Redeemable Preferred Stock, liquidation preference \$25.00 per share (incorporated by reference to Exhibit 3.3 to the Registrant's 8-A filed April 1, 2004).
3.5	Articles Supplementary of the Registrant designating an additional 2,750,000 shares of the Company's 7.875% Series A Cumulative Redeemable Preferred Stock, as filed with the State Department of Assessments and Taxation of Maryland on October 15, 2004 (incorporated by reference to Exhibit 3.2

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to the Registrant's 8-K filed October 4, 2004).

- 3.6 Articles Supplementary designating the Registrant's 6% Series B Cumulative convertible Preferred Stock, liquidation preference \$25.00 per share (incorporated by reference to Exhibit 3.1 to the Registrant's 8-K filed April 10, 2006).
- 3.7 Bylaws of the Registrant, as amended (incorporated by reference to Exhibit 3.3 to the Registrant's Registration Statement on Form S-11 (Registration No. 333-32913) filed with the Securities and Exchange Commission on August 5, 1997).
- 31.1 Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Chief Executive Officer, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer, pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

38

### SIGNATURES

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

ANNALY CAPITAL MANAGEMENT, INC.

Dated: November 8, 2006

By:/s/ Michael A.J. Farrell

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Michael A.J. Farrell  
(Chairman of the Board, Chief  
Executive Officer, President and  
authorized officer of registrant)

Dated: November 8, 2006

By:/s/ Kathryn F. Fagan

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Kathryn F. Fagan  
(Chief Financial Officer and  
Treasurer and principal financial  
and chief accounting officer)

39