

PennyMac Mortgage Investment Trust
Form 10-K
February 28, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2012

Or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to _____

Commission file number: 001-34416

PennyMac Mortgage Investment Trust

(Exact name of registrant as specified in its charter)

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Maryland
(State or other jurisdiction of
incorporation or organization)

27-0186273
(IRS Employer
Identification No.)

6101 Condor Drive, Moorpark, California
(Address of principal executive offices)

93021
(Zip Code)

(818) 224-7442

(Registrant's telephone number, including area code)

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

Title of Each Class	Name of Each Exchange on Which Registered
Common Shares of Beneficial Interest, \$0.01 Par Value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of June 30, 2012 the aggregate market value of the registrant's common shares of beneficial interest, \$0.01 par value (common shares), held by non-affiliates was \$801,056,084 based on the closing price as reported on the New York Stock Exchange on that date.

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As of February 26, 2013, there were 58,906,706 common shares of the registrant outstanding.

Documents Incorporated By Reference

Document	Parts Into Which Incorporated Part III
Definitive Proxy Statement for 2013 Annual Meeting of Shareholders	

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PENNYMAC MORTGAGE INVESTMENT TRUST

FORM 10-K

December 31, 2012

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K (Report) contains certain forward-looking statements that are subject to various risks and uncertainties. Forward-looking statements are generally identifiable by use of forward-looking terminology such as may, will, should, potential, intend, expect, seek, anticipate, estimate, approximately, believe, could, project, predict, continue, plan or other similar words or expressions.

Forward-looking statements are based on certain assumptions, discuss future expectations, describe future plans and strategies, contain financial and operating projections or state other forward-looking information. Examples of forward-looking statements include the following:

projections of our revenues, income, earnings per share, capital structure or other financial items;

descriptions of our plans or objectives for future operations, products or services;

forecasts of our future economic performance, interest rates, profit margins and our share of future markets; and

descriptions of assumptions underlying or relating to any of the foregoing expectations regarding the timing of generating any revenues.

Our ability to predict results or the actual effect of future events, actions, plans or strategies is inherently uncertain. Although we believe that the expectations reflected in such forward-looking statements are based on reasonable assumptions, our actual results and performance could differ materially from those set forth in the forward-looking statements. There are a number of factors, many of which are beyond our control, that could cause actual results to differ significantly from management's expectations. Some of these factors are discussed below.

You should not place undue reliance on any forward-looking statement and should consider the following uncertainties and risk factors, as well as the risks, risk factors and uncertainties discussed elsewhere in this Report and any subsequent Quarterly Reports on Form 10-Q.

Factors that could cause actual results to differ materially from historical results or those anticipated include, but are not limited to:

changes in our investment objectives or investment or operational strategies, including any new lines of business or new products and services that may subject us to additional risks;

volatility in our industry, the debt or equity markets, the general economy or the residential finance and real estate markets specifically, whether the result of market events or otherwise;

events or circumstances which undermine confidence in the financial markets or otherwise have a broad impact on financial markets, such as the sudden instability or collapse of large depository institutions or other significant corporations, terrorist attacks, natural or man-made disasters, or threatened or actual armed conflicts;

changes in general business, economic, market, employment and political conditions, or in consumer confidence and spending habits from those expected;

continued declines in residential real estate or significant changes in U.S. housing prices or activity in the U.S. housing market;

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the availability of, and level of competition for, attractive risk-adjusted investment opportunities in residential mortgage loans and mortgage-related assets that satisfy our investment objectives;

the inherent difficulty in winning bids to acquire distressed loans or correspondent loans, and our success in doing so;

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the concentration of credit risks to which we are exposed;

the degree and nature of our competition;

changes in personnel and lack of availability of qualified personnel;

our dependence on our manager and servicer, potential conflicts of interest with such entities, and the performance of such entities;

the availability, terms and deployment of short-term and long-term capital;

the adequacy of our cash reserves and working capital;

our ability to match the interest rates and maturities of our assets with our financing;

the timing and amount of cash flows, if any, from our investments;

unanticipated increases or volatility in financing and other costs, including a rise in interest rates;

the performance, financial condition and liquidity of borrowers;

incomplete or inaccurate information or documentation provided by customers or counterparties, or adverse changes in the financial condition of our customers and counterparties;

the quality and enforceability of the collateral documentation evidencing our ownership and rights in the assets in which we invest;

increased rates of delinquency, default and/or decreased recovery rates on our investments;

our ability to foreclose on our investments in a timely manner or at all;

increased prepayments of the mortgages and other loans underlying our mortgage-backed securities and other investments;

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

the effect of the accuracy of or changes in the estimates we make about uncertainties and contingencies when measuring and reporting upon our financial condition and results of operations;

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our failure to maintain appropriate internal controls over financial reporting;

our ability to obtain and/or maintain licenses and other approvals in those jurisdictions where required to conduct our business;

our ability to comply with various federal, state and local laws and regulations that govern our business;

developments in the secondary markets for our mortgage loan products;

legislative and regulatory changes that impact the mortgage loan industry or housing market;

changes in regulations or the occurrence of other events that impact the business, operations or prospects of government agencies such as the Government National Mortgage Association (Ginnie Mae), the Federal Housing Administration (the FHA) or the Veterans Administration (the VA), or government-sponsored entities such as the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac) (Fannie Mae, Freddie Mac and Ginnie Mae are each referred to as an Agency and, collectively, as the Agencies), or such changes that increase the cost of doing business with such entities;

the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) and its implementing regulations and regulatory agencies, and any other legislative and regulatory changes that impact the business, operations or governance of mortgage lenders and/or publicly-traded companies;

the creation of the Consumer Financial Protection Bureau (CFPB), its recently issued and future rules and the enforcement thereof by the CFPB;

changes in government support of homeownership;

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changes in government or government-sponsored home affordability programs;

changes in governmental regulations, accounting treatment, tax rates and similar matters (including changes to laws governing the taxation of real estate investment trusts (REITs), or the exclusions from registration as an investment company);

limitations imposed on our business and our ability to satisfy complex rules for us to qualify as a REIT for U.S. federal income tax purposes and qualify for an exclusion from the Investment Company Act of 1940 (the Investment Company Act) and the ability of certain of our subsidiaries to qualify as REITs or as taxable REIT subsidiaries (TRSs) for U.S. federal income tax purposes, as applicable, and our ability and the ability of our subsidiaries to operate effectively within the limitations imposed by these rules;

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

the effect of public opinion on our reputation; and

the occurrence of natural disasters or other events or circumstances that could impact our operations.

Other factors that could also cause results to differ from our expectations may not be described in this Report or any other document. Each of these factors could by itself, or together with one or more other factors, adversely affect our business, results of operations and/or financial condition.

Forward-looking statements speak only as of the date they are made, and we undertake no obligation to update any forward-looking statement to reflect the impact of circumstances or events that arise after the date the forward-looking statement was made.

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PART I

Item 1. Business

The following description of our business should be read in conjunction with the information included elsewhere in this Report. This description contains forward-looking statements that involve risks and uncertainties. Actual results could differ significantly from the projections and results discussed in the forward-looking statements due to the factors described under the caption "Risk Factors" and elsewhere in this Report. References in this Report to we, our, us, PMT, or the Company refer to PennyMac Mortgage Investment Trust and its consolidated subsidiaries, unless otherwise indicated.

Our Company

We are a specialty finance company that invests primarily in residential mortgage loans and mortgage-related assets. We were organized in Maryland on May 18, 2009, and began operations on August 4, 2009. We conduct substantially all of our operations, and make substantially all of our investments, through PennyMac Operating Partnership, L.P. (our Operating Partnership), and its subsidiaries. A wholly-owned subsidiary of ours is the sole general partner, and we are the sole limited partner, of our Operating Partnership.

The management of our business and execution of our operations is performed on our behalf by subsidiaries of Private National Mortgage Acceptance Company, LLC (PNMAC or PennyMac), which was designed specifically to address the opportunities created in the markets for residential mortgage assets. Specifically:

We are managed by PNMAC Capital Management, LLC (PCM or our Manager), a wholly-owned subsidiary of PennyMac and an investment adviser registered with the Securities and Exchange Commission (SEC) that specializes in, and focuses on, residential mortgage assets.

All of the loans we acquire in our correspondent lending operations are acquired, pooled for sale, sold and/or securitized on our behalf by another wholly-owned PennyMac subsidiary, PennyMac Loan Services, LLC (PLS or our Servicer), which also subservices most of the loans we hold in our investment portfolio and all of the loans for which we retain the obligation to service as a result of our correspondent lending operations.

Our objective is to provide attractive risk-adjusted returns to our investors over the long-term, primarily through dividends and secondarily through capital appreciation. Our targeted investments are in the U.S. residential mortgage market. We are presently focused on investing in the historically large volume of distressed mortgage loans available for acquisition from financial institutions and engaging in correspondent lending, whereby we acquire, pool and sell or securitize newly originated mortgage loans.

Correspondent lending includes the acquisition of newly originated, prime credit quality, first-lien residential mortgage loans that have been underwritten to investor guidelines, pooling loans into mortgage-backed securities (MBS) and resale of the resulting securities into the secondary markets. We purchase government and government-sponsored entity (GSE) eligible loans and jumbo loans. A jumbo loan is a loan in an amount that exceeds the maximum loan amount for eligible loans under GSE guidelines. We then sell or securitize GSE eligible loans, which we sell or securitize through the GSEs on a servicing-retained basis whereby we retain the related mortgage servicing rights (MSR); government loans (insured by the FHA or guaranteed by the VA), which we sell to PLS, a Ginnie Mae approved issuer and servicer; and jumbo mortgage loans, which we sell to third parties, generally on a servicing-retained basis.

Our correspondent lending business has grown through purchases from approved mortgage originators that meet specific criteria related to management experience, financial strength, risk management controls and loan quality. The management team of PLS and PCM has prior experience with the majority of these mortgage originators. As of December 31, 2012, 140 sellers have been approved, primarily independent mortgage originators and small banks located across the United States. We purchased approximately \$22.4 billion at fair

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value of loans in 2012, including \$13.4 billion of conventional loans and \$9.0 billion of government-insured loans. In the third quarter of 2012, with \$6.3 billion in production, PMT was the fifth largest correspondent lender in the United States as ranked by Inside Mortgage Finance.

In our distressed investment activities, many of the mortgage loans are purchased at discounts reflecting their distressed state or perceived higher risk of default, as well as a greater likelihood of collateral documentation deficiencies. Prior to the acquisition of loans or other assets, our Manager validates key information provided by the sellers that is necessary to determine the value of the asset. We then seek to maximize the value of the mortgage loans that we acquire. The objective for performing loans is value enhancement through effective high touch servicing, which is based on significant levels of borrower outreach and contact, and the ability to implement long-term, sustainable loan modification and restructuring programs that address borrowers' ability and willingness to pay their mortgage loans. Alternatively, for nonperforming loans and real estate assets, the ability to effect property resolution in a timely, orderly and economically efficient manner is essential to generating attractive returns.

Through our management agreement with PCM and our loan servicing agreements with our loan servicers (primarily our affiliate, PLS), we work with borrowers to perform loss mitigation activities. For both performing and nonperforming loans we use loan modification programs (such as the U.S. Departments of the Treasury and Housing and Urban Development's Home Affordable Modification Program (HAMP)) and workout options that we believe have the highest probability of successful resolution for both borrowers and our Company. Loan modification or resolution may include our accepting a reduction of the principal balances of certain mortgage loans in our investment portfolio. We expect these methods to increase our portfolio of performing loans, reduce default rates and enhance the value of loans in our portfolio. We believe that by using these methods, we can provide borrowers with long-term solutions that address their willingness and ability to pay their mortgage loans. Once we have improved the credit quality of a loan, we intend to monetize the enhanced value through various disposition strategies. When loan modifications and other efforts are unable to cure distressed loans, our objective is to effect timely acquisition and liquidation of the property securing the mortgage loan.

Our Manager specializes in acquiring distressed residential mortgage assets that are sold by financial institutions including banks, thrifts, and non-bank mortgage lenders. Since late 2009, our Manager has seen substantial volumes of nonperforming residential mortgage loans available for purchase from certain U.S. banks at significant discounts to their unpaid principal balances. Our Manager believes that there are several reasons these banks are motivated to sell nonperforming loans, including the following: the ability to release capital tied to nonperforming assets; the ability to relieve strain on their operations resulting from managing nonperforming loans and real estate acquired in settlement of loans (REO); the ability to reduce the percentages of their assets that are nonperforming, a key measure monitored by the banks' regulators, investors, and other stakeholders; and the ability for these banks to manage perceptions of the continued drag on their overall performance from legacy distressed assets through controlled sales of nonperforming assets.

We have elected to be taxed as a REIT for U.S. federal income tax purposes and we intend to maintain our exclusion from regulation under the Investment Company Act. Therefore, we are required to invest a substantial majority of our assets in loans secured by real estate and in real estate-related assets. Subject to maintaining our REIT qualification and our Investment Company Act exclusion, we do not have any limitations on the amounts we may invest in any of our targeted asset classes.

As our Manager, PCM conducts activities including developing our investment strategies, sourcing and acquiring mortgage loans and mortgage-related assets for our investment portfolio, and developing the appropriate approach to be taken by PLS for each loan as it performs its specialty servicing. As our loan servicer, PLS subservices the mortgage loans we acquire. PLS performs prime servicing with respect to the loans underlying our MSR, which are generally prime credit quality with low delinquency and default rates. PLS also performs special servicing for the distressed whole loans we have acquired. Special servicing utilizes a high touch model to establish and maintain borrower contact and facilitate loss mitigation.

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strategies. As part of its execution of PCM's portfolio strategy, PLS may modify or refinance loans in our investment portfolio and originate loans to finance the sale of real estate we acquire in settlement of our loans. In addition, PLS provides mortgage banking services in support of our correspondent lending activities.

Our internet address is www.pennymacmortgageinvestmenttrust.com. We make available free of charge, on or through the investor relations section of our web site, annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as well as proxy statements, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC.

Our Manager and Our Servicer

We are externally managed and advised by PCM pursuant to a management agreement. PCM specializes in and focuses on residential mortgage loans. PCM also serves as the investment manager to two private investment funds, which we refer to as the PennyMac funds, with investment objectives and policies relating to distressed mortgage loans that are substantially similar to ours. The combined net assets of the entities managed by PCM, including our shareholders' equity, amounted to approximately \$1.8 billion as of December 31, 2012.

PCM is responsible for administering our business activities and day-to-day operations. Pursuant to the terms of the management agreement, PCM provides us with our senior management team, including our officers, along with appropriate support personnel. PCM is subject to the supervision and oversight of our board of trustees and has the functions and authority specified in the management agreement.

We also have a loan servicing agreement with PLS, pursuant to which PLS provides primary and special servicing for our portfolio of residential mortgage loans. PLS' loan servicing activities include collecting principal, interest and escrow account payments, if any, with respect to mortgage loans, as well as managing loss mitigation, which may include, among other things, collection activities, loan workouts, modifications and refinancings, foreclosures, short sales, sales of REO and financings to facilitate such sales. Servicing fee rates are based on the delinquency status and other characteristics of the mortgage loans serviced and total servicing compensation is established at levels that management believes are competitive with those charged by other primary servicers and specialty servicers.

PLS' servicing platform provides for significant borrower contact, which we refer to as "high touch," and is designed to enable us to effectively implement programs that address borrower needs and maximize the value of our portfolio. PLS was established in February 2008 and also provides primary servicing and special servicing to the PennyMac funds and entities in which they have invested as well as third parties. PLS acted as the servicer for loans with an aggregate unpaid principal balance of approximately \$28.2 billion as of December 31, 2012.

Our Manager's senior management team has extensive experience in the residential mortgage industry and expertise across each of the critical capabilities that we believe are required to successfully acquire and manage both performing and nonperforming mortgage loans, including sourcing, valuation, due diligence, portfolio strategy, servicing (including modification and refinance fulfillment of outstanding loans and acquisition and liquidation of properties securing settled mortgage loans) and secondary marketing of restructured and re-performing loans. Our senior management team is supported by a dedicated team of employees at PLS and PCM.

We have no employees, and we do not pay our officers any cash compensation. Rather, under the management agreement, we pay PCM management fees quarterly in arrears, which include a base component and an incentive component. In addition, we pay PLS fees for servicing our loans and providing mortgage banking services in support of our correspondent lending activities, and we reimburse PCM and its affiliates for certain direct costs incurred on our behalf and for certain overhead expenses.

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Our management fees are calculated on a quarterly basis. The management fees that we pay PCM have two components: a base component and a performance incentive component. Under our prior management agreement with PCM, which was effective during the periods presented in this Report, the terms of the two components were as follows:

Base component. The base component was calculated at the annual rate of 1.5% of shareholders' equity (as defined in the management agreement). Effective May 16, 2012, we amended our management agreement with PCM to change the way that shareholders' equity was measured for purposes of calculating the base component of our management fee. Previously, the measure of our shareholders' equity excluded unrealized gains, losses or other non-cash items reflected in our financial statements. To better align the base component of the management fee with our investment strategy, we amended the management agreement to base the management fee on shareholders' equity computed using United States generally accepted accounting principles, or U.S. GAAP. The effect of this modification had been to increase the base management fee that we pay to PCM since the agreement was amended.

Performance incentive component. The performance incentive fee was calculated at 20% per year of the amount by which core earnings (as defined in the management agreement, core earnings generally represented our net income, adjusted for the effects of unrealized gains and losses recognized in earnings), on a rolling four-quarter basis and before the incentive fee, exceeded an 8% hurdle rate. Our core earnings did not exceed the 8% hurdle rate and we therefore did not recognize the incentive component of our management fees.

Effective February 1, 2013, we amended the terms of our management agreement with PCM. The amendment reduced the annual rate of the base component of the management fee applicable to shareholders' equity in excess of \$2.0 billion. It also changed the basis on which the performance incentive portion of our management fee is calculated from core earnings, as defined under the prior agreement, to a percentage of earnings as determined in accordance with U.S. GAAP exceeding a series of hurdles starting at 8%. As a result of this change, we expect to incur the performance incentive portion of our management fee in future periods. The management agreement is more fully described elsewhere in this Report in *Off-Balance Sheet Arrangements and Aggregate Contractual Obligations - Contractual Obligations Management Agreement*.

Effective February 1, 2013, we also amended and restated our servicing agreement with PLS. The primary purpose of the amendment was to change the nature of the fees that we pay to PLS for loan servicing to fixed per-loan monthly amounts based on the delinquency, bankruptcy and/or foreclosure status of the serviced loan or the REO. The servicing agreement is more fully described elsewhere in this Report in *Off-Balance Sheet Arrangements and Aggregate Contractual Obligations - Contractual Obligations Servicing Agreement*.

Investment Strategy

Our objective is to provide attractive risk-adjusted returns to our investors over the long-term, primarily through dividends and secondarily through capital appreciation. We seek to achieve this objective primarily by investing in mortgage loans, a substantial portion of which may be distressed and acquired at discounts to their unpaid principal balances.

Correspondent Lending

Over the past few years, a number of large banks have exited or reduced the size of their correspondent lending businesses, creating an opportunity for non-bank entities to gain market share. We believe that we are well positioned to take advantage of this opportunity based on the management expertise of PLS and PCM in the correspondent lending business, the relationships with correspondent sellers, and the supporting systems and processes of PLS.

Distressed Assets

We seek to maximize the value of the mortgage loans that we acquire through proprietary loan modification programs, special servicing and other initiatives focused on keeping borrowers in their homes. Where this is not

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possible, such as in the case of many nonperforming mortgage loans, we seek to effect property resolution in a timely, orderly and economically efficient manner. We also invest in mortgage-related securities and other mortgage-related, real estate and financial assets. A substantial portion of our investments are not rated by any rating agency.

The pools of loans that we acquire consist primarily of U.S. residential mortgage loans. These loans may be performing or nonperforming and of varying credit quality, including subprime, Alt-A and prime. PCM, in its sole discretion, and in accordance with its policies and procedures, determines the composition of our portfolio of loans, including its size, loan types and credit quality.

We rely on PCM’s expertise in identifying pools of distressed mortgage loans and other assets for acquisition. PCM’s sourcing and evaluation processes for potential acquisitions of residential mortgage loans and for mortgage-related assets are substantially similar. PCM makes investment decisions based on various factors, including expected cash yield, relative value, risk-adjusted returns, current and projected credit fundamentals, current and projected macroeconomic considerations, current and projected supply and demand, market risk, portfolio diversification, liquidity and availability and terms of financing, as well as maintaining our REIT qualification and our exclusion from registration under the Investment Company Act. The evaluation process with respect to residential mortgage-backed securities (RMBS) and other MBS also includes relative value analyses based on yield, credit rating, average life, effective duration, option-adjusted spreads, prepayment assumptions and credit expectations. Investment decisions with regard to the acquisition or disposition of any of our targeted assets are generally made by PCM’s investment committee. Our assets are not subject to any geographic diversification or concentration limitations except that we are concentrated in residential mortgage-related investments. We have established no limitations on the maturity, duration or credit rating of our assets.

PCM and its affiliates evaluate new opportunities based on their relative expected returns compared to comparable assets held in our portfolio. We re-evaluate our investment strategy as market conditions change with a view toward maximizing the returns from our investment portfolio and identifying dislocations and opportunities in the mortgage market.

Targeted Asset Classes

We invest primarily in residential mortgage loans and mortgage-related assets. Our targeted asset classes and the principal investments we make and/or expect to make in each class are as follows:

Asset class	Principal investments
Residential Mortgage Loans	Newly originated mortgage loans Seasoned performing and nonperforming residential mortgage loans
Residential Mortgage-Backed Securities	Agency RMBS Non-Agency RMBS, including investment-grade, non-investment grade classes and non-rated classes
Other assets and other MBS	Real estate and real estate acquired in settlement of loans MSRs Excess servicing spread arising from MSRs Loans to finance mortgage loan inventory for mortgage lenders Mortgage-related derivatives, including, but not limited to, credit default swaps, options, futures and derivatives on MBS Commercial mortgage-backed securities (CMBS) United States Treasury securities

Over time, our targeted asset classes may change as a result of changes in the opportunities that are available in the market, among other factors. We may not invest in certain of the investments described above if we believe those types of investments will not provide us with attractive opportunities or if we believe other types of our targeted assets provide us with better opportunities.

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During the year ended December 31, 2012, we significantly increased our participation in the secondary mortgage market through the purchase for resale of newly originated mortgage loans (correspondent lending). In our correspondent lending activities, we acquire newly originated loans from mortgage lenders, sell the loans to an Agency or other third party, sell the loans to PLS in the case of government loans, or otherwise pool loans into MBS, sell the resulting securities into the MBS markets and retain the MSR. During 2012, we purchased \$22.4 billion at fair value of newly originated mortgage loans, compared to \$1.3 billion during 2011.

Following is a summary of our correspondent lending activities:

	Year ended December 31,			Period from August 4, 2009 (commencement of operations) to December 31, 2009
	2012	2011	2010	
	(in thousands)			
Fair value of correspondent lending loans purchased:				
Agency eligible	\$ 13,463,121	\$ 660,862	\$ 9,249	\$
Government insured or guaranteed	8,969,220	623,540	20,810	
Jumbo	10,795	34,361		
	\$ 22,443,136	\$ 1,318,763	\$ 30,059	\$
Fair value of correspondent lending loans in inventory at period-end	\$ 975,184	\$ 232,016	\$ 3,966	\$
Gain on mortgage loans acquired for sale(1)	\$ 147,675	\$ 7,633	\$ 18	\$

- (1) Gain on mortgage loans acquired for sale includes changes in the value of commitments to purchase loans or interest rate lock commitments (IRLC), changes in the value of mortgage loans purchased during the period from purchase through the date of sale and changes in the value of financial instruments purchased and sold to manage the risk of changes in value of our inventory of mortgage loans and IRLCs.

Investment Activities

Following is a summary of our acquisitions of mortgage investments (excluding purchases for resale of newly originated mortgage loans):

	Year ended December 31,			Period from August 4, 2009 (commencement of operations) to December 31, 2009
	2012	2011	2010	
	(in thousands)			
MBS	\$ 112,211	\$ 21,420	\$ 91,141	\$ 93,049
Distressed mortgage loans(1)(2)				
Performing	128,221	52,256	33,745	26,046
Nonperforming	414,545	595,353	383,466	

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	542,766	647,609	417,211	26,046
REO	297	2,475	1,238	
MSRs	134,702	6,079		
	\$ 789,976	\$ 677,583	\$ 509,590	\$ 119,095

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- (1) Performance status as of the date of acquisition.
 (2) \$504.8 million and \$577.6 million of our distressed asset purchases during the year ended December 31, 2012 and 2011, respectively, were acquired from or through one or more subsidiaries of Citigroup Inc.
 Our portfolio of mortgage investments was comprised of the following:

	2012	December 31, 2011 2010		2009
		(in thousands)		
MBS	\$	\$ 72,813	\$ 119,872	\$ 83,771
Distressed mortgage loans:				
Performing	404,016	209,599	86,242	26,046
Nonperforming	785,955	615,977	278,008	
	1,189,971	825,576	364,250	26,046
REO	88,078	103,549	29,685	
MSRs	126,776	6,031		
	\$ 1,404,825	\$ 1,007,969	\$ 513,807	\$ 109,817

Our acquisitions have been primarily comprised of nonperforming loans rather than distressed performing loans. During the period from August 4, 2009 (commencement of operations) through December 31, 2011, PCM encountered a relatively higher volume of available nonperforming mortgage loan portfolios than distressed performing loan portfolios. In addition, the risk-adjusted returns for nonperforming loan portfolios have been more attractive than those for distressed performing loan portfolios.

PCM has worked to expand our sources of assets to position us to take advantage of market opportunities and market changes, such as when the mortgage market achieves more active levels of non-Agency securitization and when delinquency and foreclosure levels reduce closer to historical levels. Examples of such investments include:

Acquisition of MSR or excess servicing spread from MSRs from financial institutions. We believe that MSR investments may allow us to earn attractive current returns and to leverage the loan servicing and origination capabilities of PLS to improve the assets value. We also intend to continue to retain the MSRs that we receive as a portion of the proceeds from our sale or securitization of mortgage loans through our correspondent lending operation.

Pursuant to the terms of the MSR recapture agreement entered into with PLS effective February 1, 2013, if PLS refinances loans for which we previously created and held the MSRs through our correspondent lending activities, PLS is generally required to transfer and convey to us, without cost to us, the MSRs with respect to new mortgage loans originated in those refinancings (or, under certain circumstances, other mortgage loans) that have an aggregate unpaid principal balance that is not less than 30% of the aggregate unpaid principal balance of all the loans so originated.

Providing inventory financing of mortgage loans for mortgage lenders. We believe this activity results in attractive investment assets and will supplement and make our correspondent lending business more attractive to lenders from which we acquire newly originated loans.

To the extent that we transfer correspondent lending loans into private label securitizations in the future, we may retain a portion of the securities and residual interests created in such securitization transactions.

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Our Financing Strategy

We have pursued growth of our investment portfolio by using a combination of equity and borrowings. We have made borrowings in the form of borrowings under forward purchase agreements, sales of securities and nonperforming assets under agreements to repurchase, and lines of credit to finance loans purchased through our correspondent lending activities. We use borrowings to finance our investments and not to speculate on changes in interest rates.

During 2011 and 2012, we issued 11.5 million and 30.3 million of our common shares and received net proceeds totaling \$197.4 million and \$606.5 million, respectively, through a combination of underwritten share offerings and controlled equity offerings. We used the proceeds of these offerings to fund a portion of the purchase price of portfolios of residential mortgage whole loans, to fund the continued growth of the correspondent lending business and for general corporate purposes.

Since 2010, we entered into or amended three master repurchase agreements with three money center banks totaling \$700.0 million, to finance our investments in distressed assets. We also entered into a secured lending facility, which has since expired, with a money center bank in an aggregate amount of \$40 million. Our objective is to use these facilities to finance nonperforming mortgage loan and real estate investments pending liquidation, sale, securitization or other structured financing. The aggregate principal amount outstanding under these facilities was \$361.2 million as of December 31, 2012.

Since 2010, we also entered into six master repurchase agreements with five money center banks totaling \$1.4 billion (of which \$1.2 billion is committed), in order to fund newly originated prime mortgage loans purchased from correspondent lenders. The principal balance outstanding under these facilities was \$894.9 million as of December 31, 2012.

During 2011, we entered into forward purchase agreements pursuant to which we agreed to purchase certain nonperforming assets and residential real property acquired in settlement of loans from one money center bank which purchased these assets from unaffiliated money center banks. We assumed all of the money center bank's rights and obligations under its separate agreements with the unaffiliated money center banks. We recorded the transactions as purchases of loans. All borrowings under forward purchase agreements were repaid during the year ended December 31, 2012.

Our borrowings are made under agreements that include various covenants, including profitability, the maintenance of specified levels of cash, adjusted tangible net worth and overall leverage limits. Our ability to borrow under these facilities is limited by the amount of qualifying assets that we hold and that are eligible to be pledged to secure such borrowings. We are not otherwise required to maintain any specific debt-to-equity ratio, and we believe the appropriate leverage for the particular assets we finance depends on, among other things, the credit quality and risk of such assets. Our declaration of trust and bylaws do not limit the amount of indebtedness we can incur, and our board of trustees has discretion to deviate from or change our financing strategy at any time.

Subject to maintaining our qualification as a REIT and exclusion from registration under the Investment Company Act, we may hedge the interest rate risk associated with the financing of our portfolio.

Investment Policies

Our board of trustees has adopted the policies set forth below for our investments and borrowings. PCM will review our compliance with the investment policies regularly and will report periodically to our board of trustees regarding such compliance.

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No investment shall be made that would cause us to fail to qualify as a REIT for U.S. federal income tax purposes;

No investment shall be made that would cause us to be regulated as an investment company under the Investment Company Act; and

With the exception of real estate and housing, no single industry shall represent greater than 20% of the investments or aggregate risk exposure in our portfolio.

These investment policies may be changed by a majority of our board of trustees without the approval of, or prior notice to, our shareholders.

Investment Allocation Policy

Investment opportunities in pools of mortgage loans that are consistent with our investment objectives, on the one hand, and the investment objectives of the PennyMac funds and other future entities or accounts managed by PCM, on the other hand, are allocated among us and the PennyMac funds and the other entities or accounts generally *pro rata*. This is and has been based upon relative amounts of investment capital (including undrawn capital commitments) available for new investments by us, the PennyMac funds and any other relevant entities or accounts, or by assigning opportunities among the relevant entities such that investments assigned among us, such funds, entities or accounts are fair and equitable over time; *provided* that PCM, in its sole discretion, may allocate investment opportunities in any other manner that it deems to be fair and equitable. As of December 31, 2012, the commitment periods for the PennyMac funds had ended and the ability of the PennyMac funds to make new investments has therefore been reduced.

In the case of the allocation of investment opportunities, PCM considers a number of factors. These factors include:

investment objectives or strategies for particular entities or accounts;

tax considerations of an entity or account;

risk or investment concentration parameters for an entity or account;

supply or demand for an investment at a given price level;

size of available investment;

cash availability and liquidity requirements for an entity or account;

minimum investment size of an entity or account;

relative size or buying power of an entity or account;

regulatory considerations, including the potential impact on an entity's status under the Investment Company Act, and, in our case, our REIT status; and

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such other factors as may be relevant to a particular transaction.

In the case of *pro rata* purchases of pools of loans where the pool is allocated among us and other entities or accounts, PCM, at the time of purchase, seeks to allocate the individual mortgage loans in the pools among us and the other entities or accounts such that the overall allocation of acquired mortgage loans in the pools will target reasonable symmetry with reference to, among other factors, the following:

unpaid principal balances;

delinquency status;

purchase price;

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lien position;

expected cash flows;

geography; and

such other factors as may be relevant to a particular transaction.

As the investment programs of the various entities and accounts managed by PCM change and develop over time, additional issues and considerations may affect PCM's and our allocation policy and PCM's and our expectations with respect to the allocation of investment opportunities among the various entities and accounts managed by PCM. Notwithstanding PCM's intention to effect fair and equitable allocations of investment opportunities, we expect that our performance will differ from the performance of the PennyMac funds and any other PennyMac-managed entity or account for many reasons, including differences in the legal or regulatory characteristics, or tax classification, of the entities or accounts or due to differing fee structures or the idiosyncratic differences in the outcome of individual mortgage loans.

We have not adopted a policy that expressly prohibits our trustees, officers, shareholders or affiliates from having a direct or indirect financial interest in any investment to be acquired or disposed of by us or in any transaction to which we are a party or have an interest. We do not have a policy that expressly prohibits any such persons from engaging for their own account in business activities of the types conducted by us. However, our code of business conduct and ethics contains a conflicts of interest policy that prohibits our trustees, officers and employees, as well as employees of PCM who provide services to us, from engaging in any transaction that involves an actual or apparent conflict of interest with us without the appropriate approval. We also have written policies and procedures for the review and approval of related party transactions.

Operating and Regulatory Structure

REIT Qualification

We have elected to be treated as a REIT under Sections 856 through 859 of the Internal Revenue Code of 1986 (the "Internal Revenue Code") beginning with our taxable year ended December 31, 2009. Our qualification as a REIT depends upon our ability to meet on a continuing basis, through actual investment and operating results, various complex requirements under the Internal Revenue Code relating to, among other things, the sources of our gross income, the composition and values of our assets, our distribution levels and the diversity of ownership of our common shares. We believe that we are organized in conformity with the requirements for qualification and taxation as a REIT under the Internal Revenue Code, and that our manner of operation enables us to meet the requirements for qualification and taxation as a REIT.

As a REIT, we generally are not subject to U.S. federal income tax on our REIT taxable income we distribute to our shareholders. If we fail to qualify as a REIT in any taxable year and do not qualify for certain statutory relief provisions, we will be subject to U.S. federal income tax at regular corporate rates and may be precluded from qualifying as a REIT for the subsequent four taxable years following the year during which we lost our REIT qualification. Accordingly, our failure to qualify as a REIT could have a material adverse impact on our results of operations and amounts available for distribution to our shareholders.

Even though we have elected to be taxed as a REIT, we are subject to some U.S. federal, state and local taxes on our income or property. A portion of our business is conducted through, and a portion of our income is earned in, our TRS that is subject to corporate income taxation. In general, a TRS of ours may hold assets and engage in activities that we cannot hold or engage in directly and may engage in any real estate or non-real estate related business. A TRS is subject to U.S. federal, state and local corporate income taxes. To maintain our REIT election, at the end of each quarter no more than 25% of the value of a REIT's assets may consist of stock or securities of one or more TRSs.

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If our TRS generates net income, our TRS can declare dividends to us, which will be included in our taxable income and necessitate a distribution to our shareholders. Conversely, if we retain earnings at the TRS level, no distribution is required and we can increase shareholders equity of the consolidated entity. As discussed in Section 1A of this Report entitled *Risk Factors*, the combination of the requirement to maintain no more than 25% of our assets in the TRS coupled with the effect of TRS dividends on our income tests creates compliance complexities for us in the maintenance of our qualified REIT status.

The dividends paid deduction of a REIT for qualifying dividends to its shareholders is computed using our taxable income as opposed to net income reported on our financial statements. Taxable income generally differs from net income reported on our financial statements because the determination of taxable income is based on tax laws and regulations and not financial accounting principles.

Licensing

We and PLS are required to be licensed to conduct business in certain jurisdictions. PLS is, or is taking steps to become, licensed in those jurisdictions and for those activities where it believes it is cost effective and appropriate to become licensed. Through our wholly owned subsidiaries, we are also licensed, or are taking steps to become licensed, in those jurisdictions and for those activities where we believe it is cost effective and appropriate to become licensed. In jurisdictions in which neither we nor PLS is licensed, we do not conduct activity for which a license is required. Our failure or the failure by PLS to obtain any necessary licenses promptly, comply with applicable licensing laws or satisfy the various requirements or to maintain them over time could materially and adversely impact our business.

Competition

In our correspondent lending activities, we compete with large financial institutions and with other independent residential mortgage loan producers and servicers. We compete on the basis of product offerings, technical knowledge, manufacturing quality, speed of execution, rate and fees.

In acquiring distressed mortgage assets, we compete with specialty finance companies, private funds, other mortgage REITs, thrifts, banks, mortgage bankers, insurance companies, mutual funds, institutional investors, investment banking firms, governmental bodies and other entities. A number of these competitors may also be focused on acquiring distressed mortgage loans, and therefore may increase competition for the available supply of mortgage assets suitable for purchase. Many of our competitors are significantly larger than we are and have stronger balance sheets and greater access to capital and other resources than we have and may have other advantages over us. Such advantages include the ability to obtain lower-cost financing, such as deposits, and operational efficiencies arising from their larger size. Some of our competitors may have higher risk tolerances or different risk assessments and may not be subject to the operating restraints associated with REIT tax compliance or maintenance of an exclusion from the Investment Company Act, any of which could allow them to consider a wider variety of investments and funding strategies and to establish more relationships than we can.

Because the availability of pools of distressed mortgage assets may fluctuate, the competition for assets and sources of financing may increase. Increased competition for assets may result in our accepting lower returns for acquisitions of residential mortgage loans and other assets or adversely influence our ability to win our bids for such assets. An increase in the competition for sources of funding could adversely affect the availability and terms of financing, and thereby adversely affect the market price of our common shares.

In the face of this competition, we have access to PCM's professionals and their industry expertise, which we believe provides us with a competitive advantage and helps us assess investment risks and determine appropriate pricing for certain potential investments. We expect these relationships to enable us to compete more effectively for attractive investment opportunities. Furthermore, we believe that our access to PLS's special servicing expertise helps us to maximize the value of our residential mortgage loans and provides us with a

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competitive advantage over other companies with a similar focus. We believe that current market conditions may have adversely affected the financial condition and operations of certain owners of mortgage assets. Further, regulatory and capital issues have contributed to the decision by certain financial institutions to exit or curtail their correspondent lending business and to reduce their portfolios of mortgage servicing rights. Not having a legacy portfolio or the same regulatory or capital issues may enable us to compete more effectively for attractive business or investment opportunities. However, we cannot assure you that we will be able to achieve our business goals or expectations due to the competitive and other risks that we face.

Staffing

We are managed by PCM pursuant to a management agreement. PLS provides servicing and special servicing for our portfolio of residential mortgage loans pursuant to a loan servicing agreement and fulfillment services in connection with our correspondent lending activities pursuant to a mortgage banking and warehouse services agreement. All of our officers are employees of PCM or its affiliates. We have no employees. As of December 31, 2012, PennyMac had 907 employees. See *Our Manager and Our Servicer* above.

Item 1A. Risk Factors

Risks Associated with Our Management and Relationship with Our Manager and Its Affiliates

We are dependent upon PCM, PLS and their resources and may not find suitable replacements if any of our service agreements with PCM or PLS is terminated.

In accordance with our management agreement, we are externally advised and managed by PCM, which makes all or substantially all of our investment, financing and risk management decisions, and has significant discretion as to the implementation of our operating policies and strategies. Under our loan servicing agreement with PLS, PLS provides primary servicing and special servicing for our portfolio of residential mortgage loans, and under our mortgage banking and warehouse services agreement with PLS, PLS provides fulfillment and disposition-related services in connection with our correspondent lending business. The costs of these services increase our operating costs and may adversely affect our net income, but we rely on PCM and PLS to provide these services under these agreements because we have no in-house capability to handle the services independently.

No assurance can be given that the strategies of PCM, PLS or their affiliates under any of these agreements will be successful, that any of them will conduct complete and accurate due diligence or provide sound advice, or that any of them will act in our best interests with respect to the allocation of resources to our business. The failure of any of them to do any of the above, conduct the business in accordance with applicable laws and regulations or hold all licenses or registrations necessary to conduct the business as currently operated would materially and adversely affect our ability to continue to execute our business plan.

In addition, the terms of these agreements extend until February 1, 2017 (subject to automatic renewals for 18-month terms), but any of the agreements may be terminated earlier under certain circumstances or otherwise non-renewed. If any agreement is terminated or non-renewed and a suitable replacement is not secured in a timely manner, it would materially and adversely affect our ability to continue to execute our business plan.

If our management agreement or loan servicing agreement is terminated or non-renewed, we will have to obtain the services from another service provider. We may not be able to replace these services in a timely manner or on favorable terms, or at all. With respect to our mortgage banking and warehouse services agreement, the services provided by PLS are inherently unique and not widely available, if at all. This is particularly true because we are not a Ginnie Mae licensed issuer or servicer yet we are able to acquire government mortgage loans from our correspondent sellers that we know will ultimately be purchased from us by PLS. While we generally have exclusive rights to these services from PLS during the term of our mortgage banking and

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warehouse services agreement, in the event of a termination we may not be able to replace these services in a timely manner or on favorable terms, or at all, and we ultimately would be required to compete against PLS for the correspondent business we currently enjoy.

PennyMac, the parent company of PCM and PLS, is undergoing significant growth and its development and integration of new operations may not be effective.

PennyMac's significant growth since it commenced operations has caused significant demands on its operational, accounting and legal infrastructure, and increased expenses. The ability of PCM and PLS to provide us with the services we require to be successful depends, among other things, on the ability of PennyMac, including PCM and PLS, to maintain an operating platform and management system sufficient to address its growth. This may require PennyMac to incur significant additional expenses and to commit additional senior management and operational resources. There can be no assurance that PennyMac will be able to effectively integrate its expanding operations or that PennyMac will continue to grow successfully. PennyMac's failure to do so could adversely affect the ability of PCM and PLS to manage us and service our mortgage loan portfolio, respectively, which would materially and adversely affect us.

The management fee structure could cause disincentive and/or create greater investment risk.

Pursuant to our management agreement, PCM is entitled to receive a base management fee that is based on our shareholders' equity (as defined in our management agreement) at the end of each quarter. As a result, significant base management fees would be payable to PCM for a given quarter even if we experience a net loss during that quarter. PCM's right to non-performance-based compensation may not provide sufficient incentive to PCM to devote its time and effort to source and maximize risk-adjusted returns on our investment portfolio, which could, in turn, materially and adversely affect our ability to make distributions to our shareholders and the market price of our common shares.

Conversely, PCM is also entitled to receive incentive compensation under our management agreement based on our performance in each quarter. In evaluating investments and other management strategies, the opportunity to earn incentive compensation based on our net income may lead PCM to place undue emphasis on the maximization of short-term income at the expense of other criteria, such as preservation of capital, maintenance of sufficient liquidity and/or management of market risk, in order to achieve higher incentive compensation. Investments with higher yield potential are generally riskier and more speculative.

The servicing fee structure could create a conflict of interest.

For its services under our loan servicing agreement, PLS is entitled to base servicing fees that we believe are competitive with those charged by primary servicers and specialty servicers and are calculated as fixed per-loan monthly amounts based on the delinquency, bankruptcy and/or foreclosure status of the serviced loan or the real estate acquired in settlement of a loan. PLS is also entitled to certain customary market-based fees and charges, including boarding and deboarding fees, liquidation and disposition fees, assumption, modification and origination fees and late charges, as well as interest on funds on deposit in custodial or escrow accounts. In addition, to the extent we participate in HAMP (or other similar mortgage loan modification programs), PLS may be entitled to retain any incentive payments made to it in connection with our participation therein. Because certain of these fees are earned upon reaching a specific milestone, this fee structure may provide PLS with an incentive to foreclose more aggressively or liquidate assets for less than their fair value.

On our behalf, PLS also refinances performing and nonperforming loans and originates new loans to facilitate the disposition of real estate that we acquire through foreclosure. In order to provide PLS with an incentive to produce such loans, we have agreed to pay PLS fees and other compensation based on market-based pricing and terms that are consistent with the pricing and terms offered by PLS to unaffiliated third parties on a

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retail basis. This may provide PLS with an incentive to refinance a greater proportion of our loans than it otherwise would and/or to refinance loans on our behalf instead of arranging the refinancings with a third party lender.

Termination of our management agreement is difficult and costly.

It is difficult and costly to terminate, without cause, our management agreement. Our management agreement provides that it may be terminated by us without cause under limited circumstances and the payment to PCM of a significant termination fee. The cost to us of terminating our management agreement may adversely affect our desire or ability to terminate our management agreement with PCM without cause. PCM may also terminate our management agreement upon at least 60 days' prior written notice if we default in the performance of any material term of our management agreement and the default continues for a period of 30 days after written notice to us, or where we terminate our loan servicing agreement, our mortgage banking and warehouse services agreement or certain other agreements with PCM or PLS without cause (at any time other than at the end of the current term or any automatic renewal term), whereupon in either case we would be required to pay to PCM a significant termination fee.

PCM and PLS both have limited liability and indemnity rights.

Our agreements with PCM and PLS provide that PCM and PLS will not assume any responsibility other than to provide the services specified in the applicable agreements. Our management agreement further provides that PCM will not be responsible for any action of our board of trustees in following or declining to follow its advice or recommendations. In addition, each of PCM and PLS and their respective affiliates, managers, officers, trustees, directors, employees and members will be held harmless from, and indemnified by us against, certain liabilities on customary terms.

Existing or future entities or accounts managed by PCM may compete with us for PCM's time and services, and they may compete with us for, or may participate in, investments, any of which could result in conflicts of interest. BlackRock and HC Partners, PennyMac's strategic investors, could compete with us or transact business with us.

Pursuant to our management agreement, PCM is obligated to supply us with our senior management team, and the members of that team are required to devote such time to us as is necessary and appropriate, commensurate with the level of our activity. The members of our senior management team may have conflicts in allocating their time and services between us and other entities or accounts managed by PCM now or in the future, including the PennyMac funds. The failure of our senior managers to allocate appropriate time and services to us, or the loss of services of our senior managers for any reason, could adversely affect our business.

Although our agreements with PCM and PLS provide us with certain exclusivity and other rights and we and PCM have adopted an allocation policy to specifically address some of the conflicts relating to our investment opportunities, there is no assurance that these measures will be adequate to address all of the conflicts that may arise or will address such conflicts in a manner that is favorable to us. We are also limited in our ability to acquire assets that are not qualifying real estate assets and/or real estate related assets, whereas the PennyMac funds and other entities or accounts that PCM manages now or may manage in the future are not, or may not be, as applicable, so limited. In addition, PCM and/or the PennyMac funds and the other entities or accounts managed by PCM now or in the future may participate in some of our investments, which may not be the result of arm's length negotiations and may involve or later result in potential conflicts between our interests in the investments and those of PCM or such other entities.

In addition, PennyMac's strategic investors, BlackRock and HC Partners, each own significant investments in PennyMac. Affiliates of each of BlackRock and HC Partners currently manage investment vehicles and separate accounts that may compete directly or indirectly with us. BlackRock and HC Partners are under no

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obligation to provide us with any financial or operational assistance, or to present opportunities to us for matters in which they may become involved. We may enter into transactions with BlackRock or HC Partners or with market participants with which BlackRock or HC Partners has business relationships, and such transactions and/or relationships could influence the decisions made by PCM with respect to the purchase or sale of assets and the terms of such purchase or sale. Such activities could have an adverse effect on the value of the positions held by us, or may result in BlackRock and/or HC Partners having interests adverse to ours.

Negative publicity and media attention involving Countrywide Financial Corporation and certain of its former officers could have an adverse impact on PennyMac and us.

Certain of our and PennyMac's officers, including Stanford L. Kurland, our chairman and chief executive officer, are former employees of Countrywide Financial Corporation, or Countrywide, which has been the subject of various investigations and lawsuits and ongoing negative publicity. We cannot assure you that any existing or future investigations, litigation or negative publicity involving Countrywide will not generate negative publicity or media attention for us or adversely impact us or PCM's and PLS's ability to conduct their respective businesses.

Risks Related to Our Business

We operate in a highly regulated industry and the continually changing federal, state and local laws and regulation could materially adversely affect our business, financial condition and results of operations.

Due to the highly regulated nature of the residential mortgage industry, we are required to comply with a wide array of federal, state and local laws and regulations that regulate, among other things, the manner in which we conduct our businesses. These regulations directly impact our business and require constant compliance, monitoring and internal and external audits. A material failure to comply with any of these laws or regulations could subject us to lawsuits or governmental actions and damage our reputation, which could materially adversely affect our business, financial condition and results of operations.

Federal, state and local governments have recently proposed or enacted numerous new laws, regulations and rules related to mortgage loans. Laws, regulations, rules and judicial and administrative decisions relating to mortgage loans include those pertaining to real estate settlement procedures, equal credit opportunity, fair lending, fair credit reporting, truth in lending, fair debt collection practices, service members protections, compliance with net worth and financial statement delivery requirements, compliance with federal and state disclosure and licensing requirements, the establishment of maximum interest rates, finance charges and other charges, qualified mortgages, secured transactions, payment processing, escrow, loss mitigation, collection, foreclosure, repossession and claims-handling procedures, and other trade practices and privacy regulations providing for the use and safeguarding of non-public personal financial information of borrowers. PLS and service providers they use, including outside foreclosure counsel retained to process foreclosures, must also comply with these legal requirements.

In particular, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, or Dodd-Frank Act, represents a comprehensive overhaul of the financial services industry in the United States and includes, among other things (i) the creation of a Financial Stability Oversight Council to identify emerging systemic risks posed by financial firms, activities and practices, and to improve cooperation among federal agencies, (ii) the creation of the CFPB authorized to promulgate and enforce consumer protection regulations relating to financial products and services, including mortgage lending and servicing, (iii) the establishment of strengthened capital and prudential standards for banks and bank holding companies, (iv) enhanced regulation of financial markets, including the derivatives and securitization markets, and (v) amendments to the Truth in Lending Act, or TILA, aimed at improving consumer protections with respect to mortgage originations, including disclosures, originator compensation, minimum repayment standards, prepayment considerations appraisals and servicing requirements.

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Our failure or the failure of PLS to comply with these laws, regulations and rules may result in reduced payments by borrowers, modification of the original terms of mortgage loans, permanent forgiveness of debt, delays in the foreclosure process, increased servicing advances, litigation, enforcement actions, and repurchase and indemnification obligations.

In addition, although they have not yet been enacted, the Federal Housing Finance Agency, or FHFA, proposed changes to mortgage servicing compensation structures in 2011 for servicing with GSEs, including reducing servicing fees and channeling funds toward reserve accounts for delinquent loans. Also, there continue to be changes in legislation, rulemaking and licensing in an effort to simplify the consumer mortgage experience which requires technology changes and additional implementation costs for loan originators. We expect that legislative and regulatory changes will continue in the foreseeable future, which may increase our operating expenses, either to comply with applicable law or to satisfy our lenders and investors that we are in compliance with those laws, regulations and rules that are applicable to our business model. Any of these new, or changes in, laws, regulations or rules could adversely affect our business, financial condition and results of operations.

We may not be able to successfully operate our business or generate sufficient operating cash flows to make or sustain distributions to our shareholders. The supply of distressed residential mortgage loans will likely recede as the economy improves.

There can be no assurance that we will be able to generate sufficient returns to pay our operating expenses and make distributions to our shareholders. The results of our operations and our ability to make or sustain distributions to our shareholders depends on many factors, including the availability of attractive risk-adjusted investment opportunities that satisfy our investment strategies and our success in identifying and consummating them on favorable terms, the level and expected movement of home prices, the level and volatility of interest rates, readily accessible short-term and long-term financing on favorable terms, and conditions in the financial markets, real estate market and the economy, as to which no assurance can be given. We cannot assure you that we will be able to make investments with attractive risk-adjusted returns or will not seek investments with greater risk to obtain the same level of returns or that the value of our investments in the future will not decline substantially. We also face substantial competition in acquiring attractive investments, both in our investment activities and correspondent lending activities.

In addition, as the current conditions in the mortgage market, the financial markets and the economy stabilize and/or improve, the availability of distressed residential mortgage loans that meet our investment objectives and strategies will likely recede, which could reduce our ability to invest in distressed mortgage assets. While we continue to pursue our correspondent lending activities and reevaluate our investment strategies with a view of maximizing the returns from our investment portfolio and identifying dislocations and opportunities in the mortgage market, there can be no assurance that any of our strategies will be successful.

As a result of difficult conditions in the financial markets and the economy generally, the risks to our business strategies are high and there are no assurances that we will be successful in implementing those business strategies.

The success of our business strategies and our results of operations are materially affected by current conditions in the mortgage market, the financial markets and the economy generally. Continuing concerns over factors including inflation, deflation, unemployment, personal and business income taxes, energy costs, geopolitical issues, the availability and cost of credit, the mortgage market and a declining real estate market have contributed to increased volatility and unclear expectations for the economy and markets going forward. The residential mortgage market has been severely affected by changes in the lending landscape and has experienced defaults, credit losses and significant liquidity concerns. There is no assurance that these conditions have stabilized or that they will not worsen. A continuation or increase in the volatility and deterioration in the broader residential mortgage and RMBS markets may adversely affect the performance and market value of our investments. Although we intend to purchase distressed mortgage loans at discounts to their unpaid principal balances, further deterioration in home prices or the value of our investments could require us to take charges that may be material.

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The actions of the U.S. government, the Federal Reserve and the U.S. Treasury may materially and adversely affect our business.

The U.S. government, the Federal Reserve, the U.S. Treasury and other governmental and regulatory bodies have taken and continue to take various actions to address the recent financial crisis. There can be no assurances that such actions will have a beneficial impact on the financial markets. In addition to the foregoing, the U.S. Congress and/or various states and local legislatures may enact additional legislation or regulatory action designed to address the current economic climate or for other purposes that could have a material adverse effect on our ability to continue to execute our business strategies.

To the extent the market does not respond favorably to these initiatives or they do not function as intended, they may not have a positive impact on our business. We can provide no assurance that we will be eligible to use any government programs or, if eligible, that we will be able to utilize them successfully. Further, the incentives provided by such programs may increase competition for, and the pricing of, our targeted assets.

Mortgage loan modification and refinance programs, future legislative action, and other actions and changes may materially and adversely affect the value of, and the returns on, the assets in which we intend to invest.

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

We are highly dependent on U.S. government-sponsored entities, and any changes in these entities or their current roles could materially and adversely affect our business, liquidity, financial position and results of operations.

Our ability to generate revenues through mortgage loan sales depends to a significant degree on programs administered by GSEs, government agencies, including Ginnie Mae, and others that facilitate the issuance of MBS, in the secondary market. These GSEs and Agencies play a critical role in the residential mortgage industry and we have significant business relationships with many of them. Presently, almost all of the newly originated conforming loans that we acquire from mortgage lenders through our correspondent lending activities qualify under existing standards for inclusion in mortgage securities backed by the GSEs or Ginnie Mae. We also derive other material financial benefits from these relationships, including the assumption of credit risk by these GSEs on loans included in such mortgage securities in exchange for our payment of guarantee fees and the ability to avoid certain loan inventory finance costs through streamlined loan funding and sale procedures.

There is significant uncertainty regarding the future of Fannie Mae and Freddie Mac, including with respect to how long they will continue to be in existence, the extent of their roles in the market and what forms they will have. Although the U.S. Treasury has committed capital to Fannie Mae and Freddie Mac since they were placed into conservatorship, there can be no assurance that additional funding will be provided within the required time periods or that the actions of the U.S. Treasury will be adequate for their needs. If such funding is not provided as required, the FHFA would be obligated to place Fannie Mae and Freddie Mac into receivership. Further, Fannie Mae or Freddie Mac could be placed into receivership at the discretion of the FHFA at any time under certain circumstances. If the actions of the U.S. Treasury are inadequate or pending repurchase requests by Fannie Mae and Freddie Mac to lenders prove unsuccessful, or if Fannie Mae and Freddie Mac are adversely affected by events such as ratings downgrades, foreclosure problems and delays and problems with mortgage insurers, Fannie Mae and Freddie Mac could continue to

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suffer losses and could fail to honor their guarantees and other obligations. In addition, the future roles of Fannie Mae and Freddie Mac remain uncertain. Their roles could be significantly reduced or eliminated and the nature of the guarantees could be considerably limited relative to historical measurements. The elimination of the traditional roles of Fannie Mae and Freddie Mac, or any changes to the nature or extent of the guarantees provided by Fannie Mae and Freddie Mac or the fees, terms and guidelines that govern our selling and servicing relationships with the GSEs, such as continued increases in the guarantee fees we are required to pay to the GSEs or possible limits on delivery volumes imposed upon us and other seller/servicers by one or more of the GSEs, could adversely affect our business, including our ability to sell and securitize GSE-eligible loans in our correspondent lending activities, and the performance, liquidity and market value of our investments.

Our ability to generate revenues from newly originated loans that we acquire through our correspondent lending activities is highly dependent on the fact that the GSEs have not historically acquired such loans directly from mortgage lenders, but have instead relied on banks and non-bank aggregators such as us to acquire, aggregate and securitize or otherwise sell such loans to investors in the secondary market. If one or more of the GSEs were to start making these purchases and sales for their own accounts, our business and results of operations could be adversely affected.

Any discontinuation of, or significant reduction in, the operation of these GSEs or any significant adverse change in the level of activity of these GSEs in the primary or secondary mortgage markets or in the underwriting criteria of these GSEs could materially and adversely affect our business, liquidity, financial position and results of operations.

We leverage our investments, which may materially and adversely affect our return on our investments and may reduce cash available for distribution to our shareholders.

We currently leverage and, to the extent available, we intend to continue to leverage our investments through borrowings, the level of which may vary based on the particular characteristics of our investment portfolio and on market conditions. We have leveraged certain of our investments through repurchase agreements. When we enter into repurchase agreements, we sell securities or mortgage loans to lenders (i.e., repurchase agreement counterparties) and receive cash from the lenders. The lenders are obligated to resell the same assets back to us at the end of the term of the transaction. Because the cash we receive from the lender when we initially sell the assets to the lender is less than the value of those assets (this difference is referred to as the haircut), if the lender defaults on its obligation to resell the same assets back to us we could incur a loss on the transaction equal to the amount of the haircut (assuming there was no change in the value of the assets). In addition, repurchase agreements generally allow the counterparties, to varying degrees, to determine a new market value of the collateral to reflect current market conditions. If such counterparties determine that the value of the collateral has decreased, it may initiate a margin call and require us to either post additional collateral to cover such decrease or repay a portion of the outstanding borrowing. Should this occur, in order to obtain cash to satisfy a margin call, we may be required to liquidate assets at a disadvantageous time, which could cause us to incur further losses. In the event we are unable to satisfy a margin call, our counterparty may sell the collateral, which may result in significant losses to us.

The lenders under our repurchase agreements require us and/or our subsidiaries to comply with various financial covenants, including those relating to tangible net worth, profitability and our ratio of total liabilities to tangible net worth. Certain of our lenders also require us to maintain minimum amounts of cash or cash equivalents sufficient to maintain a specified liquidity position. In the event that we are unable to maintain these liquidity levels, we could be forced to sell additional investments at a loss and our financial condition could deteriorate rapidly.

As the servicer under our repurchase agreements, PLS is also subject to various financial covenants, including those relating to tangible net worth, liquidity, profitability and its ratio of total liabilities to tangible net worth. PLS's failure to comply with any of these covenants would generally result in a servicer termination event or event of default under one or more of our repurchase agreements. Thus, in addition to relying upon PCM to manage our financial covenants, we rely upon PLS to manage its own financial covenants in order to ensure our

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compliance with our repurchase agreements and our continued access to liquidity and capital. A servicer termination event or event of default resulting from PLS's breach of its financial or other covenants could materially adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to shareholders.

Our repurchase agreements to finance nonperforming loans and other distressed mortgage assets are complex and difficult to manage. This is due in part to the nature of the underlying assets securing such financings, which do not produce consistent cash flows and which require specific activities to be performed at specific points in time in order to preserve value. Our inability to comply with the terms and conditions of these facilities could materially and adversely impact us.

In addition, the repurchase agreements contain events of default (subject to certain materiality thresholds and grace periods), including payment defaults, breaches of financial and other covenants and/or certain representations and warranties, cross-defaults, servicer termination events, guarantor defaults, bankruptcy or insolvency proceedings and other events of default customary for these types of facilities. The remedies for such events of default are also customary for these types of facilities and include the acceleration of the principal amount outstanding and the liquidation by the lender of the assets then subject to the respective facilities. If we default on one of our obligations under a repurchase agreement, the lender may be able to terminate the transaction, accelerate any amounts outstanding and cease entering into any other repurchase transactions with us. Because our repurchase agreements typically contain cross-default provisions, a default that occurs under any one agreement could allow the lenders under our other agreements to also declare a default. Our other secured borrowings are subject to similar risks as those that apply to our repurchase agreements. Any losses we incur on our repurchase agreements and other secured borrowings could materially and adversely affect our earnings, financial condition and our cash available for distribution to our shareholders.

We may in the future utilize other sources of borrowings, including bank credit facilities and structured financing arrangements, among others. The percentage of leverage we employ varies depending on the asset class being financed, our available capital, our ability to obtain and access financing arrangements with lenders and the lenders' and rating agencies' estimate of the stability of our investment portfolio's cash flow. There can be no assurance that new sources of financing will be available to us in the future or that existing sources of financing will continue to be available to us. We also own REO, for which there is currently limited financing available and no assurance of available financing in the future.

Our governing documents contain no limitation on the amount of debt we may incur. There can be no assurance that new sources of financing will be available to us in the future or that existing sources of financing will continue to be available to us. Our return on our investments and cash available for distribution to our shareholders may be reduced to the extent that changes in market conditions increase the cost of our financing relative to the income that can be derived from the investments acquired. Our debt service payments will reduce cash flow available for distribution to shareholders. We may not be able to meet our debt service obligations and, to the extent that we cannot, we risk the loss of some or all of our assets to foreclosure or sale to satisfy the obligations.

As non-recourse long-term financing structures become available to us and are utilized, such structures expose us to risks which could result in losses to us.

We may use securitization and other non-recourse long-term financing for our investments to the extent available. In such structures, our lenders typically would have only a claim against the assets included in the securitizations rather than a general claim against us as an entity. Prior to any such financing, we would seek to finance our investments with relatively short-term facilities until a sufficient portfolio is accumulated. As a result, we would be subject to the risk that we would not be able to acquire, during the period that any short-term facilities are available, sufficient eligible assets or securities to maximize the efficiency of a securitization.

We also bear the risk that we would not be able to obtain new short-term facilities or would not be able to renew any short-term facilities after they expire should we need more time to seek and acquire sufficient eligible

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assets or securities for a securitization. In addition, conditions in the capital markets may make the issuance of any such securitization less attractive to us even when we do have sufficient eligible assets or securities. While we would intend to retain the unrated equity component of securitizations and, therefore, still have exposure to any investments included in such securitizations, our inability to enter into such securitizations may increase our overall exposure to risks associated with direct ownership of such investments, including the risk of default.

Our inability to refinance any short-term facilities would also increase our risk because borrowings thereunder would likely be recourse to us as an entity. If we are unable to obtain and renew short-term facilities or to consummate securitizations to finance our investments on a long-term basis, we may be required to seek other forms of potentially less attractive financing or to liquidate assets at an inopportune time or price.

We may not be able to raise the debt or equity capital required to finance our assets and grow our businesses.

The growth of our businesses requires continued access to debt and equity capital that may or may not be available on favorable terms or at the desired times, or at all. In addition, we invest in certain assets, including distressed loans, real estate acquired in settlement of loans, and MSRs, for which financing has historically been difficult to obtain. Our inability to continue to maintain debt financing for distressed loans and real estate acquired in settlement of loans, or our inability in the future to obtain debt financing for MSRs, could require us to seek equity capital that may be more costly or unavailable to us.

We cannot assure you that we will have access to any debt or equity capital on favorable terms or at the desired times, or at all. Our inability to obtain raise such capital or obtain financing on favorable terms could materially adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to shareholders.

Future issuances of debt securities, which would rank senior to our common shares, and future issuances of equity securities, which would dilute the holdings of our existing shareholders and may be senior to our common shares, may materially and adversely affect the market price of our common shares.

In order to grow our business, we may rely on additional equity issuances, which may rank senior and/or be dilutive to our shareholders, or on less efficient forms of debt financing that rank senior to our shareholders and require a larger portion of our cash flow from operations, thereby reducing funds available for our operations, future business opportunities, cash distributions to our shareholders and other purposes.

Upon liquidation, holders of our debt securities and other loans and preferred shares would receive a distribution of our available assets before holders of our common shares. Subject to applicable law, our board of trustees has the authority, without further shareholder approval, to issue additional common shares and to issue preferred shares on the terms and for the consideration it deems appropriate. We have issued, and intend to issue, additional common shares and securities convertible into, or exchangeable or exercisable for, common shares under our equity incentive plan. We have also filed a shelf registration statement, from which we have issued and may in the future issue additional common shares, including, without limitation through our at-the-market equity program.

We also may issue from time to time additional common shares in connection with property, portfolio or business acquisitions and may grant demand or piggyback registration rights in connection with such issuances. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict the effect, if any, of future issuances of our common shares, preferred shares or other equity-based securities or the prospect of such issuances on the market price of our common shares. Issuances of a substantial amount of such securities, or the perception that such issuances might occur, could depress the market price of our common shares. Our preferred shares, if issued, would likely have a preference on distribution payments, including liquidating distributions, which could limit our ability to make distributions, including liquidating distributions, to holders of our common shares.

Thus, holders of our common shares bear the risk that our future issuances of debt or equity securities or other borrowings will reduce the market price of our common shares and dilute their ownership in us.

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Interest rate fluctuations could significantly decrease our results of operations and cash flows and the market value of our investments.

Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Interest rate fluctuations present a variety of risks to our operations. Our primary interest rate exposures relate to the yield on our investments, their market value and the financing cost of our debt, as well as any interest rate swaps that we utilize for hedging purposes. Changes in interest rates affect our net interest income, which is the difference between the interest income we earn on our interest earning investments and the interest expense we incur in financing these investments. Interest rate fluctuations resulting in our interest expense exceeding interest income may result in operating losses for us. An increase in prevailing interest rates could adversely affect the volume of newly originated mortgages available for purchase in our correspondent lending activities. Changes in the level of interest rates also may affect our ability to make investments, the value of our investments (including our pipeline of mortgage loan commitments) and any related hedging instruments, and our ability to realize gains from the disposition of assets. Changes in interest rates may also affect borrower default rates and may impact our ability to refinance or modify loans and/or to sell REO. In addition, with respect to the MSRs we own, decreasing interest rates may cause a large number of borrowers whose loans are being serviced by PLS to refinance, which may result in the loss of any such mortgage servicing business and associated write-downs of such MSRs. Any such scenario could materially and adversely affect us.

Hedging against interest rate exposure may materially and adversely affect our results of operations and cash flows.

We pursue hedging strategies to reduce our exposure to changes in interest rates. Our hedging activity varies in scope based on the level of interest rates, the type of investments held, and other changing market conditions. However, while we enter into such transactions seeking to reduce interest rate risk, unanticipated changes in interest rates may result in poorer overall investment performance than if we had not engaged in any such hedging transactions. Interest rate hedging may fail to protect or could adversely affect us because, among other things, it may not fully eliminate interest rate risk, it could expose us to counterparty and default risk that may result in greater losses or the loss of unrealized profits, and it will create additional expense, while any income it generates to offset losses may be limited by federal tax provisions applicable to REITs. Thus hedging activity, while intended to limit losses, may materially and adversely affect our results of operations and cash flows.

We utilize derivative instruments, which could subject us to risk of loss.

We utilize derivative instruments for hedging purposes, which may include swaps, options and futures. However, the prices of derivative instruments, including futures and options, are highly volatile, as are payments made pursuant to swap agreements. As a result, the cost of utilizing derivatives may reduce our income that would otherwise be available for distribution to shareholders or for other purposes, and the derivative instruments that we utilize may fail to effectively hedge our positions. We are also subject to credit risk with regard to the counterparties involved in the derivative transactions.

Competition for distressed assets may limit the availability of desirable investments and result in reduced risk-adjusted returns.

Our profitability depends, in part, on our ability to continue to acquire our targeted investments at favorable prices. As described in greater detail elsewhere in this Report, we compete in our distressed investment activities with other mortgage REITs, specialty finance companies, private funds, thrifts, banks, mortgage bankers, insurance companies, mutual funds, institutional investors, investment banking firms, depository institutions, governmental bodies and other entities, many of which focus on acquiring distressed mortgage loans. Many of our competitors also have competitive advantages over us, including size, financial strength, access to capital, cost of funds, federal pre-emption and risk tolerance. Competition may result in fewer investments, higher prices, acceptance of greater risk, lower yields and a narrower spread of yields over our financing costs.

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Our board of trustees has approved very broad investment policies for PCM and will not review or approve each investment decision. We may change our investment strategies and policies without shareholder consent, which may materially and adversely affect the market value of our common shares and our ability to make distributions to our shareholders.

PCM is authorized to follow very broad investment policies and, therefore, has great latitude in determining the types of assets that are proper investments for us, as well as the individual investment decisions. In the future, PCM may make investments with lower rates of return than those anticipated under current market conditions and/or may make investments with greater risks to achieve those anticipated returns. Our board of trustees will periodically review our investment policies and our investment portfolio but will not review or approve each proposed investment by PCM unless it falls outside our investment policies or constitutes a related party transaction.

In addition, in conducting periodic reviews, our board of trustees will rely primarily on information provided to it by PCM. Furthermore, PCM may use complex strategies, and transactions entered into by PCM may be costly, difficult or impossible to unwind by the time they are reviewed by our board of trustees. In addition, we may change our investment strategies and policies and targeted asset classes at any time without the consent of our shareholders, and this could result in our making investments that are different in type from, and possibly riskier than our current investments or the investments currently contemplated. Changes in our investment strategies and policies and targeted asset classes may increase our exposure to interest rate risk, counterparty risk, default risk and real estate market fluctuations, which could materially and adversely affect the market value of our common shares and our ability to make distributions to our shareholders.

We are not an approved Ginnie Mae issuer and servicer, and an increase in the percentage of government loans we acquire could be detrimental to us.

We are not currently approved as a Ginnie Mae issuer and servicer. As long as we are unable to obtain approval as a Ginnie Mae issuer and servicer, we will be unable to produce or acquire Ginnie Mae MSRs. While PLS has agreed to negotiate in good faith with us to structure alternative arrangements whereby we can participate in the economics associated with government MSRs, there can be no assurance that any such arrangement will obtain government approval on favorable terms, or at all. In the absence of approval as a Ginnie Mae issuer and servicer or government approval of an alternative arrangement, we may continue to earn significantly less income in connection with our acquisition of government loans as opposed to conventional loans. Further, PLS may offer pricing to our approved correspondent sellers for government loans that is more competitive in the market than pricing for conventional loans, the result of which may be our acquisition of a greater proportion of government loans. Any significant increase in the percentage of government loans we acquire could adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to shareholders.

Our correspondent lending activities could subject us to increased risk of loss.

In our correspondent lending activities, we acquire newly originated loans, including jumbo loans, from mortgage lenders and sell or securitize those loans to or through the Agencies or other third party investors. We also sell the resulting securities into the MBS markets. However, there can be no assurance that PCM will continue to be successful in operating this business on our behalf or that we will continue to be able to capitalize on these opportunities on favorable terms or at all. In particular, we have committed, and expect to continue to commit, capital and other resources to this operation; however, PCM may not be able to continue to source sufficient investment opportunities to justify the expenditure of such capital and other resources. In the event that PCM is unable to continue to source sufficient investment opportunities for this operation, there can be no assurance that we would be able to acquire such investments on favorable terms or at all, or that such investments, if acquired, would be profitable to us. In addition, we may be unable to finance the acquisition of these investments and/or may be unable to sell the resulting MBS in the secondary mortgage market on favorable terms or at all. We are also subject to the risk that the value of the acquired loans may decrease prior to their disposition. The occurrence of any one or more of these risks could adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

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Our failure or the failure by PLS to obtain any necessary licenses, comply with applicable licensing laws or satisfy the various requirements to maintain them over time could restrict our direct business activities, result in civil and other monetary penalties, or cause us to default under certain of our lending arrangements, any of which could materially and adversely impact our business.

We and PLS are also required to hold Agency approvals in order to sell mortgage loans to the Agencies and service such mortgage loans on their behalf. Our failure, or the failure of PLS, to satisfy the various requirements necessary to maintain such Agency approvals over time would also restrict our direct business activities and could adversely impact our business.

In addition, we and PLS are subject to periodic examinations by state and other regulators, which can result in increases in our administrative costs, and we or PLS may be required to pay substantial penalties imposed by these regulators due to compliance errors, or we or PLS may lose our licenses. Fines and penalties incurred in one jurisdiction may cause investigations or other actions by regulators in other jurisdictions.

We and/or PLS are required to have various Agency approvals and state licenses in order to conduct our business and there is no assurance we and/or PLS will be able to obtain or maintain those Agency approvals or state licenses.

Because we are not depository institutions, we and PLS do not benefit from exemptions to state mortgage banking, loan servicing or debt collection licensing and regulatory requirements. Accordingly, we and PLS are required to be licensed to conduct business in certain jurisdictions. PLS is licensed, or is taking steps to become licensed, in those jurisdictions, and for those activities, where it believes it is cost effective and appropriate to become licensed. Through our wholly owned subsidiaries, we are licensed or are taking steps to become licensed, in those jurisdictions, and for those activities, where we believe it is cost effective and appropriate to become licensed.

Our failure or the failure by PLS to obtain any necessary licenses, comply with applicable licensing laws or satisfy the various requirements to maintain them over time could restrict our direct business activities, result in civil and other monetary penalties, or cause us to default under certain of our lending arrangements, any of which could materially and adversely impact our business.

We and PLS are also required to hold Agency approvals in order to sell mortgage loans to the Agencies and service such mortgage loans on their behalf. Our failure, or the failure of PLS, to satisfy the various requirements necessary to maintain such Agency approvals over time would also restrict our direct business activities and could adversely impact our business.

In addition, we and PLS are subject to periodic examinations by state and other regulators, which can result in increases in our administrative costs, and we or PLS may be required to pay substantial penalties imposed by these regulators due to compliance errors, or we or PLS may lose our licenses. Fines and penalties incurred in one jurisdiction may cause investigations or other actions by regulators in other jurisdictions.

A disruption in the MBS market could materially adversely affect our business, financial condition and results of operations.

In our correspondent lending activities, we deliver newly originated GSE-eligible mortgage loans that we acquire to Fannie Mae or Freddie Mac to be pooled into Agency MBS securities or transfer government loans that we acquire to PLS, which pools them into Ginnie Mae MBS securities. Disruptions in the general MBS market have occurred in the past. Any significant disruption or period of illiquidity in the general MBS market would directly affect our liquidity because no existing alternative secondary market would likely be able to accommodate on a timely basis the volume of loans that we typically acquire and sell in any given period. Accordingly, if the MBS market experiences a period of illiquidity, we might be prevented from selling the loans that we acquire into the secondary market in a timely manner or at favorable prices, which could materially adversely affect our business, financial condition and results of operations.

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The industry in which we operate is highly competitive, and is likely to become more competitive, and our inability to compete successfully or decreased margins resulting from increased competition could adversely affect our business, financial condition and results of operations.

We operate in a highly competitive industry that could become even more competitive as a result of economic, legislative, regulatory and technological changes. Competition in acquiring newly originated mortgage loans comes from large commercial banks and savings institutions and other independent mortgage lenders and servicers. Many of these institutions generally have significantly greater resources and access to capital than we do, which gives them the benefit of a lower cost of funds. Additionally, our existing and potential competitors may decide to modify their business models to compete more directly with our correspondent lending business. For example, non-bank loan servicers may try to leverage their servicing operations to develop or expand a correspondent lending business. Since the withdrawal of a number of large participants from these markets following the financial crisis in 2008, there have been relatively few large non-bank participants. As more non-bank entities enter these markets, our correspondent lending activities may generate lower margins in order to effectively compete.

We may be subject to liability for potential violations of various lending laws, which could adversely impact our results of operations, financial condition and business.

Residential mortgage loan originators and servicers operate in a highly regulated industry and are required to comply with various federal, state and local laws and regulations, including anti-predatory lending laws and laws and regulations imposing certain restrictions and requirements on high cost loans. To the extent these originators or servicers fail to comply with applicable law and any of their residential mortgage loans become part of our assets, it could subject us, as an assignee or purchaser of the related residential mortgage loans, to monetary penalties or other losses and could result in the borrowers rescinding the affected residential mortgage loans. Further, if any of our loans are found to have been originated, serviced or owned by us or a third party in violation of applicable law, we could be subject to lawsuits or governmental actions, or we could be fined or incur losses, any of which could adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

Compliance with changing regulation of corporate governance and public disclosure has and will continue to result in increased compliance costs and pose challenges for our management team.

Changing laws, regulations and standards relating to corporate governance and public disclosure, including the Dodd-Frank Act and the rules, regulations and agencies promulgated thereunder, the Sarbanes-Oxley Act of 2002 and SEC regulations, have created uncertainty for public companies and significantly increased the compliance requirements, costs and risks associated with accessing the U.S. public markets. Our management team has and will continue to devote significant time and financial resources to comply with both existing and evolving standards for public companies; however, this will continue to lead to increased general and administrative expenses and a diversion of management time and attention from revenue generating activities to compliance activities.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us and, more generally, the financial services and mortgage industries. Additionally, we cannot predict whether there will be additional proposed laws or reforms that would affect us, whether or when such changes may be adopted, how such changes may be interpreted and enforced or how such changes may affect us. However, the costs of complying with any additional laws or regulations could have a material adverse effect on our financial condition and results of operations.

Technology failures could damage our business operations and increase our costs, which could adversely affect our business, financial condition and results of operations.

The financial services industry as a whole is characterized by rapidly changing technologies, and system disruptions and failures caused by fire, power loss, telecommunications failures, unauthorized intrusion,

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computer viruses and disabling devices, natural disasters and other similar events may interrupt or delay the ability of PCM or PLS to provide services to our customers on our behalf. Security breaches, acts of vandalism and developments in computer capabilities could result in a compromise or breach of the technology used to protect our customers' personal information and transaction data. Despite efforts by PCM or PLS to ensure the integrity of their systems, it is possible that they may not be able to anticipate or implement effective preventive measures against all security breaches, especially because the methods of attack change frequently or are not recognized until launched, and because security attacks can originate from a wide variety of sources, including third parties such as persons involved with organized crime or associated with external service providers. Those parties may also attempt to fraudulently induce employees, customers or other users of these systems to disclose sensitive information in order to gain access to our data or that of our customers or clients. These risks may increase in the future along with the industry's increase in its reliance on the Internet and use of web-based product offerings.

A successful penetration or circumvention of the security of our systems or a defect in the integrity of PCM's or PLS's systems or cyber security could cause serious negative consequences for our business, including significant disruption of our activities, misappropriation of our confidential information or that of our customers, or damage to PCM's or PLS's computers or operating systems and to those of our customers and counterparties. Any of the foregoing events could result in violations of applicable privacy and other laws, financial loss to us, to PCM or PLS, or to our customers, loss of confidence in us, customer dissatisfaction, significant litigation exposure and harm to our reputation, all of which could adversely affect our business, financial condition and results of operations.

The success and growth of our correspondent lending activities will depend upon PLS's ability to adapt to and implement technological changes.

Our correspondent lending activities are currently dependent upon the ability of PLS to effectively interface with our mortgage lenders and other third parties and to efficiently process loan fundings and closings. The correspondent lending process is becoming more dependent upon technological advancement. Maintaining and improving new technology and becoming proficient with it may also require significant capital expenditures by PLS. As these requirements increase in the future, PLS will have to fully develop these technological capabilities to remain competitive and its failure to do so could adversely affect our business, financial condition and results of operations.

Our entry into the warehouse lending business could subject us to increased risk of loss.

We intend to enter into the warehouse lending business through one or more of our subsidiaries. In connection with such activity, we will generally finance a mortgage loan originated by a correspondent lender under a master repurchase agreement, pursuant to which we will purchase the loan at a discount to its unpaid principal balance. Upon its sale of the loan to us or a third party, the correspondent lender would then repurchase the loan from us in an amount equal to our purchase price plus accrued interest through the date of repurchase.

The ability of the correspondent lender to repurchase a loan from us may be contingent on its ability to sell such loan in an amount sufficient to pay us the full repurchase price. There can be no assurance that the correspondent lender will be able to sell the loan for an amount sufficient to repay its borrowings from us, or at all. As a result, we are subject to the credit risk of our correspondent lenders. If the correspondent lender is unable to sell the loan and unable to repay its borrowings from us, there can be no assurance that any value we are able to realize through a sale or liquidation of the underlying loan will be sufficient to avoid a loss of all or a portion of the amount of the borrowing. Such losses could harm our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

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If we fail to maintain an effective system of internal controls, we may not be able to accurately determine our financial results or prevent fraud.

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. We may in the future discover areas of our internal controls that need improvement. Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate and report on our internal controls over financial reporting and have our independent auditors annually attest to our evaluation, as well as issue their own opinion on our internal control over financial reporting. While we have undertaken substantial work to comply with Section 404, we cannot be certain that we will be successful in maintaining adequate control over our financial reporting and financial processes. Furthermore, as we grow our business, our internal controls will become more complex, and we will require significantly more resources to ensure our internal controls remain effective. If we or our independent auditors discover a material weakness, the disclosure of that fact, even if quickly remedied, could reduce the market value of our common shares. Additionally, the existence of any material weakness or significant deficiency would require management to devote significant time and incur significant expense to remediate any such material weakness or significant deficiency and management may not be able to remediate any such material weakness or significant deficiency in a timely manner, or at all.

Terrorist attacks and other acts of violence or war may materially and adversely affect the real estate industry generally and our business, financial condition, liquidity and results of operations.

The terrorist attacks on September 11, 2001 disrupted the U.S. financial markets, including the real estate capital markets, and negatively impacted the U.S. economy in general. Any future terrorist attacks, the anticipation of any such attacks, the consequences of any military or other response by the U.S. and its allies, and other armed conflicts could cause consumer confidence and spending to decrease or result in increased volatility in the U.S. and worldwide financial markets and economy. The economic impact of these events could also materially and adversely affect the collectability of some of our loans and the credit quality of our loans and investments and the properties underlying our interests. We may suffer losses as a result of the adverse impact of any future attacks and these losses may adversely impact our performance and may cause the market value of our common shares to decline or be more volatile. We cannot predict the severity of the effect that potential future armed conflicts and terrorist attacks would have on us. Losses resulting from these types of events may not be fully insurable.

Risks Related to Our Investments

The mortgage loans in which we invest and the mortgage loans underlying the MBS in which we invest subject us to delinquency, foreclosure and loss, as well as the risks associated with residential real estate and residential real estate-related investments, any of which could result in losses to us.

We invest in performing and nonperforming residential mortgage loans, and newly originated prime credit quality residential mortgage loans through our correspondent lending business. Residential mortgage loans are typically secured by single-family residential property and are subject to risks of delinquency and foreclosure and risks of loss. These risks are greater for nonperforming loans. In addition, we invest in RMBS that are not guaranteed by federally chartered entities such as Fannie Mae and Freddie Mac or, in the case of Ginnie Mae, the U.S. government. The ability of borrowers to repay residential mortgage loans that we own, or underlying RMBS that we own, is dependent upon the income or assets of these borrowers.

We are authorized to invest in CMBS and may also invest in commercial mortgage loans. Commercial mortgage loans are secured by multifamily or commercial property and are subject to risks of delinquency and foreclosure, and risks of loss that are greater than similar risks associated with loans made on the security of single-family residential property. The ability of a borrower to repay a loan secured by an income-producing property typically is dependent primarily upon the successful operation of such property rather than upon the existence of independent income or assets of the borrower. Net operating income of an income producing property can be affected by a variety of factors, and if the net operating income of the property is reduced, the

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borrower's ability to repay the loan may be impaired. In the event of any default under a mortgage loan held directly by us, we will bear a risk of loss of principal to the extent of any deficiency between the value of the collateral and the price we paid for the loan and any accrued interest of the mortgage loan plus advances made, which could have a material adverse effect on our cash flow from operations.

In the event of the bankruptcy of a mortgage loan borrower, the mortgage loan to such borrower will be deemed to be secured only to the extent of the value of the underlying collateral at the time of bankruptcy (as determined by the bankruptcy court), and the lien securing the mortgage loan will be subject to the avoidance powers of the bankruptcy trustee or debtor-in-possession to the extent the lien is unenforceable under state law.

Our investments in mortgage loans and MBS also subject us to the risks of residential real estate and residential real estate-related investments, including, among others: (i) continued declines in the value of residential real estate; (ii) risks related to general and local economic conditions; (iii) possible lack of availability of mortgage funds for borrowers to refinance or sell their homes; (iv) overbuilding; (v) the general deterioration of the borrower's ability to keep a rehabilitated nonperforming mortgage loan current; (vi) increases in property taxes and operating expenses; (vii) changes in zoning laws; (viii) costs resulting from the clean-up of, and liability to third parties for damages resulting from, environmental problems, such as indoor mold; (ix) casualty or condemnation losses; (x) uninsured damages from floods, earthquakes or other natural disasters; (xi) limitations on and variations in rents; (xii) fluctuations in interest rates; (xiii) fraud by borrowers, originators and/or sellers of mortgage loans; (xiv) undetected deficiencies and/or inaccuracies in underlying mortgage loan documentation and calculations; and (xv) failure of the borrower to adequately maintain the property, particularly during times of financial difficulty. To the extent that assets underlying our investments are concentrated geographically, by property type or in certain other respects, we may be subject to certain of the foregoing risks to a greater extent. Additionally, we may be required to foreclose on a mortgage loan and such actions would subject us to greater concentration of the risks of the residential real estate markets and risks related to the ownership and management of real property.

A significant portion of the residential mortgage loans that we acquire are or may become nonperforming loans, which increases our risk of loss of our investment.

We acquire distressed residential mortgage loans and mortgage-related assets where the borrower has failed to make timely payments of principal and/or interest. We also acquire performing loans that subsequently become nonperforming. Under current market conditions, it is likely that many of these loans will have current loan-to-value ratios in excess of 100%, meaning the amount owed on the loan exceeds the value of the underlying real estate. Further, the borrowers on such loans may be in economic distress and/or may have become unemployed, bankrupt or otherwise unable or unwilling to make payments when due. If PLS as our primary and special servicer is not able to address the issues concerning these loans, we may incur significant losses. There are no limits on the percentage of nonperforming assets we may hold. Any loss we incur may be significant and may reduce distributions to our shareholders and materially and adversely affect the market value of our common shares.

We invest in subprime residential mortgage loans or RMBS collateralized by subprime mortgage loans, which are subject to increased risks.

As part of our investment activities, we invest in subprime residential mortgage loans or RMBS backed by collateral pools of subprime residential mortgage loans, which are mortgage loans originated using underwriting standards that are less restrictive than the underwriting standards for other first and junior lien mortgage loan purchase programs, such as the programs of Fannie Mae and Freddie Mac. Because of the higher delinquency rates and losses associated with subprime mortgage loans, the performance of subprime mortgage loans or RMBS backed by subprime mortgage loans in which we invest could be correspondingly adversely affected, which could materially and adversely impact our business, financial condition, liquidity, and results of operations.

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A significant portion of our investments is and will continue to be in the form of whole loan mortgages, which are subject to increased risks.

A significant portion of our investments is and will continue to be in the form of whole loan mortgages, which are directly exposed to losses resulting from default and foreclosure. In the event of a foreclosure, we may assume direct ownership of the underlying real estate. The liquidation proceeds upon sale of such real estate may not be sufficient to recover our investment in the loan, resulting in a loss to us. In addition, the foreclosure process may be lengthy and expensive, and any delays or costs involved in the effectuation of a foreclosure of the loan or a liquidation of the underlying property may further reduce the proceeds and thus increase the loss.

Our acquisition of mortgage servicing rights exposes us to significant risks.

MSRs arise from contractual agreements between us and the investors (or their agents) in mortgage securities and mortgage loans. We generally acquire MSRs from the sale of mortgage loans where we assume the obligation to service the loan in connection with the sale transaction or we may purchase MSRs. Any MSRs we acquire are recorded at fair value on our balance sheet based upon significant estimates and assumptions. The determination of the fair value of MSRs requires our management to make numerous estimates and assumptions. Such estimates and assumptions include, without limitation, estimates of future cash flows associated with MSRs based upon assumptions involving interest rates as well as the prepayment rates, delinquencies and foreclosure rates of the underlying serviced mortgage loans. The ultimate realization of the value of MSRs may be materially different than the fair values of such MSRs as may be reflected in our consolidated balance sheet as of any particular date. The use of different estimates or assumptions in connection with the valuation of these assets could produce materially different fair values for such assets, which could have a material adverse effect on our business, financial condition, results of operations and cash flows. Accordingly, there may be material uncertainty about the fair value of any MSRs we acquire.

Changes in interest rates are a key driver of the performance of MSRs since the values of MSRs are highly sensitive to changes in interest rates. Historically, the value of MSRs has increased when interest rates rise and decreased when interest rates decline due to the effect those changes in interest rates have on prepayment estimates. We may pursue various hedging strategies to seek to reduce our exposure to adverse changes in interest rates. Our hedging activity will vary in scope based on the level and volatility of interest rates, the type of assets held and other changing market conditions. Interest rate hedging may fail to protect or could adversely affect us. To the extent we do not utilize derivatives to hedge against changes in fair value of MSRs, our balance sheet, financial condition and results of operations would be susceptible to volatility due to changes in the fair value of, or cash flows from, MSRs as interest rates change.

Prepayment speeds significantly affect MSRs. Prepayment speed is the measurement of how quickly borrowers pay down the unpaid principal balance of their loans or how quickly loans are otherwise brought current, modified, liquidated or charged off. We base the price we pay for MSRs and the rate of amortization of those assets on, among other things, our projection of the cash flows from the related pool of mortgage loans. Our expectation of prepayment speeds is a significant assumption underlying those cash flow projections. If prepayment speeds are significantly greater than expected, the fair value of the MSRs could decline and we may be required to record a non-cash charge, which would have a negative impact on our financial results. Furthermore, a significant increase in prepayment speeds could materially reduce the ultimate cash flows we receive from MSRs, and we could ultimately receive substantially less than what we paid for such assets. Moreover, delinquency rates have a significant impact on the valuation of any MSRs. An increase in delinquencies generally results in lower revenue because typically we only collect servicing fees from GSEs or mortgage owners for performing loans. We base the price we pay for MSRs on, among other things, our projections of the cash flows from related pools of mortgage loans. Our expectation of delinquencies is a significant assumption underlying those cash flow projections. If delinquencies are significantly greater than we expect, the estimated fair value of the MSRs could be diminished. When the estimated fair value of MSRs is reduced, we could suffer a loss, which could have a negative impact on our financial results.

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Furthermore, MSR's and the related servicing activities are subject to numerous federal, state and local laws and regulations and may be subject to various judicial and administrative decisions imposing various requirements and restrictions on our business. Our failure to comply, or the failure of the servicer to comply, with the laws, rules or regulations to which we or they are subject by virtue of ownership of MSR's, whether actual or alleged, could expose us to fines, penalties or potential litigation liabilities, including costs, settlements and judgments, any of which could have a material adverse effect on our business, financial condition and results of operations.

We cannot independently protect our MSR asset from borrower refinancing and are dependent upon PLS to do so for our benefit.

While PLS has agreed pursuant to the terms of an MSR recapture agreement to transfer to us a portion of the MSR's relating to mortgage loans it refinances, we are not independently capable of protecting our MSR asset from borrower refinancing through targeted solicitations to, and origination of, refinance loans for borrowers in our servicing portfolio. Accordingly, unlike traditional mortgage originators and many servicers, we must rely on PLS to refinance mortgage loans in our servicing portfolio that would otherwise be targeted by third party lenders. There can be no assurance that PLS will either have or allocate the time and resources required to effectively and efficiently solicit our servicing portfolio. Its failure to do so, or the termination of our MSR recapture agreement, could result in accelerated runoff of our MSR asset, decreasing its value and adversely impacting our business, financial condition and results of operations.

RMBS and CMBS investments are subject to significant risks.

We invest in RMBS and may invest in CMBS. RMBS evidence interests in or secured by pools of residential mortgage loans and CMBS evidence interests in or secured by a single commercial mortgage loan or a pool of commercial mortgage loans. Accordingly, RMBS and CMBS are subject to all of the risks of the respective underlying mortgage loans. In addition, the market value of mortgage securities will generally vary inversely with changes in market interest rates, declining when interest rates rise and rising when interest rates decline. However, mortgage securities, while having comparable risk of decline during periods of rising rates, usually have less potential for capital appreciation than other investments of comparable maturities due to the likelihood of increased prepayments of mortgages as interest rates decline.

Investments in subordinated loans and subordinated MBS could subject us to increased risk of losses.

We invest in subordinated loans and may invest in subordinated MBS. In the event a borrower defaults on a subordinated loan and lacks sufficient assets to satisfy such loan, we may lose all or a significant part of our investment. In the event a borrower becomes subject to bankruptcy proceedings, we will not have any recourse to the assets, if any, of the borrower that are not pledged to secure our loan, and the unpledged assets of the borrower may not be sufficient to satisfy our loan. If a borrower defaults on our subordinated loan or on its senior debt (*i.e.*, a first-lien loan, in the case of a residential mortgage loan, or a contractually or structurally senior loan, in the case of a commercial mortgage loan), or in the event of a borrower bankruptcy, our subordinated loan will be satisfied only after all senior debt is paid in full. As a result, we may not recover all or even a significant part of our investment, which could result in losses. In the case of commercial mortgage loans where senior debt exists, the presence of intercreditor arrangements may also limit our ability to amend our loan documents, assign our loan, accept prepayments, exercise our remedies and control decisions made in bankruptcy proceedings relating to borrowers.

In general, losses on an asset securing a mortgage loan included in a securitization will be borne first by the equity holder of the property, then by a cash reserve fund or letter of credit provided by the borrower, if any, and then by the first loss subordinated security holder and then by the second loss subordinated security holder. In the event of default and the exhaustion of any equity support, reserve fund, letter of credit and any classes of securities junior to those in which we invest, we may not recover all or even a significant part of our investment, which could result in losses.

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In addition, if the underlying mortgage portfolio has been serviced ineffectively by the loan servicer or overvalued by the originator, or if the values of the assets subsequently decline and, as a result, less collateral is available to satisfy interest and principal payments due on the related MBS, the securities in which we invest may suffer significant losses. The prices of these types of lower credit quality investments are generally more sensitive to adverse actual or perceived economic downturns or individual issuer developments than more highly rated investments. An economic downturn or a projection of an economic downturn, for example, could cause a decline in the price of lower credit quality investments because the ability of obligors to make principal and interest payments or to refinance may be impaired.

Our investments in loans to and debt securities of real estate companies will be subject to the specific risks relating to the particular borrower or issuer of the securities and to the general risks of investing in real estate-related loans and securities, which could result in significant losses.

We may invest in loans to and debt securities of real estate companies, including REITs. These investments involve special risks relating to the particular borrower or issuer of the securities, including the financial condition, liquidity, results of operations, business and prospects of the borrower or issuer. Investments in REIT debt securities may also be subject to risks relating to transfer restrictions, substantial market price volatility resulting from changes to prevailing interest rates, and, in the case of subordinated investments, the seniority of claims of banks and other senior lenders to the issuer. In addition, real estate companies often invest, and REITs generally are required to invest substantially, in real estate or real estate-related assets and are subject to some or all of the risks inherent with real estate and real estate-related investments referred to in this Report. These risks may adversely affect the value of our debt securities of real estate companies and the ability of the issuers thereof to make principal and interest payments in a timely manner, or at all, which could result in significant losses for us.

The failure of PLS or any other servicer to effectively service our portfolio of mortgage loans would materially and adversely affect us.

Pursuant to our loan servicing agreement, PLS provides us with primary and special servicing. PLS loan servicing activities include collecting principal, interest and escrow account payments, if any, with respect to mortgage loans, as well as managing loss mitigation, which may include, among other things, collection activities, loan workouts, modifications and refinancings, foreclosures, short sales, sales of REO and financings to facilitate such sales. The ability of PLS or any other servicer or subservicer to effectively service our portfolio of mortgage loans is critical to our success, particularly given our strategy of maximizing the value of the mortgage loans that we acquire through proprietary loan modification programs, special servicing and other initiatives focused on keeping borrowers in their homes; or in the case of nonperforming loans, effecting property resolutions in a timely, orderly and economically efficient manner. The failure of PLS or any other servicer or subservicer to effectively service our portfolio of mortgage loans would adversely impact our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

The increasing number of proposed U.S. federal, state and local laws may affect certain mortgage-related assets in which we intend to invest and could increase our cost of doing business.

Legislation has been enacted and proposed which, among other provisions, could hinder the ability of a servicer to foreclose promptly on defaulted mortgage loans or would permit limited assignee liability for certain violations in the mortgage loan origination process, which could result in us being held responsible for such violations. We cannot predict whether or in what form the U.S. Congress or the various state and local legislatures may enact legislation affecting our business. We will evaluate the potential impact of any initiatives which, if enacted, could materially and adversely affect our practices and results of operations. We are unable to predict whether U.S. federal, state or local authorities will enact laws, rules or regulations that will require changes in our practices in the future, and any such changes could materially and adversely affect our cost of doing business and profitability.

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Our inability to promptly foreclose upon defaulted mortgage loans could increase our cost of doing business and/or diminish our expected return on investments.

Our ability to promptly foreclose upon defaulted mortgage loans and liquidate the underlying real property plays a critical role in our valuation of the assets in which we invest and our expected return on those investments. There are a variety of factors that may inhibit our ability, through PLS, to foreclose upon a mortgage loan and liquidate the real property within the time frames we model as part of our valuation process. These factors include, without limitation: federal, state or local legislative action or initiatives designed to provide homeowners with assistance in avoiding residential mortgage loan foreclosures and that serve to delay the foreclosure process; HAMP and similar programs that require specific procedures to be followed to explore the refinancing of a mortgage loan prior to the commencement of a foreclosure proceeding; and continued declines in real estate values and sustained high levels of unemployment that increase the number of foreclosures and place additional pressure on the already overburdened judicial and administrative systems.

In addition, certain issues, including robo-signing, have been identified recently throughout the mortgage industry that relate to affidavits used in connection with the mortgage loan foreclosure process. A substantial portion of our investments are nonperforming mortgage loans, many of which are already subject to foreclosure proceedings at the time of purchase. While we have obtained assurances from PLS about its own practices relative to foreclosure proceedings and its proper use of affidavits, there can be no assurance that similar practices have been followed in connection with mortgage loans that are already subject to foreclosure proceedings at the time of purchase. To the extent we determine that any of these loans are impacted by these issues, we may be required to re-commence the foreclosure proceedings relating to such loans, thereby resulting in additional delay that could have the effect of increasing our cost of doing business and/or diminishing our expected return on our investments. The uncertainty surrounding these issues could also result in legal, regulatory or industry changes to the foreclosure process as a whole, any or all of which could lengthen the foreclosure process and negatively impact our business.

Challenges to the MERS[®] System could materially and adversely affect our business, results of operations and financial condition.

MERSCORP, Inc. is a privately held company that maintains an electronic registry, referred to as the MERS System, that tracks servicing rights and ownership of loans in the United States. Mortgage Electronic Registration Systems, Inc. (MERS), a wholly owned subsidiary of MERSCORP, Inc., can serve as a nominee for the owner of a mortgage loan and in that role initiate foreclosures and/or become the mortgagee of record for the loan in local land records. We, or PLS on our behalf, may choose to use MERS as a nominee. The MERS System is widely used by participants in the mortgage finance industry.

Several legal challenges have been made disputing MERS' legal standing to initiate foreclosures and/or act as nominee in local land records. These challenges have focused public attention on MERS and on how loans are recorded in local land records. As a result, these challenges could negatively affect MERS' ability to serve as the mortgagee of record in some jurisdictions. In addition, where MERS is the mortgagee of record, it must execute assignments of mortgages, affidavits and other legal documents in connection with foreclosure proceedings. As a result, investigations by governmental authorities and others into the servicer foreclosure process deficiencies referenced above may impact MERS. Failures by MERS to apply prudent and effective process controls and to comply with legal and other requirements in the foreclosure process could pose operational, reputational and legal risks that may materially and adversely affect us.

A decline in the value of the real estate underlying our mortgage loans may result in reduced risk-adjusted returns.

The value of the real estate that underlies mortgage loans is subject to market conditions. Changes in the real estate market may adversely affect the value of the collateral and thereby lower the value to be derived from its

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liquidation. In addition, adverse changes in the real estate market increase the probability of default, as the incentive of the borrower to retain and protect equity in the property declines. Distressed loans may require a substantial amount of workout negotiations and/or restructuring, which may entail, among other things, a substantial reduction in the interest rate, capitalization of interest payments, and a substantial write-down of the principal of the loan. However, even if such restructuring were successfully accomplished, a risk exists that the borrower will not be able or willing to maintain the restructured payments or refinance the restructured mortgage upon maturity.

Changes in prepayment rates could affect the value of our investment portfolio, which could result in losses or reduced earnings and materially and adversely affect the cash available for distribution to our shareholders.

The value of our investment portfolio may be materially and adversely affected by prepayment rates on mortgage loans. Prepayment rates on loans are influenced by changes in market interest rates and a variety of economic, geographic and other factors beyond our control. Consequently, we cannot predict with certainty such prepayment rates, and no strategy can completely insulate us from prepayment or other such risks. Changes in prepayment rates may materially and adversely affect our ability to maintain targeted amounts of leverage on our portfolio and may result in losses or reduced earnings for us and materially and adversely affect the cash available for distribution to our shareholders.

Many of our investments are illiquid and we may not be able to vary our portfolio in response to changes in economic and other conditions.

Our investments in mortgage loans are, and our investments in securities may be, illiquid. As a result, it may be difficult or impossible to obtain or validate third party pricing on the investments we purchase. Illiquid investments typically experience greater price volatility, as a ready market does not exist, and can be more difficult to value. The illiquidity of our investments may make it difficult for us to sell such investments if the need or desire arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the recorded value.

Many of our investments are unrated or, where any credit ratings are assigned to our investments, they will be subject to ongoing evaluations and revisions and we cannot assure you that those ratings will not be downgraded.

Many of our current investments are, and many of our future investments will not be, rated by any rating agency. Therefore, PCM's assessment of the value and pricing of our investments may be difficult and the accuracy of such assessment is inherently uncertain. However, certain of our investments may be rated. If rating agencies assign a lower-than expected rating or reduce or withdraw, or indicate that they may reduce or withdraw, their ratings of our investments in the future, the value of these investments could significantly decline, which would materially and adversely affect the value of our investment portfolio and could result in losses upon disposition or the failure of borrowers to satisfy their debt service obligations to us.

We may not realize gains or income from our investments.

While we seek to generate both current income and capital appreciation from our investments, our investments may not appreciate and, in fact, may decline in value. In addition, the obligors on our investments may default on, or be delayed in making, interest and/or principal payments, especially given that our current investment strategies focus, in part, on distressed opportunities and that we acquire nonperforming residential mortgage loans. Accordingly, we are subject to an increased risk of loss and may not be able to realize gains or income from our investments. Any gains that we do realize may not be sufficient to offset our losses and expenses.

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Insurance on real estate securing mortgage loans and real estate securities collateral may not cover all losses.

There are certain types of losses, generally of a catastrophic nature, that result from such events as earthquakes, floods, hurricanes, terrorism or acts of war, and that may be uninsurable or not economically insurable. Inflation, changes in building codes and ordinances, environmental considerations and other factors, including terrorism or acts of war, also might make the insurance proceeds insufficient to repair or replace a property if it is damaged or destroyed. Under these circumstances, the insurance proceeds received might not be adequate to restore our economic position with respect to the affected real property. Any uninsured loss could result in the loss of cash flow from, and the asset value of, the affected property.

We may be materially and adversely affected by risks affecting borrowers or the asset or property types in which our investments may be concentrated at any given time, as well as from unfavorable changes in the related geographic regions.

Our assets are not subject to any geographic, diversification or concentration limitations except that we will be concentrated in residential mortgage-related investments. Accordingly, our investment portfolio may be concentrated by geography, asset, property type and/or borrower, increasing the risk of loss to us if the particular concentration in our portfolio is subject to greater risks or undergoing adverse developments. In addition, adverse conditions in the areas where the properties securing or otherwise underlying our investments are located (including business layoffs or downsizing, industry slowdowns, changing demographics and other factors) and local real estate conditions (such as oversupply or reduced demand) may have an adverse effect on the value of our investments. A material decline in the demand for real estate in these areas may materially and adversely affect us. Lack of diversification can increase the correlation of non-performance and foreclosure risks among our investments.

A prolonged economic slowdown, recession or declining real estate values could materially and adversely affect us.

The risks associated with our investments are more acute during periods of economic slowdown or recession, especially if these periods are accompanied by high unemployment and declining real estate values. A weakening economy, high unemployment and declining real estate values significantly increase the likelihood that borrowers will default on their debt service obligations to us and that we will incur losses on our investments with them in the event of a default on a particular investment because the value of any collateral we foreclose upon may be insufficient to cover the full amount of such investment or may require a significant amount of time to realize. They may also increase the likelihood of re-default rates even after we have completed loan modifications. Any period of increased payment delinquencies, foreclosures or losses could adversely affect the net interest income generated from our portfolio and our ability to make and finance future investments, which would materially and adversely affect our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

Fair values of our investments are imprecise and may materially and adversely affect periodic reported results and credit availability, which may reduce earnings and, in turn, cash available for distribution to our shareholders.

The values of some of our investments are not readily determinable. We measure the fair value of these investments monthly, but the fair value at which our assets are recorded may not be an indication of their realizable value. Ultimate realization of the value of an asset depends to a great extent on economic and other conditions that are beyond the control of PCM, our company or our board of trustees. Further, fair value is only an estimate based on good faith judgment of the price at which an investment can be sold since market prices of investments can only be determined by negotiation between a willing buyer and seller. In certain cases, PCM's estimation of the fair value of our investments includes inputs provided by third-party dealers and pricing services, and valuations of certain securities or other assets in which we invest are often difficult to obtain and are subject to judgments that may vary among market participants. Changes in the estimated fair values of those

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assets are directly charged or credited to earnings for the period. If we were to liquidate a particular asset, the realized value may be more than or less than the amount at which such asset was recorded. Accordingly, in either event, the value of our common shares could be materially and adversely affected by our determinations regarding the fair value of our investments, and such valuations may fluctuate over short periods of time.

PCM utilizes analytical models and data in connection with the valuation of our investments, and any incorrect, misleading or incomplete information used in connection therewith would subject us to potential risks.

Given the complexity of our investments and strategies, PCM must rely heavily on models and data, including analytical models (both proprietary models developed by PCM and those supplied by third parties) and information and data supplied by third parties. Models and data are used to value investments or potential investments and also in connection with hedging our investments. In the event models and data prove to be incorrect, misleading or incomplete, any decisions made in reliance thereon expose us to potential risks. For example, by relying on incorrect models and data, especially valuation models, PCM may be induced to buy certain investments at prices that are too high, to sell certain other investments at prices that are too low or to miss favorable opportunities altogether. Similarly, any hedging based on faulty models and data may prove to be unsuccessful.

Liability relating to environmental matters may impact the value of properties that we may acquire or the properties underlying our investments.

Under various U.S. federal, state and local laws, an owner or operator of real property may become liable for the costs of removal of certain hazardous substances released on its property. These laws often impose liability without regard to whether the owner or operator was responsible for, or aware of, the release of such hazardous substances. The presence of hazardous substances may also adversely affect an owner's ability to sell real estate, borrow using real estate as collateral or make debt payments to us. In addition, if we take title to a property, the presence of hazardous substances may adversely affect our ability to sell the property, and we may become liable to a governmental entity or to third parties for various fines, damages or remediation costs. Any of these liabilities or events may materially and adversely affect the value of the relevant asset and/or our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

We are subject to counterparty risk and may be unable to seek indemnity or require our counterparties to repurchase mortgage loans if they breach representations and warranties, which could cause us to suffer losses.

When we purchase nonperforming assets or newly originated loans through our correspondent lending activities, our counterparty typically makes customary representations and warranties to us about such assets or loans. Our residential mortgage loan purchase agreements may entitle us to seek indemnity or demand repurchase or substitution of the loans in the event our counterparty breaches a representation or warranty given to us. However, there can be no assurance that our mortgage loan purchase agreements will contain appropriate representations and warranties, that we will be able to enforce our contractual right to repurchase or substitution, or that our counterparty will remain solvent or otherwise be able to honor its obligations under our mortgage loan purchase agreements. Further, the majority of our nonperforming assets owned as of December 31, 2012 were purchased from or through one or more subsidiaries of Citigroup Inc., creating a concentration of risk and a potential conflict of interest with one of our key sources of financing. Our inability to obtain indemnity or require repurchase of a significant number of loans could materially and adversely affect our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

We depend on the accuracy and completeness of information about borrowers and counterparties and any misrepresented information could adversely affect our business, financial condition and results of operations.

In connection with our correspondent lending activities, we may rely on information furnished by or on behalf of borrowers and counterparties, including financial statements and other financial information. We also

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may rely on representations of borrowers and counterparties as to the accuracy and completeness of that information and, with respect to financial statements, on reports of independent auditors. If any of this information is intentionally or negligently misrepresented and such misrepresentation is not detected prior to loan funding, the value of the loan may be significantly lower than expected. Whether a misrepresentation is made by the loan applicant or another third party, we generally bear the risk of loss associated with the misrepresentation. Our controls and processes may not have detected or may not detect all misrepresented information in our loan acquisitions or from our business clients. Any such misrepresented information could adversely affect our business, financial condition and results of operations.

We may be required to repurchase mortgage loans or indemnify investors if we breach representations and warranties, which could materially and adversely affect our earnings.

As part of our correspondent lending activities, PLS re-underwrites a percentage of the loans that we acquire, and we rely upon PLS to ensure quality underwriting by our correspondent sellers, accurate third party appraisals, and strict compliance with the representations and warranties that we require from our correspondent sellers and that are required from us by our investors.

When we sell loans, we are required to make customary representations and warranties about such loans to the loan purchaser. Our residential mortgage loan sale agreements may require us to repurchase or substitute loans in the event we breach a representation or warranty given to the loan purchaser. In addition, we may be required to repurchase loans as a result of borrower fraud or in the event of early payment default on a mortgage loan. Likewise, we may be required to repurchase or substitute loans if we breach a representation or warranty in connection with our securitizations. The remedies available to the GSEs and other purchasers of mortgage loans are generally broader than those available to us against the originator or correspondent lender, and if a purchaser enforces its remedies against us, we may not be able to enforce the remedies we have against the sellers. The repurchased loans typically can only be financed at a steep discount to their repurchase price, if at all. They are also typically sold at a significant discount to the unpaid principal balance. Significant repurchase activity could materially and adversely affect our business, financial condition, liquidity, results of operations and our ability to make distributions to our shareholders.

Risks Related to Our Organization and Structure

Certain provisions of Maryland law, our staggered board of trustees and certain provisions in our declaration of trust could each inhibit a change in our control.

Certain provisions of the Maryland General Corporation Law (the "MGCL"), applicable to a Maryland real estate investment trust may have the effect of inhibiting a third party from making a proposal to acquire us or of impeding a change in our control under circumstances that otherwise could provide the holders of our common shares with the opportunity to realize a premium over the then prevailing market price of such common shares.

In addition, our board of trustees is divided into three classes of trustees. Trustees of each class will be elected for three-year terms upon the expiration of their current terms, and each year one class of trustees will be elected by our shareholders. The staggered terms of our trustees may reduce the possibility of a tender offer or an attempt at a change in control, even though a tender offer or change in control might be in the best interests of our shareholders.

Further, our declaration of trust authorizes us to issue additional authorized but unissued common shares and preferred shares. Our board of trustees may, without shareholder approval, increase the aggregate number of our authorized common shares or the number of shares of any class or series that we have authority to issue and classify or reclassify any unissued common shares or preferred shares and may set the preferences, rights and other terms of the classified or reclassified shares. As a result, our board may establish a class or series of common shares or preferred shares or take other actions that could delay or prevent a transaction or a change in our control that might involve a premium price for our common shares or otherwise be in the best interests of our shareholders.

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Compliance with our Investment Company Act exclusion imposes limits on our operations.

We intend to conduct our operations so that we are not required to register as an investment company under the Investment Company Act. However, our qualification for exclusion from registration under the Investment Company Act will limit our ability to make certain investments, as discussed below.

Failure to maintain our exclusion from registration under the Investment Company Act could materially and adversely affect us.

Because we are organized as a holding company that conducts its businesses primarily through our Operating Partnership and its wholly-owned subsidiaries, our status under the Investment Company Act is dependent upon the status of our Operating Partnership which, as a holding company, in turn, will have its status determined by the status of its subsidiaries. The securities issued to our Operating Partnership by subsidiaries excepted from the definition of investment company under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act, together with any other investment securities owned by our Operating Partnership, may not have a value in excess of 40% of the value of our Operating Partnership's total assets on an unconsolidated basis. While we will monitor our holdings to ensure continuing and ongoing compliance with this asset test, if the value of such securities exceeds such 40% threshold, or if one or more of such subsidiaries fail to maintain their exceptions or exclusions from the Investment Company Act and we do not have available to us another basis on which we may avoid registration, we may have to register under the Investment Company Act. This could subject us to substantial regulation with respect to our capital structure (including our ability to use leverage), management, operations, transactions with affiliated persons (as defined in the Investment Company Act), portfolio composition, including restrictions with respect to diversification and industry concentration, and other matters. It could also cause the breach of covenants we have made under certain of our financing arrangements, which could result in an event of default, acceleration of debt and/or termination.

In August 2011, the SEC solicited public comment through a concept release on a wide range of issues relating to the Section 3(c)(5)(C) exemption from the Investment Company Act, including the nature of the assets that qualify for purposes of the exemption and whether mortgage-related REITs should be regulated in a manner similar to investment companies. There can be no assurance that the laws and regulations governing the Investment Company Act status of REITs, including guidance and interpretations from the Division of Investment Management of the SEC regarding the exceptions and exclusions therefrom, will not change in a manner that adversely affects our operations. If the SEC takes action that could result in our or our subsidiaries' failure to maintain an exception or exclusion from the Investment Company Act, we could, among other things, be required to (a) restructure our operations to avoid being required to register as an investment company, (b) effect sales of our assets in a manner that, or at a time when, we would not otherwise choose to do so or (c) register as an investment company (which, among other things, would require us to comply with the leverage constraints applicable to investment companies), any of which could negatively affect the value of our common shares, the sustainability of our business model, and our ability to make distributions to our shareholders, which could, in turn, materially and adversely affect our business and the market price of our common shares.

Further, a loss of our Investment Company Act exclusion would allow PCM to terminate our management agreement with us, and our loan servicing agreement with PLS is subject to early termination in the event our management agreement is terminated for any reason. If either of these agreements is terminated, we will have to obtain the services on our own, and we may not be able to replace these services in a timely manner or on favorable terms, or at all. This would have a material adverse effect on our ability to continue to execute our business strategy.

Rapid changes in the values of our investments may make it more difficult for us to maintain our REIT qualification or exclusion from the Investment Company Act.

If the market value or income potential of our residential mortgage loans and other real estate-related assets declines as a result of increased interest rates, prepayment rates or other factors, we may need to increase certain

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real estate investments and income and/or liquidate our non-qualifying assets in order to maintain our REIT qualification or exclusion from the Investment Company Act. If the decline in real estate asset values and/or income occurs quickly, this may be especially difficult to accomplish, particularly given the illiquid nature of our investments. We may have to make investment decisions that we otherwise would not make absent our REIT and Investment Company Act considerations.

Our rights and the rights of our shareholders to take action against our trustees and officers are limited, which could limit your recourse in the event of actions not in your best interest.

Our declaration of trust limits the liability of our present and former trustees and officers to us and our shareholders for money damages to the maximum extent permitted under Maryland law. Under current Maryland law, our present and former trustees and officers will not have any liability to us or our shareholders for money damages other than liability resulting from either (a) actual receipt of an improper benefit or profit in money, property or services or (b) active and deliberate dishonesty by the trustee or officer that was established by a final judgment and is material to the cause of action.

Our declaration of trust authorizes us to indemnify our present and former trustees and officers for actions taken by them in those capacities to the maximum extent permitted by Maryland law. Our bylaws require us to indemnify each present and former trustee or officer, to the maximum extent permitted by Maryland law, in the defense of any proceeding to which he or she is made, or threatened to be made, a party by reason of his or her service to us. In addition, we may be obligated to pay or reimburse the expenses incurred by our present and former trustees and officers without requiring a preliminary determination of their ultimate entitlement to indemnification. As a result, we and our shareholders may have more limited rights against our present and former trustees and officers than might otherwise exist absent the current provisions in our declaration of trust and bylaws or that might exist with other companies, which could limit your recourse in the event of actions not in your best interest.

Our declaration of trust contains provisions that make removal of our trustees difficult, which could make it difficult for our shareholders to effect changes to our management.

Our declaration of trust provides that, subject to the rights of holders of any series of preferred shares, a trustee may be removed only for cause (as defined in our declaration of trust), and then only by the affirmative vote of at least two-thirds of the votes entitled to be cast generally in the election of trustees. Vacancies generally may be filled only by a majority of the remaining trustees in office, even if less than a quorum, for the full term of the class of trustees in which the vacancy occurred. These requirements make it more difficult to change our management by removing and replacing trustees and may prevent a change in our control that is in the best interests of our shareholders.

Risks Related to Taxation

Our failure to qualify as a REIT would result in higher taxes and reduced cash available for distribution to our shareholders.

We are organized and operate in a manner so as to qualify as a REIT for U.S. federal income tax purposes. Our qualification as a REIT depends on our satisfaction of certain asset, income, organizational, distribution, shareholder ownership and other requirements on a continuing basis. If we were to fail to qualify as a REIT in any taxable year, we would be subject to U.S. federal income tax, including any applicable alternative minimum tax, on our taxable income at regular corporate rates, and distributions to our shareholders would not be deductible by us in computing our taxable income. Any such corporate tax liability could be substantial and would reduce the amount of cash available for distribution to our shareholders, which in turn would have an adverse impact on the value of our common shares. Unless we were entitled to relief under certain Internal Revenue Code provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we ceased to qualify as a REIT.

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Even if we qualify as a REIT, we face tax liabilities that reduce our cash flow, and a significant portion of our income may be earned through TRSs that are subject to U.S. federal income taxation.

Even if we qualify for taxation as a REIT, we may be subject to certain U.S. federal, state and local taxes on our income and assets, including taxes on any undistributed income, tax on income from some activities conducted as a result of a foreclosure, and state or local income, property and transfer taxes, such as mortgage recording taxes. Any of these taxes would decrease cash available for distribution to our shareholders.

We also engage in business activities that are required to be conducted in a TRS. In order to meet the REIT qualification requirements, or to avert the imposition of a 100% tax that applies to certain gains derived by a REIT from dealer property or inventory, we hold a significant portion of our assets through, and derive a significant portion of our taxable income and gains in, a TRS, subject to the limitation that securities in TRSs may not represent more than 25% of our assets in order for us to remain qualified as a REIT. All taxable income and gains derived from the assets held from time to time in our TRS are subject to regular corporate income taxation.

The percentage of our assets represented by a TRS and the amount of our income that we can receive in the form of TRS dividends are subject to statutory limitations that could jeopardize our REIT status.

No more than 25% of the value of a REIT's assets may consist of stock or securities of one or more TRSs (at the end of each quarter). While we intend to manage our affairs so as to satisfy this requirement, there can be no assurance that we will be able to do so in all market circumstances. Although a TRS is subject to U.S. federal, state and local income tax on its taxable income, we may from time to time need to make distributions of such after-tax income in order to keep the value of our TRS below 25% of our total assets. However, for purposes of one of the tests we must satisfy to qualify as a REIT, at least 75% of our gross income must in each taxable year generally be from real estate assets. While we monitor our compliance with both this income test and the limitation on the percentage of our assets represented by TRS securities, the two may at times be in conflict with one another. That is, it is possible that we may wish to distribute a dividend from a TRS in order to reduce the value of our TRS below 25% of our assets, but be unable to do so without violating the requirement that 75% of our gross income in the taxable year be derived from real estate assets. There can be no assurance that we will be able to comply with both of these tests in all market conditions.

Dividends payable by REITs do not generally qualify for the reduced tax rates applicable to certain corporate dividends.

Recently enacted legislation provides for a 20% maximum tax rate for dividends paid by corporations to eligible domestic shareholders that are individuals, trusts or estates. Dividends paid by REITs, however, are generally not eligible for the reduced rates. The more favorable rates applicable to regular corporate dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could materially and adversely affect the value of the stock of REITs, including our common shares.

We have not established a minimum distribution payment level and no assurance can be given that we will be able to make distributions to our shareholders in the future at current levels or at all.

We are generally required to distribute to our shareholders at least 90% of our taxable income each year for us to qualify as a REIT under the Internal Revenue Code, which requirement we currently intend to satisfy. To the extent we satisfy the 90% distribution requirement but distribute less than 100% of our taxable income, we will be subject to U.S. federal corporate income tax on our undistributed taxable income. We have not established a minimum distribution payment level, and our ability to make distributions to our shareholders may

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be materially and adversely affected by the risk factors discussed in this Report and any subsequent Quarterly Reports on Form 10-Q. Although we have made, and anticipate continuing to make, quarterly distributions to our shareholders, our board of trustees has the sole discretion to determine the timing, form and amount of any future distributions to our shareholders, and such determination will depend upon, among other factors, our historical and projected results of operations, financial condition, cash flows and liquidity, maintenance of our REIT qualification and other tax considerations, capital expenditure and other expense obligations, debt covenants, contractual prohibitions or other limitations and applicable law and such other matters as our board of trustees may deem relevant from time to time. Among the factors that could impair our ability to continue to make distributions to our shareholders are:

our inability to invest the net proceeds from our equity offerings;

our inability to make attractive risk-adjusted returns on our current and future investments;

non-cash earnings or unanticipated expenses that reduce our cash flow;

defaults in our investment portfolio or decreases in its value; and

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

As a result, no assurance can be given that we will be able to continue to make distributions to our shareholders in the future or that the level of any future distributions will achieve a market yield or increase or even be maintained over time, any of which could materially and adversely affect the market price of our common shares.

The REIT distribution requirements could materially and adversely affect our ability to execute our business strategies.

We intend to continue to make distributions to our shareholders to comply with the requirements of the Internal Revenue Code and to avoid paying corporate tax on undistributed income. However, differences in timing between the recognition of taxable income and the actual receipt of cash could require us to sell assets, borrow funds on a short-term or long-term basis, or issue equity to meet the distribution requirements of the Internal Revenue Code. We may find it difficult or impossible to meet distribution requirements in certain circumstances. Due to the nature of the assets in which we invest and may invest, we may be required to recognize taxable income from those assets in advance of our receipt of cash flow on or proceeds from disposition of such assets. As a result, to the extent such income is not realized within a TRS, the requirement to distribute a substantial portion of our net taxable income could cause us to: (i) sell assets in adverse market conditions, (ii) borrow on unfavorable terms, (iii) distribute amounts that would otherwise be invested in future acquisitions, capital expenditures or repayment of debt or (iv) make a taxable distribution of our shares as part of a distribution in which shareholders may elect to receive shares or (subject to a limit measured as a percentage of the total distribution) cash, in order to comply with REIT requirements.

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

We acquire and/or expect to acquire in the secondary market debt instruments for less than their face amount, MBS issued with original issue discount, or debt instruments or MBS that are delinquent as to mandatory principal and interest payments. In each case, we may be required to report income regardless of whether corresponding cash payments are received or are ultimately collectible. If we eventually collect less than we had previously reported as income, there may be a bad debt deduction available to us at that time, but our ability to benefit from that bad debt deduction would depend on our having taxable income in that later taxable year. This possible income early, losses later phenomenon could materially and adversely affect us and our shareholders if it were persistent and in significant amounts.

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The share ownership limits applicable to us that are imposed by the Internal Revenue Code for REITs and our declaration of trust may restrict our business combination opportunities.

In order for us to maintain our qualification as a REIT under the Internal Revenue Code, not more than 50% in value of our outstanding shares may be owned, directly or indirectly, by five or fewer individuals (as defined in the Internal Revenue Code to include certain entities) at any time during the last half of each taxable year following our first year. Our declaration of trust, with certain exceptions, authorizes our board of trustees to take the actions that are necessary and desirable to preserve our qualification as a REIT. Under our declaration of trust, no person may own more than 9.8% by vote or value, whichever is more restrictive, of our outstanding common shares or more than 9.8% by vote or value, whichever is more restrictive, of our outstanding shares of beneficial interest. Our board may grant an exemption to the share ownership limits in its sole discretion, subject to certain conditions and the receipt of certain representations and undertakings. These share ownership limits are based upon direct or indirect ownership by individuals, which term includes certain entities.

Ownership limitations are common in the organizational documents of REITs and are intended, among other purposes, to provide added assurance of compliance with the tax law requirements and to minimize administrative burdens. However, our share ownership limits might also delay or prevent a transaction or a change in our control that might involve a premium price for our common shares or otherwise be in the best interests of our shareholders.

Complying with the REIT requirements can be difficult and may cause us to forego otherwise attractive opportunities or liquidate otherwise attractive investments.

To qualify as a REIT for U.S. federal income tax purposes, we must continually satisfy tests concerning, among other things, the sources of our income, the nature and diversification of our assets, the amounts we distribute to our shareholders and the ownership of our shares. We may be required to make distributions to our shareholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with the REIT requirements may hinder our ability to make certain attractive investments or require us to liquidate from our portfolio otherwise attractive investments. If we are compelled to liquidate our investments, we may be unable to comply with these requirements, ultimately jeopardizing our qualification as a REIT, or we may be subject to a 100% tax on any resultant gain if we sell assets that are treated as dealer property or inventory. These actions could have the effect of reducing our income and amounts available for distribution to our shareholders.

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

The REIT provisions of the Internal Revenue Code may limit our ability to hedge our assets and operations. Under current law, any income that we generate from transactions intended to hedge our interest rate or currency risks will be excluded from gross income for purposes of the REIT gross income tests in certain instances. Generally, income derived from other types of hedging transactions will not be treated as qualifying income for purposes of the REIT gross income tests. As a result of these rules, we may have to limit our use of hedging techniques that might otherwise be advantageous, which could result in greater risks associated with interest rate or other changes than we would otherwise be subject to.

If our Operating Partnership failed to qualify as a partnership for U.S. federal income tax purposes, we could fail to qualify as a REIT and suffer other adverse consequences.

We believe that our Operating Partnership is organized and operated in a manner so as to be treated as a partnership or an entity that is disregarded, and not an association or publicly traded partnership taxable as a corporation, for U.S. federal income tax purposes. As a partnership, it is not subject to U.S. federal income tax on its income. Instead, each of its partners, including us, is allocated its share of our Operating Partnership's income. No assurance can be provided, however, that the Internal Revenue Service (the IRS) will not challenge its

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status as a partnership or disregarded entity for U.S. federal income tax purposes, or that a court would not sustain such a challenge. If the IRS were successful in treating our Operating Partnership as an association or publicly-traded partnership taxable as a corporation for U.S. federal income tax purposes, we could fail to meet the gross income tests and certain of the asset tests applicable to REITs and, accordingly, could cease to qualify as a REIT. Also, the failure of our Operating Partnership to qualify as a partnership would cause it to become subject to U.S. federal corporate income tax, which would reduce significantly the amount of its cash available for debt service and for distribution.

The tax on prohibited transactions limits our ability to engage in transactions, including certain methods of securitizing mortgage loans, that would be treated as sales for U.S. federal income tax purposes.

A REIT's net income from prohibited transactions is subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property, but including mortgage loans, held primarily for sale to customers in the ordinary course of business. We might be subject to this tax if we were to dispose of or securitize loans in a manner that was treated as a sale of the loans for U.S. federal income tax purposes. Therefore, in order to avoid the prohibited transactions tax, we may choose to engage in certain sales of loans through a TRS and not at the REIT level, and may limit the structures we utilize for our securitization transactions, even though the sales or structures might otherwise be beneficial to us. We may hold a substantial amount of assets in one or more TRSs that are subject to corporate income tax on its earnings, which may reduce the cash flow generated by us and our subsidiaries in the aggregate, and our ability to make distributions to our shareholders.

The taxable mortgage pool (TMP) rules may increase the taxes that we or our shareholders may incur, and may limit the manner in which we effect future securitizations.

Certain of our securitizations may likely be considered to result in the creation of TMPs for U.S. federal income tax purposes. A TMP is always classified as a corporation for U.S. federal income tax purposes. However, as long as a REIT owns 100% of a TMP, such classification generally does not result in the imposition of corporate income tax, because the TMP is a qualified REIT subsidiary. Prior to September 1, 2012, the requirement that a TMP be wholly-owned by a REIT to be a qualified REIT subsidiary means that we would be precluded from holding equity interests in such a TMP through our Operating Partnership if the TMP were a U.S. entity that would be subject to taxation as a domestic corporation, unless our Operating Partnership itself formed another subsidiary REIT to own the TMP. On August 31, 2012, the general partner of the Operating Partnership and the REIT jointly elected to revoke the general partner's TRS election. As a result, after August 31, 2012, the general partner is no longer an entity that is regarded for income tax purposes and all of the interests in the Operating Partnership are treated as being owned by the REIT. Thus after August 31, 2012, the Operating Partnership is also treated as a disregarded entity for income tax purposes and any assets that it owns are treated as if they are directly owned by the REIT.

In the case of such wholly-REIT owned TMPs, certain categories of our shareholders, such as foreign shareholders otherwise eligible for treaty benefits, shareholders with net operating losses, and tax exempt shareholders that are subject to unrelated business income tax, could be subject to increased taxes on a portion of their dividend income received from us that is attributable to the TMP or excess inclusion income. In addition, to the extent that our shares are owned in record name by tax exempt disqualified organizations, such as certain government-related entities that are not subject to tax on unrelated business income, we may incur a corporate level tax on our allocable portion of excess inclusion income from such a wholly-REIT owned TMP. In that case and to the extent feasible, we may reduce the amount of our distributions to any disqualified organization whose share ownership gave rise to the tax, or we may bear such tax as a general corporate expense. To the extent that our shares owned by disqualified organizations are held in record name by a broker/dealer or other nominee, the broker/dealer or other nominee would be liable for the corporate level tax on the portion of our excess inclusion income allocable to the shares held by the broker/dealer or other nominee on behalf of disqualified organizations. While we intend to attempt to minimize the portion of our distributions that is subject to these rules, the law is unclear concerning computation of excess inclusion income, and its amount could be significant.

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In the case of any TMP that would be taxable as a domestic corporation if it were not wholly-REIT owned, we would be precluded from selling equity interests in these securitizations to outside investors, or selling any debt securities issued in connection with these securitizations that might be considered to be equity interests for tax purposes. This marketing limitation may prevent us from selling more junior or non-investment grade debt securities in such securitizations and maximizing our proceeds realized in those offerings.

New legislation or administrative or judicial action, in each instance potentially with retroactive effect, could make it more difficult or impossible for us to qualify as a REIT.

The present U.S. federal income tax treatment of REITs may be modified, possibly with retroactive effect, by legislative, judicial or administrative action at any time, which could affect the U.S. federal income tax treatment of an investment in our common shares. The U.S. federal tax rules that affect REITs constantly are under review by persons involved in the legislative process, the IRS and the U.S. Treasury, which results in statutory changes as well as frequent revisions to Treasury Regulations and interpretations. Revisions in U.S. federal tax laws and interpretations thereof could cause us to change our investments and commitments, which could also affect the tax considerations of an investment in our common shares.

An IRS administrative pronouncement with respect to investments by REITs in distressed debt secured by both real and personal property, if interpreted adversely to us, could cause us to pay penalty taxes or potentially to lose our REIT status.

Most of the mortgage loans that we acquire are acquired by us at a discount from their outstanding principal amount, because our pricing is generally based on the value of the underlying real estate that secures those mortgage loans.

Treasury Regulation Section 1.856-5(c) (the interest apportionment regulation) provides rules for determining what portion of the interest income from mortgage loans that are secured by both real and personal property is treated as interest on obligations secured by mortgages on real property or on interests in real property. Under the interest apportionment regulation, if a mortgage covers both real property and other property, a REIT is required to apportion its annual interest income to the real property security based on a fraction, the numerator of which is the value of the real property securing the loan, determined when the REIT commits to acquire the loan, and the denominator of which is the highest principal amount of the loan during the year. The IRS has recently issued a revenue procedure, Revenue Procedure 2011-16, that contains an example regarding the application of the interest apportionment regulation. The example interprets the principal amount of the loan to be the face amount of the loan, despite the Internal Revenue Code requiring taxpayers to treat any market discount, that is the difference between the purchase price of the loan and its face amount, for all purposes (other than certain withholding and information reporting purposes) as interest rather than principal.

The interest apportionment regulation applies only if the debt in question is secured both by real property and personal property. We believe that all of the mortgage loans that we acquire are secured only by real property and no other property value is taken into account in our underwriting and pricing. Accordingly, we believe that the interest apportionment regulation does not apply to our portfolio.

Nevertheless, if the IRS were to assert successfully that our mortgage loans were secured by property other than real estate, that the interest apportionment regulation applied for purposes of our REIT testing, and that the position taken in Revenue Procedure 2011-16 should be applied to our portfolio, then depending upon the value of the real property securing our loans and their face amount, and the sources of our gross income generally, we might not be able to meet the 75% REIT gross income test, and possibly the asset tests applicable to REITs. If we did not meet this test, we could potentially either lose our REIT status or be required to pay a tax penalty to the IRS.

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With respect to the 75% REIT asset test, Revenue Procedure 2011-16 provides a safe harbor under which the IRS will not challenge a REIT's treatment of a loan as being a real estate asset in an amount equal to the lesser of (1) the fair market value of the real property securing the loan determined as of the date the REIT committed to acquire the loan or (2) the fair market value of the loan on the date of the relevant quarterly REIT asset testing date. This safe harbor, if it applied to us, would help us comply with the REIT asset tests following the acquisition of distressed debt if the value of the real property securing the loan were to subsequently decline. However, if the value of the real property securing the loan were to increase, the safe harbor rule of Revenue Procedure 2011-16, read literally, could have the peculiar effect of causing the corresponding increase in the value of the loan to not be treated as a real estate asset. We do not believe, however, that this was the intended result in situations in which the value of a loan has increased because the value of the real property securing the loan has increased, or that this safe harbor rule applies to debt that is secured solely by real property. Nevertheless, if the IRS took the position that the safe harbor rule applied in these scenarios, then we might not be able to meet the various quarterly REIT asset tests if the value of the real estate securing our loans increased, and thus the value of our loans increased by a corresponding amount. If we did not meet one or more of these tests, then we could potentially either lose our REIT status or be required to pay a tax penalty to the IRS.

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

Qualification as a REIT involves the application of highly technical and complex Internal Revenue Code provisions for which only limited judicial and administrative authorities exist. Even a technical or inadvertent violation could jeopardize our REIT qualification. Our qualification as a REIT will depend on our satisfaction of certain asset, income, organizational, distribution, stockholder ownership and other requirements on a continuing basis.

Item 1B. *Unresolved Staff Comments*

None.

Item 2. *Properties*

We do not own or lease any property. Our operations are carried out on our behalf at the principal executive offices of PennyMac, at 6101 Condor Road, Moorpark, California, 93021.

Item 3. *Legal Proceedings*

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of December 31, 2012, we were not involved in any material legal proceedings.

Item 4. *Mine Safety Disclosures*

Not applicable.

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Our common shares began trading publicly on July 30, 2009, and are listed on the New York Stock Exchange (Symbol: PMT). As of February 19, 2013, our common shares were held by 53,866 beneficial holders. The following table sets forth the high and low sales prices (as reported by the New York Stock Exchange) for our common shares and the amount of cash dividends declared during the last two years:

For the year ended December 31, 2012

Period Ended	Stock price		Cash dividends declared
	High	Low	
March 31, 2012	\$ 19.23	\$ 16.69	\$ 0.55
June 30, 2012	\$ 20.67	\$ 17.46	\$ 0.55
September 30, 2012	\$ 23.52	\$ 19.72	\$ 0.55
December 31, 2012	\$ 25.78	\$ 21.69	\$ 0.57

For the year ended December 31, 2011

Period Ended	Stock price		Cash dividends declared
	High	Low	
March 31, 2011	\$ 19.04	\$ 17.93	\$
June 30, 2011	\$ 18.62	\$ 16.14	\$ 0.42
September 30, 2011	\$ 17.26	\$ 15.82	\$ 0.50
December 31, 2011	\$ 17.50	\$ 15.14	\$ 0.50

We intend to pay quarterly dividends and to distribute to our shareholders at least 90% of our taxable income in each year (subject to certain adjustments). This will enable us to qualify for the tax benefits accorded to a REIT under the Internal Revenue Code. We have not established a minimum dividend payment level and our ability to pay dividends may be adversely affected for the reasons described in Item 1A of this Report in the section entitled *Risk Factors*. All distributions are made at the discretion of our board of trustees and depend on our earnings, our financial condition, maintenance of our REIT status and such other factors as our board of trustees may deem relevant from time to time.

Equity Compensation Plan Information

We have adopted an equity incentive plan which provides for the issuance of equity based awards, including share options, restricted shares, restricted share units, unrestricted common share awards, LTIP units (a special class of partnership interests in our Operating Partnership) and other awards based on our shares that may be made by us directly to our officers and trustees, and the members, officers, trustees, directors and employees of PCM, PLS, or their affiliates and to PCM, PLS and other entities that provide services to us and the employees of such other entities. The equity incentive plan is administered by our compensation committee, pursuant to authority delegated by our board of trustees, which has the authority to make awards to the eligible participants referenced above, and to determine what form the awards will take, and the terms and conditions of the awards. Our equity incentive plan allows for grants of equity-based awards up to an aggregate of 8% of our issued and outstanding common shares on a diluted basis at the time of the award. However, the total number of shares available for issuance under the plan cannot exceed 40 million.

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The following table provides information as of December 31, 2012 concerning our common shares authorized for issuance under our equity incentive plan:

	(a)	(b)	(c)
Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted-average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders(1)	665,617	\$	4,100,000
Equity compensation plans not approved by security holders(2)			
Total	665,617	\$	4,100,000

(1) Represents our 2009 equity incentive plan.

(2) We do not have any equity plans that have not been approved by our shareholders.

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	Year ended December 31,			Period from August 4, 2009 (commencement of operations) to December 31, 2009
	2012	2011	2010	
(in thousands, except per share data)				
Condensed Statements of Operations:				
Net investment income:				
Net gain on mortgage loans acquired for sale	\$ 147,675	\$ 7,633	\$ 18	\$
Net gain on investments	103,649	82,643	27,428	152
Interest income	72,441	36,148	14,574	2,149
Loan origination fees	10,545	1,085	23	
Other	858	1,105	2,011	
	335,168	128,614	44,054	2,301
Expenses:				
Loan fulfillment fees	62,906	1,747		
Interest	31,642	16,946	826	
Loan servicing	20,180	15,364	3,200	
Management fees	12,436	6,740	4,878	1,981
Other	21,182	15,322	8,124	2,203
	148,346	56,119	17,028	4,184
Income (loss) before provision for income taxes	186,822	72,495	27,026	(1,883)
Provision for income taxes	48,573	8,056	2,543	
Net income (loss)	\$ 138,249	\$ 64,439	\$ 24,483	\$ (1,883)
Condensed Balance Sheets:				
Investments:				
Short-term investments	\$ 39,017	\$ 30,319	\$	\$ 213,628
United States Treasury security		50,000		
Mortgage-backed securities at fair value		72,813	119,872	83,771
Mortgage loans acquired for sale at fair value	975,184	232,016	3,966	
Mortgage loans at fair value	1,189,971	696,266	364,250	26,046
Mortgage loans under forward purchase agreements at fair value		129,310		
Real estate acquired in settlement of loans	88,078	80,570	29,685	
Real estate acquired in settlement of loans under forward purchase agreements		22,979		
Mortgage servicing rights	126,776	6,031		
	2,419,026	1,320,304	517,773	323,445
Other assets	140,637	65,758	71,322	1,001
Total assets	\$ 2,559,663	\$ 1,386,062	\$ 589,095	\$ 324,446
Borrowings:				
Assets sold under agreements to repurchase	\$ 1,256,102	\$ 631,313	\$ 248,624	\$
Note payable secured by mortgage loans at fair value		28,617		
Borrowings under forward purchase agreements		152,427		
	1,256,102	812,357	248,624	
Other liabilities	102,225	27,688	20,558	10,648
Total liabilities	1,358,327	840,045	269,182	10,648

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Shareholders' equity	1,201,336	546,017	319,913	313,798
Total liabilities and shareholders' equity	\$ 2,559,663	\$ 1,386,062	\$ 589,095	\$ 324,446

Per Share Data:

Earnings (loss):				
Basic	\$ 3.14	\$ 2.41	\$ 1.46	\$ (0.11)
Diluted	\$ 3.14	\$ 2.41	\$ 1.44	\$ (0.11)
Cash dividends:				
Declared	\$ 2.22	\$ 1.42	\$ 1.19	\$
Paid	\$ 2.22	\$ 1.84	\$ 0.77	\$
Period-end:				
Share price	\$ 25.29	\$ 16.62	\$ 18.15	\$ 17.18
Book value	\$ 20.39	\$ 19.22	\$ 19.01	\$ 18.75

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

This discussion includes forward-looking statements concerning future events and performance of the Company, which are subject to certain risks and uncertainties as discussed above in the section entitled *Special Note Regarding Forward-Looking Statements* and in Item 1A of this Report, entitled *Risk Factors*.

Overview

We are a specialty finance company that invests primarily in residential mortgage loans and mortgage-related assets. Our objective is to provide attractive risk-adjusted returns to our investors over the long-term, principally through dividends and secondarily through capital appreciation. We intend to achieve this objective largely by investing in distressed mortgage assets and acquiring, pooling, securitizing and/or selling newly originated prime credit quality residential mortgage loans (correspondent lending).

We believe that there is a need for mortgage originators to find outlets to sell government-sponsored entity (GSE) eligible, government-insured, and jumbo loans. A jumbo loan is a loan in an amount that exceeds the maximum loan amount for eligible loans under GSE guidelines. These opportunities include the purchase from mortgage lenders of newly originated mortgage loans that are eligible for (a) sale to participating GSEs such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and (b) the securitization through Government National Mortgage Association (Ginnie Mae) (Fannie Mae, Freddie Mac and Ginnie Mae are each referred to as an Agency and, collectively, as the Agencies). The opportunities also include the purchase and sale or securitization of jumbo conventional loans underwritten to GSE guidelines other than with respect to the maximum loan amount. Accordingly, our Manager, PCM, has built a correspondent lending operation whereby we purchase newly originated GSE eligible loans, which we sell or securitize through the GSEs on a servicing-retained basis and whereby we retain the related MSR; government-insured loans (insured by the FHA or guaranteed by the VA), which we sell to PLS, a Ginnie Mae approved issuer and servicer; and jumbo mortgage loans, which we sell to third parties, generally on a servicing-retained basis.

During the year ended December 31, 2012, we purchased mortgage loans with fair values totaling \$22.4 billion in furtherance of our correspondent lending strategy. We received MSRs as proceeds on sale of mortgage loans with fair values totaling \$134.7 million during the year ended December 31, 2012 and held MSRs with carrying values of \$126.8 million as of December 31, 2012. To the extent that we purchase loans that conform to standards to be FHA-insured or VA-guaranteed, we sell such loans to PLS, which is a Ginnie Mae approved issuer and seller/servicer. We receive a sourcing fee from PLS of three basis points on the unpaid principal balance of each loan that we sell to PLS under such arrangement. We held an inventory of mortgage loans acquired for sale totaling \$975.2 million at December 31, 2012. To the extent that we transfer these loans into securitizations in the future, we intend to retain a portion of the securities and residual interests created in the securitization transaction.

We acquire distressed mortgage loans through direct acquisitions of mortgage loan portfolios from institutions such as banks, mortgage companies and insurance companies and direct acquisitions or participations in structured transactions. A substantial portion of the nonperforming loans we have purchased has been acquired from or through one or more subsidiaries of Citigroup Inc.

We seek to maximize the value of the distressed mortgage loans that we acquire using means that are appropriate for the particular loan, including both proprietary and nonproprietary loan modification programs (such as the U.S. Departments of the Treasury and Housing and Urban Development's Home Affordable Modification Program (HAMP)), special servicing and other initiatives focused on avoiding foreclosure, when possible. When we are unable to effect a cure for a mortgage delinquency, our objective is to effect timely acquisition and/or liquidation of the property securing the loan. During the year ended December 31, 2012, we purchased \$542.8 million of distressed mortgage loans and received proceeds from payoffs and sales from our portfolio of distressed mortgage loans totaling \$184.2 million.

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We supplement these activities through participation in other mortgage-related activities, which are in various states of analysis, planning or implementation including:

Acquisition of MSR or excess servicing spread from MSRs from financial institutions. We believe that MSR investments may allow us to earn attractive current returns and to leverage the loan servicing and origination capabilities of PLS to improve the assets value. We also intend to continue to retain the MSRs that we receive as a portion of the proceeds from our sale or securitization of mortgage loans through our correspondent lending operation.

Pursuant to the terms of the MSR recapture agreement entered into with PLS effective February 1, 2013, if PLS refinances loans for which we previously created and held the MSRs through our correspondent lending activities, PLS is generally required to transfer and convey to us, without cost to us, the MSRs with respect to new mortgage loans originated in those refinancings (or, under certain circumstances, other mortgage loans) that have an aggregate unpaid principal balance that is not less than 30% of the aggregate unpaid principal balance of all the loans so originated.

Acquisition of REIT-eligible MBS. We purchased \$112.2 million of MBS during the year ended December 31, 2012. We also sold all of our investment in MBS during the year ended December 31, 2012. We held no MBS at December 31, 2012.

Providing inventory financing of mortgage loans for mortgage lenders. We believe this activity may result in attractive investment assets and will supplement and make our correspondent lending business more attractive to lenders from which we acquire newly originated loans.

We are externally managed by PCM, an investment adviser that specializes in, and focuses on, residential mortgage loans. Most of our mortgage loan portfolio is serviced by PLS, an affiliate of PCM.

We conduct substantially all of our operations, and make substantially all of our investments, through our Operating Partnership and its subsidiaries. One of our subsidiaries is the sole general partner, and we are the sole limited partner, of our Operating Partnership.

We believe that we qualify to be taxed as a REIT. We believe that we will not be subject to federal income tax on that portion of our income that is distributed to shareholders as long as we meet certain asset, income and share ownership tests. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, our profits will be subject to income taxes and we may be precluded from qualifying as a REIT for the four tax years following the year we lose our REIT qualification. A portion of our activities are conducted in a TRS, which is subject to corporate federal and state income taxes. Accordingly, we have made a provision for income taxes with respect to the operations of our TRS. We expect that the effective rate for the provision for income taxes will be volatile in future periods. Our goal is to manage the business to take full advantage of the tax benefits afforded to us as a REIT.

Observations on Current Market Opportunities

Our business is affected by macroeconomic conditions in the United States, including economic growth, unemployment rates, the residential housing market and interest rate levels and expectations. During 2012, the U.S. economy continued its pattern of modest growth as reflected in recent economic data. Real U.S. gross domestic product, as reported by the Bureau of Economic Analysis, expanded at an annual rate of 2.2% for 2012 as compared to a revised 1.8% annual rate for 2011. The seasonally adjusted national unemployment rate, as reported by the Bureau of Labor Statistics, was 7.8% at December 31, 2012, the fourth consecutive month the rate was below 8% and equaling the previous lowest rate for the year, and compares to an unemployment rate of 8.5% at December 31, 2011. Declining unemployment may, however, be partially reflective of a declining workforce labor participation rate. Before declining below 8% as of September, 2012, the persistently high monthly unemployment rate above 8% since February 2009 continues to be reflected in high delinquency rates

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on single family residential mortgage loans. As reported by the Federal Reserve, during the first three quarters of 2012 charge-off and delinquency rates on loans and leases at commercial banks ranged from a low of 10.28% for the first quarter to a high of 10.77% for the third quarter, a modest reduction from the recent high of 11.25% during the first quarter of 2010.

Residential real estate activity appears to be modestly improving. The seasonally adjusted annual rate of existing home sales for December 2012, as reported by the National Association of Realtors® (NAR), was 12.8% higher than for December 2011. The national median existing home price for all housing types in December 2012, as reported by the NAR, was \$180,800, an 11.5% increase from December 2011, and represents the 10th consecutive month of year-over-year price gains as well as the largest year-over-year price increase reported in any one month since November 2005. Foreclosure filings, as reported by RealtyTrac, on a national level decreased 3% during 2012 as compared to 2011 and 36% from the foreclosure filings peak in 2010 with December 2012 filings representing a 68 month low. However, foreclosure activity in 2012 increased from 2011 in 25 states, primarily those states with longer judicial foreclosure processes as lenders began catching up with their foreclosure backlogs. Nationwide, the average time to foreclose increased to 414 days during the fourth quarter of 2012 from 348 days in the fourth quarter of 2011. As of January, 2013, 26% of all homes with outstanding mortgages had a balance owed that was at least 25% more than the value of the homes collateralizing such loans, down from 28% of all homes with outstanding mortgages in January, 2012 as reported by RealtyTrac.

Thirty-year fixed rate mortgage interest rates ranged from a high of 4.08% to a low of 3.31% during 2012 with the low of 3.31% representing an all-time record low for the thirty-year fixed rate mortgage (Source: Freddie Mac's Weekly Primary Mortgage Market Survey). The average annual interest rate for the thirty-year fixed rate mortgages in 2012 was 3.66% compared to 4.45% in 2011.

Our Manager continues to see substantial volumes of distressed residential mortgage loan sales (sales of loan pools that consist of either nonperforming loans, troubled but performing loans or a combination thereof) offered for sale by a limited number of sellers. During 2012, our Manager reviewed 96 mortgage loan pools with unpaid principal balances totaling approximately \$19.7 billion and one pool of real estate acquired in settlement of loans totaling approximately \$30.1 million. This compares to our Manager's review of 88 mortgage loan pools with unpaid principal balances totaling approximately \$13.6 billion during 2011. We acquired distressed mortgage loans with fair values totaling \$542.8 million and \$647.6 million during the years ended December 31, 2012 and 2011, respectively.

We believe that the shifting investment and operational priorities of banks and other traditional mortgage lenders have created additional opportunities for our business. Under current market conditions, these opportunities include the purchase from mortgage lenders of newly originated mortgage loans that are eligible for sale to an Agency. These opportunities also include the purchase of newly originated mortgage loans that can be resold in the non-Agency whole loan market or securitized in the private label market as well as providing inventory financing to originators of such loans. Residential mortgage originations increased in 2012 due to, among other things, government quantitative easing programs that have helped drive primary mortgage interest rates to historic lows, government refinance programs such as HARP, and a recovering housing market. However, despite this recent growth, origination volumes remain well below pre-recession levels (high of \$3.8 trillion in 2003). According to the Mortgage Bankers Association, total residential mortgage originations in the United States were expected to reach \$1.8 trillion in 2012, 71% of which were expected to be refinancings. This represents an increase of 22% over the originations in 2011. The refinance-driven origination growth is expected to change in the next two years as refinance volume drops and purchase volume gradually recovers. During the years ended December 31, 2012 and 2011, we acquired approximately \$22.4 billion and \$1.3 billion, respectively, in fair value of newly originated mortgage loans and received proceeds of approximately \$21.7 billion and \$1.1 billion, respectively, on the sale of loans.

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Reporting Metrics and Prospective Trends

We expect our results of operations to be affected by various factors, many of which are beyond our control. Our primary sources of income are from:

Gains on mortgage loans acquired for sale, including commitments to purchase or originate mortgage loans and the related hedging instruments

Net gains on investments

Interest income

Loan origination fees

Net servicing income

Gain on Mortgage Loans Acquired for Sale

When we sell our mortgage loans, we record a gain or loss which is determined by the nature and terms of the transaction. The gain or loss that we realize on the sale of loans acquired through our mortgage lending activities is primarily determined by the price paid for purchased loans or the terms of originated loans, the effect of any hedging and other risk management activities that we undertake, the sales price of the loan and the value of any MSR's received in the transaction. Gain on mortgage loans acquired for sale is significantly influenced by mortgage loan prepayment activity which is, in turn, significantly influenced by the level and direction of mortgage interest rates. Certain of these factors are beyond our control.

Our gain on mortgage loans acquired for sale includes both cash and non-cash elements. We receive proceeds on sale that include both cash and our estimate of the value of MSR's. We also provide an estimate of the losses we expect to incur relating to representations and warranties that we make to the investors.

We recognize the fair value of loan commitments we make to correspondent lenders to purchase loans. We refer to these commitments as IRLC's. We recognize the value of these commitments upon their issuance, which is generally before we purchase the mortgage loans subject to the commitment. We presently issue IRLC's with commitment periods ranging to sixty days. The value that we assign to an IRLC is estimated based on our estimated gain on sale of a mortgage loan funded under the commitment, adjusted for the probability that the loan will be purchased within the terms of the IRLC. The IRLC is subject to changes in fair value as the loan approaches funding, as market interest rates for similar loans change and as our assessment of the probability of the funding of mortgage loans at similar points in the origination process changes. The value of an IRLC can be either positive or negative, depending on the relationship of the mortgage loan's interest rates to current market rates for similar mortgage loans.

The primary factor influencing the probability that the loan will fund within the terms of the IRLC is the change, if any, in mortgage interest rates subsequent to the commitment date. In general, the probability of funding increases if current rates rise and decreases if current rates fall. This is due primarily to the relative attractiveness of current mortgage interest rates compared to the correspondent lender's committed rate. The probability that a loan will fund within the terms of the IRLC is also influenced by the source of the application, age of the application, purpose of the loan (purchase or refinance) and the application approval rate. We have developed closing ratio estimates using empirical data that take into account all of these variables, as well as renegotiations of rate and point commitments that tend to occur when mortgage interest rates fall. These closing ratio estimates are used to calculate the aggregate balance of loans that we expect to fund within the terms of the IRLC's.

We manage the risk created by IRLC's relating to mortgage loans and by our inventory of mortgage loans acquired for sale by entering into forward sale agreements to sell the mortgage loans and by the purchase and sale of interest rate options and futures. Such agreements are accounted for as derivative financial instruments.

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We account for our derivative financial instruments as free-standing derivatives. We do not designate our forward sale agreements or options and futures for hedge accounting. We recognize all of our derivative financial instruments on the balance sheet at fair value with changes in the fair value being reported in current period income as a component of net gain on mortgage loans acquired for sale.

We also provide for our estimate of the fair value of future losses that we may be required to incur as a result of our breach of representations and warranties provided to the purchasers of the loans we have sold. The representations and warranties require adherence to investor or insurer origination and underwriting guidelines, including but not limited to the validity of the lien securing the loan, property eligibility, borrower credit, income and asset requirements, and compliance with applicable federal, state and local law.

In the event of a breach of our representations and warranties, we may be required to either repurchase the mortgage loans with the identified defects or indemnify the investor or insurer from its related losses. In such cases, we bear any subsequent credit loss on the mortgage loans. Our losses from representations and warranties may be reduced by any recourse that we have to correspondent lenders that, in turn, had sold such mortgage loans to us and breached similar or other representations and warranties. In such event, we generally have the right to seek a repurchase or indemnity from that originator.

We record a provision for losses relating to representations and warranties as part of our loan sale transactions. The method we use to estimate our liability for representations and warranties is a function of the representations and warranties given and considers a combination of factors, including, but not limited to, estimated future defaults and loan repurchase rates, the potential severity of loss in the event of defaults and the probability of reimbursement by the correspondent loan seller. We establish a liability at the time loans are sold and continually update our liability estimate.

The level of the liability for losses from representations and warranties is difficult to estimate and requires considerable management judgment. The level of mortgage loan repurchase losses is dependent on economic factors, investor repurchase demand strategies, and other external conditions that may change over the lives of the underlying loans. Our representations and warranties are generally not subject to stated limits of exposure. However, we believe that the current unpaid principal balance of loans that we have sold to date represents the maximum exposure to repurchases related to representations and warranties.

We evaluate the adequacy of our liability for losses from representations and warranties based on our loss experience and our assessment of future losses to be incurred relating to loans that we have previously sold and which remain outstanding at the balance sheet date. As our portfolio of loans sold subject to representations and warranties grows and as economic fundamentals change, such adjustments can be material. However, we believe that our current estimates adequately approximate the future losses to be incurred on our servicing portfolio of mortgage loans sold subject to such representations and warranties.

Net Gains on Investments

Realized Gain or Loss. When we sell our mortgage loans, REO or securities, we record a gain or loss which is determined by the nature and terms of the disposition transaction. When a mortgage loan is satisfied through a full or partial payoff, the amount of gain or loss recorded represents the difference between the amount received and the fair value of the loan at the beginning of the month in which the payoff is received. Gain or loss on the sale of REOs is determined by the difference between the net proceeds and the carrying value of the property at the date the property is sold.

We are generally not in a position to dispose of our mortgage loans following modification until adequate time has passed to establish a satisfactory payment history. As a result, our ability to realize gain on our modified loans is correspondingly deferred and our initial periods of operations have not included material levels of disposition transactions with regard to modified loans. As a result of our fair value accounting, in the event of a significant loan modification, we record a realized gain (or loss) to the extent that the fair value of the modified loan exceeded (or was less than) the fair value of the loan before modification.

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Unrealized Gain or Loss. Many of our assets, including our mortgage loans and securities, are carried at fair value. Accordingly, changes in the fair value affect the results of our operations for the period in which such change in value occurs, and these changes may be material. Changes, and the expectation of future changes, in home prices are major determinants of the value of residential mortgage loans. These factors are beyond our control.

Interest Income

Interest income represents interest earned on our residential mortgage loans and mortgage-related assets. We anticipate that the primary contributing elements of our interest income (some of which are beyond our control) will be the size of our mortgage loan and securities portfolio, the timing of purchases and prices paid for such assets, the level and changes of interest rates, prepayment speeds and the payment performance of borrowers.

Loan origination fees

Loan origination fees represent fees we charge to correspondent lenders as part of our loan acquisition activities. We deduct the loan origination fees from the proceeds we pay the correspondent lenders on the date of purchase of the respective loans.

Net Servicing Income

Net servicing income includes the fees that we earn as well as the amortization, impairment and changes in fair value that we recognize from holding MSR. A significant component of our net servicing income is driven by the changes in the fair value of the MSR that we hold. Changes in the fair value of MSR are significantly influenced by prepayment expectations and actual prepayments relating to the underlying loans that are, in turn, primarily influenced by mortgage interest rate expectations.

Valuation, Amortization, Impairment and Change in Estimated Fair Value of Mortgage Servicing Rights

MSR represent the value of a contract that obligates us to service the mortgage loans on behalf of the owner of the loan in exchange for servicing fees and the right to collect certain ancillary income from the borrower. We recognize MSR at our estimate of the fair value of the contract to service the loans.

How much of the MSR we realize in cash depends upon how our initial estimates of the future cash flows accruing to the MSR are realized. As economic fundamentals influencing the loans change, our estimate of the fair value of the related MSR we retain will also change. As a result, we will record changes in fair value as a component of net servicing income for the MSR we carry at fair value, and we may recognize changes in fair value relating to our MSR carried at the lower of amortized cost or fair value depending on the relationship of the asset's fair value to its amortized cost at the measurement date.

After the initial recognition of MSR, we account for such assets based on the initial interest rates of the mortgage loans underlying the respective MSR. We account for MSR differently based on whether the interest rates of the mortgage loans underlying such assets are above 4.5% because we have concluded that mortgage loans with initial interest rates of 4.5% or less present different risks to us than MSR relating to mortgage loans with initial interest rates of more than 4.5% and, therefore, require a different risk management approach. Our risk management efforts in connection with MSR relating to mortgage loans with initial interest rates of 4.5% or less are generally aimed at moderating the effects of non-interest rate risks on fair value, such as the effect of changes in home prices on the assets' values. Our risk management efforts in connection with MSR relating to mortgage loans with initial interest rates of more than 4.5% are aimed at moderating the effects of changes in interest rates on the assets' values.

We account for MSR relating to mortgage loans with initial interest rates of more than 4.5% at estimated fair value. Changes in the fair value of MSR carried at fair value are included in current period income as a component of net servicing income.

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We account for MSR accounting relating to mortgage loans with initial interest rates of less than or equal to 4.5% using the amortization method. Under the amortization method, we amortize the cost of MSRs in proportion to, and over the period of, net servicing income for the mortgage loans underlying the respective assets.

We also evaluate MSRs accounted for using the amortization method with reference to the assets' fair value at the measurement date. Impairment occurs when the current fair value of the MSR falls below the asset's carrying value (carrying value is the amortized cost reduced by any related valuation allowance). If MSRs are impaired, the impairment is recognized in current period income and the carrying value of the MSRs is adjusted through a valuation allowance. If the value of impaired MSRs subsequently increases, we recognize the increase in value in current period earnings and, through a reduction in the valuation allowance, adjust the carrying value of the MSRs to a level not in excess of amortized cost.

When evaluating MSRs for impairment, we stratify the assets by predominant risk characteristic including loan type (fixed-rate or adjustable-rate) and note rate. We stratify fixed-rate loans into note rate pools of 50 basis points for note rates between 3.0% and 4.5% and a single pool for note rates below 3%. We evaluate adjustable-rate mortgage loans with initial interest rates of 4.5% or less in a single pool.

We periodically review the various impairment strata to determine whether the value of the impaired MSRs in a given stratum is likely to recover. When we deem recovery of the value to be unlikely in the foreseeable future, a write-down of the cost of the MSRs for that stratum to its estimated recoverable value is charged to the valuation allowance.

Amortization and impairment of MSRs accounted for using the amortization method are included in current period income as a component of net servicing income.

We manage the impairment risk created by holding MSRs in part through the purchase and sale of MBS options and futures. Such agreements are accounted for as derivative instruments.

We account for our derivative financial instruments as free-standing derivatives. We do not designate our forward sale agreements or options and futures for hedge accounting. We recognize all of our derivative financial instruments on the balance sheet at fair value with changes in the fair value being reported in current period income as a component of net gain on mortgage loans acquired for sale.

Expenses

Under our management agreement with PCM, we incur base management and performance incentive fees that are determined based upon our equity and profitability, among other factors. Under our loan servicing agreement with PLS, we incur loan servicing, origination and other fees that are determined by the size of our mortgage loan portfolio, the delinquency status and characteristics of our loans, and the volumes of mortgage loan and property resolution events, among other factors. In connection with our correspondent lending business, we procure certain mortgage banking services from PLS, including fulfillment and disposition-related services, for a fulfillment fee based on a percentage of the unpaid principal balance of the mortgage loans we sell to non-affiliates.

We also incur ongoing operating and administrative expenses necessary to conduct our business. In connection with investigating portfolios for investment, we are obligated to reimburse PCM's upfront expenses related to due diligence, credit and collateral evaluation and the costs to board the loans onto PCM's and PLS's systems. In some cases, these costs may not be recoverable from the selling party if PCM's bidding efforts are not successful.

Other Factors Influencing Our Results

Prepayment Speeds. Prepayment speeds, as reflected by the constant prepayment rate, vary according to interest rates, the type of investment, conditions in the financial markets, competition and other factors, none of which can be predicted with any certainty. In general, when interest rates rise, it is relatively less attractive for

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borrowers to refinance their mortgage loans and, as a result, prepayment speeds tend to decrease. This can extend the period over which we earn loan servicing fees and interest income. When interest rates fall, prepayment speeds tend to increase, thereby decreasing the period over which we earn loan servicing fees and interest income.

Rising Interest Rate Environment. Rising interest rates increase our financing costs which may result in a net negative impact on our net interest income. With respect to our floating rate investments, such interest rate increases should result in increases in our net interest income because our floating rate assets will likely be greater in amount than the related floating rate liabilities. Similarly, such an increase in interest rates should generally result in an increase in our net interest income on future fixed-rate investments made by us because our fixed-rate assets would be greater in amount than our fixed-rate liabilities. We expect, however, that our fixed-rate assets would decline in value in a rising interest rate environment and that our net interest spreads on fixed rate assets could decline in a rising interest rate environment to the extent such assets are financed with floating rate debt.

Changing Home Prices. The state of the real estate market/home prices will determine proceeds from sale of real estate acquired in settlement of loans and the value of distressed loans. While we make extensive efforts at anticipating real estate price trends and estimate those trends' effects on the valuations of our portfolios of mortgage loans and real estate acquired in settlement of loans, future real estate values are subject to influences beyond our control. Generally, rising home prices are expected to positively affect our results of real estate acquired in settlement of loans. Conversely, declining real estate prices are expected to negatively affect our results of real estate acquired in settlement of loans. Likewise, expectations of rising home prices generally positively influence our estimates of the fair value of our distressed mortgage loans and declining home prices generally negatively influence our estimates of the fair value of our distressed mortgage loans. We cannot predict future home prices with any certainty.

Risk Management Effectiveness Credit Risk. We are subject to the risk of potential credit losses on all of the residential mortgage loans we hold in our portfolio, particularly those that are nonperforming. Additionally, we may purchase all classes of certain RMBS securities for the purpose of maintaining our exclusion from the Investment Company Act, and thereby will have the credit exposure on all of the loans underlying these RMBS. Before the purchase of these securities, we intend to conduct due diligence that allows us to identify loans that do not meet our credit standards based on loan-to-value ratios, borrowers' credit scores, income and asset documentation and other criteria that we believe to be important indications of credit risk. In the event that we identify such loans, we intend to either price the securities to our expectation of value or decline to purchase the RMBS.

Risk Management Effectiveness Interest Rate Risk. Since changes in interest rates may significantly affect our activities, our operating results will depend, in large part, upon our ability to effectively manage interest rate risks and prepayment risks while maintaining our status as a REIT and our exclusion from the Investment Company Act. Such risks include the risk arising from the change in value of our inventory of mortgage loans acquired for sale and commitments to fund mortgage loans and related hedging derivative instruments, as well as the effects of changes in interest rates on the value of our investment in MSRs.

Liquidity. Our ability to operate profitably is dependent on both our access to capital to finance our assets, our ability to profitably sell mortgage loans acquired through our correspondent lending activities and our ability to manage distressed assets acquired through our investment activities. An important source of capital for the residential mortgage industry is warehouse financing facilities. These facilities provide funding to mortgage loan producers until the loans are sold to investors or securitized in the secondary mortgage loan market. Our ability to hold loans pending sale and/or securitization and loans held for investment depends, in part, on the availability to us of adequate financing lines of credit at suitable interest rates.

Size of Investment Portfolio. The size of our investment portfolio, as measured by the aggregate unpaid principal balance of our mortgage loans and aggregate principal balance of our mortgage-related securities and the other assets we own will also be a key revenue driver. Generally, as the size of our investment portfolio grows, the amount of interest income we receive will increase. The larger investment portfolio, however, will drive increased expenses, including servicing and related fees payable to PLS. We may also incur additional interest expense to finance the purchase of our assets.

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Critical Accounting Policies

We have identified what we believe are our most critical accounting policies to be the following:

Valuation of Financial Instruments

We have elected to record our financial assets at fair value and group them in three levels, based on the markets in which the assets are traded and the observability of the assumptions used to determine fair value. These levels are:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Prices determined using other significant observable inputs. Observable inputs are inputs that other market participants would use in pricing an asset or liability and are developed based on market data obtained from sources independent of us. These may include quoted prices for similar assets or liabilities, interest rates, prepayment speeds, credit risk and others.

Level 3 Prices determined using significant unobservable inputs. In situations where quoted prices or observable inputs are unavailable (for example, when there is little or no market activity for an investment at the end of the period), unobservable inputs may be used. Unobservable inputs reflect our own assumptions about the factors that market participants use in pricing an asset or liability, and are based on the best information available in the circumstances.

The valuation method used to estimate fair value may produce a fair value measurement that may not be indicative of ultimate realizable value. Furthermore, while we believe our valuation methods are appropriate and consistent with those used by other market participants, the use of different methods or assumptions to estimate the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Those estimated values may differ significantly from the values that would have been used had a readily available market for such loans or investments existed, or had such loans or investments been liquidated, and those differences could be material to the financial statements.

We incorporate lack of liquidity into its fair value estimates based on the type of asset or liability measured and the valuation method used. For example, for mortgage loans where the significant inputs have become unobservable due to illiquidity in the markets for distressed loans or non-Agency, non-conforming mortgage loans, we use a discounted cash flow technique to estimate fair value. This technique incorporates forecasting of expected cash flows discounted at an appropriate market discount rate that is intended to reflect the lack of liquidity in the market.

Mortgage-Backed Securities

MBS fair values are presently determined based on whether the securities are issued by one of the Agencies as discussed below:

Agency MBS are categorized as Level 2 financial statement items. Fair value of Agency MBS is estimated based on quoted market prices for similar securities.

Non-Agency MBS are categorized as Level 3 financial statement items. We categorize our investments in non-Agency MBS as Level 3 fair value financial statement items due to their illiquidity and the present lack of an active market for such securities. Fair value of non-Agency MBS is estimated using nonaffiliate broker indications of value. For indications of value received, the our Manager's Financial Analysis and Valuation group (the FAV group) reviews the price indications provided by non-affiliate brokers for completeness, accuracy and consistency across all similar MBS managed by the Manager. Bond-level analytics such as yield, weighted average life and projected prepayment and default speeds of the underlying collateral are computed. The reasonableness of the brokers' indications of value and

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of changes in value from period to period is evaluated in light of the analytical review performed and considering market conditions. The review of the FAV group is reported to our Manager's valuation committee as part of its review and approval of monthly valuation results. Our Manager has not adjusted, and does not intend to adjust, its fair value estimates to amounts different than the brokers' indications of value.

The significant unobservable inputs used in the fair value measurement of our non-Agency MBS are discount rates, prepayment speeds, default speeds and the total expected future loss in comparison to the current balance of outstanding collateral (or collateral remaining loss percentage). Significant changes in any of those inputs in isolation could result in a significant change in fair value measurement. Changes in these assumptions are not directly related, as they may be separately affected by changes in collateral characteristics and performance, servicer behavior, legal and regulatory actions, economic and housing market data and market sentiment.

We recognize interest income on MBS over the life of the security using the interest method. Changes in fair value arising from amortization of purchase premiums and accrual of unearned discounts are recognized as a component of interest income. We estimate, at the time of purchase, the future expected cash flows and determine the effective interest rate based on these estimated cash flows and our purchase price. We update our estimates of future cash flows monthly. In estimating these cash flows, there are a number of assumptions that are subject to uncertainties. These include the rate and timing of principal payments (including prepayments, repurchases, defaults and liquidations), the pass-through or coupon rate, interest rate fluctuations, interest payment shortfalls due to delinquencies on the underlying mortgage loans, the likelihood of modification and the timing of the magnitude of credit losses on the mortgage loans underlying the securities. These estimates are difficult to predict and are subject to future events that will likely affect the realization of our estimates and interest income. Changes in fair value arising from other factors are recognized as a component of *Net gain (loss) on investments*.

Mortgage Loans

Mortgage loans are carried at their estimated fair values. Changes in the estimated fair value of mortgage loans are recognized in current period income. All changes in fair value, including changes arising from the passage of time, are recognized as a component of *Net gain on investments*. Fair value of mortgage loans is estimated based on whether the mortgage loans are saleable into active markets with established counterparties and transparent pricing.

Mortgage loans that are saleable into active markets are categorized as Level 2 fair value financial statement items and their fair values are estimated using their quoted market price or market price equivalent.

Loans that are not saleable into active markets are categorized as Level 3 fair value financial statement items, and their fair values are estimated using a discounted cash flow valuation model. Inputs to the model include current interest rates, loan amount, payment status and property type, and forecasts of future interest rates, home prices, prepayment speeds, defaults and loss severities. The estimates of value are developed by our Manager's FAV group and are reviewed and approved by PCM's senior management valuation committee.

Real Estate Acquired in Settlement of Loans

REO is measured based on its fair value on a nonrecurring basis and is categorized as a Level 3 fair value financial statement item. Fair value of REO is determined by using a current estimate of value from a broker's price opinion, a full appraisal or the price given in a current contract of sale of the property. Changes in fair value and gains and losses on sale of REO is recognized in the consolidated statement of operations under the caption *Results of real estate acquired in settlement of loans*.

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Mortgage Servicing Rights

We recognize MSRMs initially at their estimated fair values, either as proceeds from sales of mortgage loans where we assume the obligation to service the loan in the sale transaction, or from the purchase of MSRMs. MSRMs arise from contractual agreements between us and the investors (or their agents) in mortgage securities and mortgage loans. Under these contracts, we are responsible for loan servicing functions in exchange for fees and other remuneration. The servicing functions typically performed include, among other responsibilities, collecting and remitting loan payments; responding to borrower inquiries; accounting for principal and interest, holding custodial (impound) funds for payment of property taxes and insurance premiums; counseling delinquent mortgagors; and supervising the acquisition of real estate in settlement of the loans and property dispositions.

The value of MSRMs is derived from the net positive cash flows associated with the servicing contracts. We receive a servicing fee generally of 0.25% annually on the remaining outstanding principal balances of the loans. The servicing fees are collected from the monthly payments made by the mortgagors. We generally receive other remuneration including rights to various mortgagor-contracted fees such as late charges, collateral reconveyance charges and loan prepayment penalties and we are generally entitled to retain the interest earned on funds held pending remittance for mortgagor principal, interest, tax and insurance payments. We also generally have the right to solicit the mortgagors for other products and services, such as second mortgages and insurance, as well as for new mortgages for those considering refinancing or purchasing a new home.

The precise fair value of MSRMs cannot be readily determined because MSRMs are not actively traded in stand-alone markets. Considerable judgment is required to estimate the fair values of these assets and the exercise of such judgment can significantly affect our earnings. MSR values are estimated by our Manager's FAV group and are reviewed and approved by its senior management valuation committee. Therefore, we classify our MSRMs as Level 3 fair value financial statement items.

We use a discounted cash flow approach to estimate the fair value of MSRMs. This approach consists of projecting servicing cash flows discounted at a rate that our Manager assumes market participants would use in their determinations of value. The cash flow and prepayment assumptions used in our discounted cash flow model are based on market factors which our Manager believes are consistent with assumptions and data used by market participants valuing similar MSRMs.

The key assumptions used in the valuation of MSRMs include mortgage prepayment speeds, cost to service the loans and discount rates. These variables can, and generally do, change from period to period as market conditions change.

Our subsequent accounting for MSRMs is based on the class of MSRMs. Our Manager has identified two classes of MSRMs: MSRMs backed by mortgage loans with initial interest rates of less than or equal to 4.5% and MSRMs backed by mortgage loans with initial interest rates of more than 4.5%. MSRMs backed by mortgage loans with initial interest rates of less than or equal to 4.5% are accounted for using the amortization method. MSRMs backed by loans with initial interest rates of more than 4.5% are accounted for at fair value with changes in fair value recorded in current period income.

MSRMs Accounted for Using the MSR Amortization Method

We amortize MSRMs accounted for using the amortization method. MSR amortization is determined by applying the ratio of the net MSR cash flows projected for the current period to the estimated total remaining net MSR cash flows. The estimated total net MSR cash flows are determined at the beginning of each month using prepayment assumptions applicable at that time.

We periodically assess MSRMs accounted for using the amortization method for impairment. Impairment occurs when the current fair value of the MSR falls below the asset's carrying value (carrying value is the amortized cost reduced by any related valuation allowance). If MSRMs are impaired, we recognize the impairment.

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in current-period earnings and adjust the carrying value of the MSR through a valuation allowance. If the value of impaired MSR subsequently increases, we recognize the increase in value in current-period earnings and we adjust the carrying value of the MSR through a reduction in the valuation allowance. Value is not increased above amortized cost.

We stratify our MSR by predominate risk characteristic when evaluating for impairment. For purposes of performing our MSR impairment evaluation, we stratify our servicing portfolio on the basis of certain risk characteristics including loan type (fixed-rate or adjustable-rate) and note rate. We stratify fixed-rate loans into note rate pools of 50 basis points for note rates between 3.0% and 4.5% and a single pool for note rates below 3%. If the fair value of MSR in any of the note rate pools is below the carrying value of the MSR for that pool, we recognize impairment to the extent of the difference between the estimated fair value and the existing valuation allowance for that pool.

Our Manager periodically reviews the various impairment strata to determine whether the value of the impaired MSR in a given stratum is likely to recover. When our Manager deems recovery of the value to be unlikely in the foreseeable future, a write-down of the cost of the MSR for that stratum to its estimated recoverable value is charged to the valuation allowance to adjust the carrying value to a level not in excess of amortized cost.

Amortization and impairment of MSR are included in current period income as a component of *Net servicing income*.

MSRs Accounted for at Fair Value

Changes in fair value of MSR accounted for at fair value are recognized in current period income as a component of *Net servicing income*.

Recourse Liability

Our agreements with the Agencies include representations and warranties related to the loans we sell to the Agencies. The representations and warranties require adherence to Agency origination and underwriting guidelines, including but not limited to the validity of the lien securing the loan, property eligibility, borrower credit, income and asset requirements, and compliance with applicable federal, state and local law.

In the event of a breach of our representations and warranties, we may be required to either repurchase the mortgage loans with the identified defects or indemnify the investor or insurer. In such cases, we bear any subsequent credit loss on the mortgage loans. Our credit loss may be reduced by any recourse we have to correspondent lenders that, in turn, have sold such mortgage loans to us and breached similar or other representations and warranties. In such event, we have the right to seek a recovery of related repurchase losses from that originator.

We record a provision for losses relating to our representations and warranties as part of our loan sale transactions. The method we use to estimate the liability for representations and warranties is a function of the representations and warranties given and considers a combination of factors, including, but not limited to, estimated future defaults and loan repurchase rates and the potential severity of loss in the event of defaults and the probability of reimbursement by the correspondent loan seller. We establish a liability at the time loans are sold and continually update our liability estimate.

The level of the liability for representations and warranties is difficult to estimate and requires considerable management judgment. The level of mortgage loan repurchase losses is dependent on economic factors, investor demand strategies, and other external conditions that may change over the lives of the underlying loans. Our representations and warranties are generally not subject to stated limits of exposure. However, we believe the current unpaid principal balance of loans sold by us to date represents the maximum exposure to repurchases related to representations and warranties.

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We evaluate the adequacy of our liability for losses from representations and warranties based on our loss experience and our assessment of future losses to be incurred relating to loans that we have previously sold and which remain outstanding at the balance sheet date. As our portfolio of loans sold subject to representations and warranties grows and as economic fundamentals change, such adjustments can be material. However, we believe the amount and range of reasonably possible losses in relation to the recorded liability is not material to our financial condition or results of operations.

Investment Consolidation

We evaluate every investment with reference to the underlying entity that issued the loans or securities we acquire to determine whether to include the investment in our consolidated reporting group. We perform a similar analysis for each entity with which we make an agreement for management, servicing or similar services. Where voting rights do not effectively identify the investor with a controlling financial interest, the entity is classified as a variable interest entity (VIE).

With certain exceptions, VIEs are subject to consolidation if the investors do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support, or are unable to direct the entity's activities or are not exposed to the entity's losses or entitled to its residual returns. VIEs are consolidated by the entity that is deemed the primary beneficiary of the VIE as indicated by the entity that has both the power to direct the activities of the VIE that most significantly impacts its economic performance and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the entity. We did not have variable interests in our affiliated service providers or our investments as of December 31, 2012.

Income Taxes

We have elected to be taxed as a REIT and we believe that we comply with the provisions of the Internal Revenue Code applicable to REITs. Accordingly, we believe that we will not be subject to federal income tax on that portion of our REIT taxable income that is distributed to shareholders as long as certain asset, income and share ownership tests are met. If we fail to qualify as a REIT, and do not qualify for certain statutory relief provisions, we will be subject to income taxes and may be precluded from qualifying as a REIT for the four tax years following the year of loss of our REIT qualification.

Our TRS is subject to federal and state income taxes. Income taxes are provided for using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted rates expected to apply to taxable income in the years in which we expect those temporary differences to be recovered or settled.

The effect on deferred taxes of a change in tax rates is recognized in income in the period in which the change occurs. Subject to our judgment, a valuation allowance is established if realization of deferred tax assets is not more likely than not.

We recognize tax benefits relating to tax positions we take only if it is more likely than not that the position will be sustained upon examination by the appropriate taxing authority. A tax position that meets this standard is recognized as the largest amount that exceeds 50 percent likelihood of being realized upon settlement. We will classify any penalties and interest as a component of income tax expense.

Table of Contents**Results of Operations Comparison Years Ended December 31, 2012 (2012), 2011 (2011), 2010 (2010)**

The following is a summary of our key performance measures:

	Year ended December 31,		
	2012	2011	2010
	(in thousands, except per share amounts)		
Net investment income	\$ 335,168	\$ 128,614	\$ 44,054
Pre-tax income by segment:			
Correspondent lending	\$ 100,727	\$ 7,272	\$
Investment	86,095	65,223	27,026
	\$ 186,822	\$ 72,495	\$ 27,026
Net income	\$ 138,249	\$ 64,439	\$ 24,483
Earnings per share:			
Basic	\$ 3.14	\$ 2.41	\$ 1.46
Diluted	\$ 3.14	\$ 2.41	\$ 1.44
Dividends per share:			
Declared	\$ 2.22	\$ 1.42	\$ 1.19
Paid	\$ 2.22	\$ 1.84	\$ 0.77
Cash Flow:			
Investment activities:			
Correspondent lending:			
Purchases of mortgage loans for sale	\$ 22,443,136	\$ 1,318,763	\$ 43,841
Proceeds from sales of mortgage loans acquired for sale:			
Cash:			
Sales to nonaffiliated investors	\$ 12,834,002	\$ 512,447	\$ 36,458
Sales of government-insured and guaranteed loans to PLS	8,864,264	577,852	3,395
	21,698,266	1,090,299	39,853
MSRs	134,682	6,073	
	\$ 21,832,948	\$ 1,096,372	\$ 39,853
Distressed mortgage loans and REO:			
Purchases	\$ 543,063	\$ 454,834	\$ 418,449
Cash proceeds from liquidation activities	\$ 320,580	\$ 211,752	\$ 79,828
MBS:			
Purchases	\$ 112,211	\$ 21,420	\$ 91,141
Cash proceeds from repayment and sales	\$ 189,167	\$ 67,660	\$ 58,560
Share price:			
High	\$ 25.52	\$ 19.04	\$ 18.25
Low	\$ 16.75	\$ 15.14	\$ 15.68
At year end	\$ 25.29	\$ 16.62	\$ 18.15
At year end:			
Total assets	\$ 2,559,663	\$ 1,386,062	\$ 589,095
Book value per share	\$ 20.39	\$ 19.22	\$ 19.01

During 2012, we recorded net income of \$138.2 million, or \$3.14 per diluted share. Our net income for 2012 reflects net gains on our investments in financial instruments totaling \$251.3 million (comprised of net gain on investments and net gain on mortgage loans acquired for sale), including \$84.7 million of valuation gains on MBS and mortgage loans excluding mortgage loans acquired for sale, supplemented by \$72.4 million of interest income. Our results reflect the growth in our correspondent lending segment. During 2012, we purchased \$22.4 billion in fair value of newly originated mortgage loans. We recognized gains on such loans totaling approximately \$147.7 million. At December 31, 2012, we held mortgage loans acquired for sale with fair values totaling \$975.2 million.

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During 2011, we recorded net income of \$64.4 million, or \$2.41 per diluted share. Our net income for 2011 reflects net gains on our investments in financial instruments totaling \$90.3 million (comprised of net gain on investments and net gain on mortgage loans acquired for sale), including \$62.1 million of valuation gains on MBS and mortgage loans excluding mortgage loans acquired for sale, supplemented by \$36.1 million of interest income. Our results also reflect the growth in our correspondent lending segment. During 2011, we purchased \$1.3 billion in fair value of newly originated mortgage loans, \$1.0 billion of which were purchased during the fourth quarter. We recognized gains on such loans totaling approximately \$7.6 million. At December 31, 2011, we held mortgage loans acquired for sale with fair values totaling \$232.0 million.

During 2010, we recorded net income of \$24.5 million, or \$1.44 per diluted share. Our net income reflects net gains on our investments in financial instruments totaling \$27.4 million, including \$11.1 million of valuation gains on MBS and mortgage loans excluding mortgage loans acquired for sale, supplemented by \$14.6 million of interest income. We did not engage in correspondent lending activities to a material extent in 2010. Our net income for 2010 does not include provision for approximately \$500,000 of common overhead costs relating to the quarter ended March 31, 2010 that were otherwise due to PCM because PCM waived recovery of such costs through the first quarter of 2010 as discussed below.

PCM management waived recovery of common overhead during our startup period through March 31, 2010. From March 31, 2010, PCM has not waived, and we believe that PCM does not intend to waive in the future, recovery of common overhead costs. Our results for the years ended December 31, 2012, 2011 and 2010 include provision for reimbursement of \$4.2 million, \$3.8 million and \$1.4 million, respectively, of common overhead expenses.

Net Investment Income

During 2012, we recorded net investment income of \$335.2 million, comprised primarily of net gains on investments in financial instruments of \$251.3 million supplemented by \$72.4 million of interest income, \$10.5 million of loan origination fees and \$1.4 million from results of REO. This compares to net investment income of \$128.6 million recognized during 2011, comprised primarily of \$90.3 million of net gains on investments in financial instruments, supplemented by \$36.1 million of interest income, \$1.1 million of loan origination fees and \$1.1 million of gains from results of REO. During 2010, we recorded net investment income of \$44.1 million, comprised primarily of \$27.4 million of net gains on investments in financial instruments, supplemented by \$14.6 million of interest income and \$2.0 million of gains from results of REO.

The growth in net investment income reflects the introduction of and growth in our correspondent lending activities as well as continued growth in our investment activities, all facilitated by issuances of common shares and increases in our borrowing capacity.

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Net investment income on financial instruments is summarized below:

	Year ended December 31, 2012							
	Net gain (loss)	Interest income/expense		Total revenue/ expense	Annualized %		Total return(2)	
		Coupon	Discount/ fees(1)	Total interest		Average balance	Interest yield/cost	
				(dollars in thousands)				
Assets:								
Short-term investments	\$	\$ 42	\$	\$ 42	\$ 42	\$ 49,880	0.08%	0.08%
United States Treasury security						2,459	0.00%	0.01%
Mortgage-backed securities:								
Fannie Mae 30-year fixed	(233)	1,476	(222)	1,254	1,021	44,713	2.76%	2.25%
Non-Agency subprime	496	181	378	559	1,055	29,048	1.89%	3.57%
Non-Agency Alt-A	211	221	(32)	189	400	3,779	4.92%	10.42%
Non-Agency prime jumbo	138	64	18	82	220	2,464	3.25%	8.73%
Total mortgage-backed securities	612	1,942	142	2,084	2,696	80,004	2.56%	3.31%
Mortgage loans:								
Correspondent lending:								
Acquired for sale at fair value	147,675	19,731		19,731	167,406	452,824	4.29%	36.36%
Investment portfolio:								
At fair value	93,744	49,462		49,462	143,206	807,301	6.03%	17.45%
Under forward purchase agreements at fair value	9,293	997		997	10,290	46,295	2.12%	21.86%
Total investment portfolio	103,037	50,459		50,459	153,496	853,596	5.81%	17.69%
Total mortgage loans	250,712	70,190		70,190	320,902	1,306,420	5.28%	24.16%
Other interest		125		125	125			
	\$ 251,324	\$ 72,299	\$ 142	\$ 72,441	\$ 323,765	\$ 1,438,763	4.95%	22.13%
Liabilities:								
Assets sold under agreements to repurchase:								
Securities	\$	\$ 488	\$	\$ 488	\$ 488	\$ 74,560	0.64%	
Mortgage loans acquired for sale at fair value		9,725	3,255	12,980	12,980	412,242	3.10%	
Mortgage loans at fair value		11,597	1,579	13,176	13,176	300,285	4.32%	
Real estate acquired in settlement of loans		714	500	1,214	1,214	16,666	7.16%	
Note payable secured by warehouse notes receivable			167	167	167			
Note payable secured by mortgage loans at fair value		121	(8)	113	113	1,708	6.47%	
Borrowings under forward purchase agreements		2,396		2,396	2,396	58,719	4.01%	
Interest bearing liabilities		25,041	5,493	30,534	30,534	864,180	3.48%	
Other interest - servicing related		1,108		1,108	1,108			

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\$	\$ 26,149	\$ 5,493	\$ 31,642	\$ 31,642	\$ 864,180
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- (1) Amounts in this column represent accrual of unearned discounts for assets and amortization of facility commitment fees for liabilities.
- (2) Total return includes the net gain (loss) and interest income relating to the asset and does not include the cost of managing the asset or indirect costs incurred in PCM's management of us.

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Year ended December 31, 2011
Interest income/expense

(dollars in thousands)

g to the Exchange Offer (including any memorandum, information circular, brochure or any similar documents) has been or shall be distributed or made available, di

1.04
2.16
1.47

4.90
5.12
6.59
8.90

8.65
11.38
15.82
15.82

\$

\$

\$

\$

367.50
430.00
725.00

725.00
910.00
930.00
870.00

1,020.00
1,040.00
N/A
1,037.50

370.00
260.00
280.00

600.00
657.60
600.00
627.50

792.40
832.50
921.50
959.30

10.25	\$
12.25	\$
10.05	
18.80	\$
20.98	
23.68	
24.78	
24.66	\$
24.61	
25.01	
25.04	

9.90
10.20
6.02

16.77
19.27
21.01
21.47

22.70
22.00
23.56
24.00

complete understanding of the differences between the shares of Preferred Stock or Trust Preferred Securities and the Common Stock.

suspension of dividends on our Common Stock and on the Series A and Series B Preferred Stock.

25.25
25.00
25.50
25.25
25.00

**Redemption Price as a
Percentage of
Principal Amount**

(1)
100%(2)
100%
100%

tax planning purposes that is revocable by the NEOs and/or the NEOs' spouse.

ng Officer as a group. Also, it includes shares granted under the Popular, Inc. 2004 Omnibus Incentive Plan and the Senior Executive Long-Term Incentive Plan, sub

Percent of Class⁽²⁾

Exchange Offer, any gain on the subsequent disposition of such shares of our Common Stock will be treated as ordinary interest income to the extent of such accrued

, limitations and assumptions set forth therein, for U.S. federal income tax purposes the Trust will be

as ordinary interest income to the extent of such accrued market discount that has not previously been included in income.

le or exchange of the Common Stock.

es under Section 302 of the Code will generally be subject to income tax under the Code as dividends to the extent of current and accumulated earnings and profits of

you must include the gross amount of any such dividend paid by us out of our accumulated earnings and profits (as determined for U.S. federal income tax purposes)

an Puerto Rico. It does not address special classes of holders, such as life insurance companies, special partnerships, corporations of individuals, registered investme

ares of our Common Stock received pursuant to your tender of securities in the Exchange Offer will include your holding period for the 6.70% Trust Preferred Securi

limitations and assumptions set forth therein, for U.S. federal income tax purposes the Trust will be classified as a grantor trust and the Underlying Debt Securities w

imposed if the gain constitutes income from sources outside Puerto Rico.

s under applicable federal, state, local, non-U.S or other laws (Similar Laws).

ctive investment funds), PTCE 95-60 (for transactions involving certain insurance company general accounts), and PTCE 96-23 (for transactions managed by in-hou

that such an investment meets all relevant legal requirements with respect to investments by any such Plans, Plan Asset Entities or Non-ERISA Arrangements general

Form of Consent is included in a detachable portion to the form of letter of transmittal for the Preferred Stock Exchange Offer accompanying the Prospectus. The Prospectus also includes information regarding the preference on the Series C Preferred Stock.

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f in the manner specified in the accompanying letter of transmittal with respect to such shares of Preferred Stock (each of the instructions referred to in (1) and (2) ab

A-2

ior Preferred Stock Issuance) of a new series of our preferred stock (Senior Preferred Stock) ranking, as to dividend rights and rights on liquidation, winding up

f, in the manner specified in the accompanying Letter of Transmittal, with respect to such shares of Preferred Stock (each of the instructions referred to in (1) and (2)

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FORWARD-LOOKING STATEMENTS

erally intended to identify forward-looking statements.

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**QUESTIONS AND ANSWERS ABOUT THE CONSENT MATERIALS
AND THE CONSENT SOLICITATION**

Cancelled and new shares of Senior Preferred Stock are issued (the Series C Preferred Stock Exchange). We are providing this consent solicitation statement, a Pros

...please promptly and instruct it to consent on, withhold consent on, or abstain on your behalf, in the manner specified in the accompanying Letter of Transmittal with r

...r completed Tendering Consent or Tender Certification, and comply with the other procedures set forth in the Prospectus prior to the Consent Deadline.

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Non-Tendering Consent. The board of directors may, subject to applicable law, extend the Consent Deadline in its sole discretion. If you hold your shares of Preferred

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Global Bondholder Services Corporation

65 Broadway, Suite 723

New York, New York 10006

Banks and Brokers, Call Collect:

(212) 430-3774

All Others Call Toll-Free:

(866) 540-1500

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INFORMATION ON GRANTING CONSENTS

BACKGROUND FOR THE EXCHANGE OFFER

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APPROVAL OF SENIOR PREFERRED STOCK ISSUANCE

ectors shall exist until all accumulated but unpaid dividends on the preferred shares have been paid.

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on the Series C Preferred Stock and having a distribution rate of 7.7% for the first five years and 13.8% thereafter (which rate is higher than the dividend rate on the

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

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A-13

ng Officer as a group. Also, it includes shares granted under the Popular, Inc. 2004 Omnibus Incentive Plan and the Senior Executive Long-Term Incentive Plan, sub

A-14

Percent of Class⁽²⁾

OTHER MATTERS

A-15

UNAUDITED PRO FORMA FINANCIAL INFORMATION

A-16

(8,134)¹⁰

(8,134)

(528,188)¹
1,691²
412,726^{3,10}
105,637⁴

(8,134)

(8,134)

(5,349)¹⁰

(5,349)

(410,813)¹
1,315²
321,985¹⁰
82,164⁴

(5,349)

(5,349)

**High
Participation
Scenario**

\$

\$

\$

\$

\$

\$

\$

\$

\$

\$

\$

1,646,627
(76,966)
(154,590)

(606,440)
(29,768)
(2,343)
124,962

901,482

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PROPOSALS OF COMMON STOCKHOLDERS TO BE PRESENTED

AT THE 2010 ANNUAL MEETING OF STOCKHOLDERS

Notice is mailed, or a public announcement is first made by Popular, Inc. of the date of such meeting, whichever occurs first. Stockholders may obtain a copy of our A

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INCORPORATION BY REFERENCE

Notes to Consolidated Financial Statements of the Form 10-K and the Form 10-Q.

Enrique Martel

Corporate Communications

Popular, Inc.

P.O. Box 362708

San Juan, Puerto Rico 00936-2708

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THE EXCHANGE AGENT FOR SHARES OF PREFERRED STOCK TENDERED THAT ARE NOT IN CERTIFICATED FORM:

THE EXCHANGE AGENT FOR SHARES OF PREFERRED STOCK TENDERED IN CERTIFICATED FORM IS:

THE INFORMATION AGENT FOR THE EXCHANGE OFFER IS:

Global Bondholder Services Corporation

65 Broadway, Suite 723

New York, New York 10006

Banks and Brokers, Call Collect:

(212) 430-3774

All Others Call Toll-Free:

(866) 540-1500

THE LEAD DEALER MANAGERS FOR THE EXCHANGE OFFER ARE: