

Armour Residential REIT, Inc.  
Form 10-Q  
May 05, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended March 31, 2014

OR

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

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

ARMOUR RESIDENTIAL REIT, INC.  
(Exact name of registrant as specified in its charter)

|                                                                   |                          |                                      |
|-------------------------------------------------------------------|--------------------------|--------------------------------------|
| Maryland                                                          | 001-34766                | 26-1908763                           |
| (State or other jurisdiction of<br>incorporation or organization) | (Commission File Number) | (I.R.S. Employer Identification No.) |

3001 Ocean Drive, Suite 201, Vero Beach, FL 32963  
(Address of principal executive offices)(zip code)

(772) 617-4340  
(Registrant's telephone number, including area code)

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

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

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

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

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

The number of outstanding shares of the Registrant's common stock as of May 2, 2014 was 357,110,307.

---

ARMOUR Residential REIT, Inc.  
TABLE OF CONTENTS

|                                                                                                      |           |
|------------------------------------------------------------------------------------------------------|-----------|
| <u>PART I. FINANCIAL INFORMATION</u>                                                                 | <u>3</u>  |
| <u>Item 1. Financial Statements</u>                                                                  | <u>3</u>  |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | <u>26</u> |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>                            | <u>48</u> |
| <u>Item 4. Controls and Procedures</u>                                                               | <u>50</u> |
| <u>PART II. OTHER INFORMATION</u>                                                                    | <u>50</u> |
| <u>Item 1. Legal Proceedings</u>                                                                     | <u>50</u> |
| <u>Item 1A. Risk Factors</u>                                                                         | <u>50</u> |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | <u>51</u> |
| <u>Item 3. Defaults Upon Senior Securities</u>                                                       | <u>51</u> |
| <u>Item 4. Mine Safety Disclosures</u>                                                               | <u>51</u> |
| <u>Item 5. Other Information</u>                                                                     | <u>51</u> |
| <u>Item 6. Exhibits</u>                                                                              | <u>51</u> |

ARMOUR Residential REIT, Inc.  
 CONDENSED BALANCE SHEETS  
 (in thousands, except per share amounts)  
 (Unaudited)

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

|                                                                                                                                                         | March 31, 2014 | December 31,<br>2013 |
|---------------------------------------------------------------------------------------------------------------------------------------------------------|----------------|----------------------|
| Assets                                                                                                                                                  |                |                      |
| Cash                                                                                                                                                    | \$588,832      | \$496,478            |
| Cash collateral posted                                                                                                                                  | 23,873         | 35,917               |
| Agency Securities, available for sale, at fair value (including pledged securities of \$15,711,007 and \$13,832,482)                                    | 16,479,734     | 14,648,178           |
| Receivable for unsettled sales (including pledged securities of \$257,201 in 2014)                                                                      | 296,378        | —                    |
| Derivatives, at fair value                                                                                                                              | 310,370        | 508,988              |
| Principal payments receivable                                                                                                                           | 39             | 70                   |
| Accrued interest receivable                                                                                                                             | 45,492         | 42,034               |
| Prepaid and other assets                                                                                                                                | 790            | 852                  |
| Total Assets                                                                                                                                            | \$17,745,508   | \$15,732,517         |
| Liabilities and Stockholders' Equity                                                                                                                    |                |                      |
| Liabilities:                                                                                                                                            |                |                      |
| Repurchase agreements                                                                                                                                   | \$15,163,375   | \$13,151,504         |
| Cash collateral held                                                                                                                                    | 238,852        | 387,845              |
| Payable for unsettled purchases                                                                                                                         | 382,833        | 159,159              |
| Derivatives, at fair value                                                                                                                              | 82,968         | 102,795              |
| Accrued interest payable                                                                                                                                | 6,041          | 6,629                |
| Accounts payable and other accrued expenses                                                                                                             | 3,663          | 23,357               |
| Dividends payable                                                                                                                                       | 2              | —                    |
| Total Liabilities                                                                                                                                       | \$15,877,734   | \$13,831,289         |
| Commitments and contingencies (Note 8)                                                                                                                  |                |                      |
| Stockholders' Equity:                                                                                                                                   |                |                      |
| Preferred stock, \$0.001 par value, 50,000 shares authorized;                                                                                           |                |                      |
| 8.250% Series A Cumulative Preferred Stock; 2,181 and 2,181 issued and outstanding at March 31, 2014 and December 31, 2013                              | 2              | 2                    |
| 7.875% Series B Cumulative Preferred Stock; 5,650 and 5,650 issued and outstanding at March 31, 2014 and December 31, 2013                              | 6              | 6                    |
| Common stock, \$0.001 par value, 1,000,000 shares authorized, 357,102 and 357,613 shares issued and outstanding at March 31, 2014 and December 31, 2013 | 357            | 358                  |
| Additional paid-in capital                                                                                                                              | 2,732,269      | 2,734,480            |
| Accumulated deficit                                                                                                                                     | (720,676)      | (643,138)            |
| Accumulated other comprehensive loss                                                                                                                    | (144,184)      | (190,480)            |
| Total Stockholders' Equity                                                                                                                              | \$1,867,774    | \$1,901,228          |
| Total Liabilities and Stockholders' Equity                                                                                                              | \$17,745,508   | \$15,732,517         |

See notes to condensed financial statements.

3

---

ARMOUR Residential REIT, Inc.  
CONDENSED STATEMENTS OF OPERATIONS  
(in thousands, except per share amounts)  
(Unaudited)

|                                                                                                  | For the Quarters<br>Ended |                |
|--------------------------------------------------------------------------------------------------|---------------------------|----------------|
|                                                                                                  | March 31, 2014            | March 31, 2013 |
| Interest income, net of amortization of premium on Agency Securities                             | \$123,082                 | \$130,637      |
| Interest expense                                                                                 | (14,747                   | ) (25,475      |
| Net interest income                                                                              | \$108,335                 | \$105,162      |
| Other Income (Loss):                                                                             |                           |                |
| Realized gain on sale of Agency Securities (reclassified from Other comprehensive income (loss)) | 69,869                    | 18,514         |
| Subtotal                                                                                         | \$69,869                  | \$18,514       |
| Realized loss on derivatives (1)                                                                 | (11,739                   | ) (29,053      |
| Unrealized gain (loss) on derivatives                                                            | (176,355                  | ) 16,301       |
| Subtotal                                                                                         | \$(188,094                | ) \$(12,752    |
| Total Other Income (Loss)                                                                        | \$(118,225                | ) \$5,762      |
| Expenses:                                                                                        |                           |                |
| Management fee                                                                                   | 6,965                     | 6,633          |
| Professional fees                                                                                | 1,274                     | 1,004          |
| Insurance                                                                                        | 184                       | 78             |
| Compensation                                                                                     | 712                       | 257            |
| Other                                                                                            | 753                       | 662            |
| Total expenses                                                                                   | \$9,888                   | \$8,634        |
| Net Income (Loss)                                                                                | \$(19,778                 | ) \$102,290    |
| Dividends declared on preferred stock                                                            | (3,905                    | ) (2,497       |
| Net Income (Loss) available (related) to common stockholders                                     | \$(23,683                 | ) \$99,793     |
| Net income (loss) available (related) per share to common stockholders (Note 11):                |                           |                |
| Basic                                                                                            | \$(0.07                   | ) \$0.30       |
| Diluted                                                                                          | \$(0.07                   | ) \$0.29       |
| Dividends declared per common share                                                              | \$0.15                    | \$0.24         |
| Weighted average common shares outstanding:                                                      |                           |                |
| Basic                                                                                            | 357,496                   | 337,935        |
| Diluted                                                                                          | 357,496                   | 339,722        |

(1) Interest expense related to our interest rate swap contracts is recorded in realized loss on derivatives on the condensed statements of operations. For additional information, see Note 7 to the condensed financial statements.

See notes to condensed financial statements.

ARMOUR Residential REIT, Inc.

CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(in thousands)

(Unaudited)

|                                                                                               | For the Quarters |                |
|-----------------------------------------------------------------------------------------------|------------------|----------------|
|                                                                                               | Ended            |                |
|                                                                                               | March 31, 2014   | March 31, 2013 |
| Net Income (Loss)                                                                             | \$(19,778 )      | \$102,290      |
| Other comprehensive income (loss):                                                            |                  |                |
| Reclassification adjustment for realized gain on sale of available for sale Agency Securities | (69,869 )        | (18,514 )      |
| Net unrealized gain (loss) on available for sale Agency Securities                            | 116,165          | (180,055 )     |
| Other comprehensive income (loss)                                                             | \$46,296         | \$(198,569 )   |
| Comprehensive Income (Loss)                                                                   | \$26,518         | \$(96,279 )    |

See notes to condensed financial statements.

ARMOUR Residential REIT, Inc.  
 CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY  
 (in thousands, except per share amounts)  
 (Unaudited)

|                                                                       | Preferred Stock |               |                                  |                 |               |                                  | Common Stock |               |                                  | Total<br>Additional<br>Paid in<br>Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehens<br>Loss |
|-----------------------------------------------------------------------|-----------------|---------------|----------------------------------|-----------------|---------------|----------------------------------|--------------|---------------|----------------------------------|-------------------------------------------|------------------------|--------------------------------------------|
|                                                                       | 8.250% Series A |               |                                  | 7.875% Series B |               |                                  | Shares       | Par<br>Amount | Additional<br>Paid in<br>Capital |                                           |                        |                                            |
|                                                                       | Shares          | Par<br>Amount | Additional<br>Paid in<br>Capital | Shares          | Par<br>Amount | Additional<br>Paid in<br>Capital |              |               |                                  |                                           |                        |                                            |
| Balance,<br>January 1, 2014                                           | 2,181           | \$2           | \$53,172                         | 5,650           | \$6           | \$136,547                        | 357,613      | \$358         | \$2,544,761                      | \$2,734,480                               | \$(643,138)            | \$(190,480)                                |
| Series A<br>Preferred<br>dividends<br>declared                        | —               | —             | —                                | —               | —             | —                                | —            | —             | —                                | —                                         | (1,124)                | —                                          |
| Series B<br>Preferred<br>dividends<br>declared                        | —               | —             | —                                | —               | —             | —                                | —            | —             | —                                | —                                         | (2,781)                | —                                          |
| Common stock<br>dividends<br>declared                                 | —               | —             | —                                | —               | —             | —                                | —            | —             | —                                | —                                         | (53,855)               | —                                          |
| Issuance of<br>common stock,<br>net                                   | —               | —             | —                                | —               | —             | —                                | 19           | —             | 81                               | 81                                        | —                      | —                                          |
| Stock based<br>compensation,<br>net of<br>withholding<br>requirements | —               | —             | —                                | —               | —             | —                                | 70           | —             | 292                              | 292                                       | —                      | —                                          |
| Common stock<br>repurchased                                           | —               | —             | —                                | —               | —             | —                                | (600)        | (1)           | (2,584)                          | (2,584)                                   | —                      | —                                          |
| Net loss                                                              | —               | —             | —                                | —               | —             | —                                | —            | —             | —                                | —                                         | (19,778)               | —                                          |
| Other<br>comprehensive<br>income                                      | —               | —             | —                                | —               | —             | —                                | —            | —             | —                                | —                                         | —                      | 46,296                                     |
| Balance, March<br>31, 2014                                            | 2,181           | \$2           | \$53,172                         | 5,650           | \$6           | \$136,547                        | 357,102      | \$357         | \$2,542,550                      | \$2,732,269                               | \$(720,676)            | \$(144,184)                                |

See notes to condensed financial statements.



ARMOUR Residential REIT, Inc.  
 CONDENSED STATEMENTS OF CASH FLOWS  
 (in thousands)  
 (Unaudited)

|                                                                                          | For the Quarters Ended |                  |
|------------------------------------------------------------------------------------------|------------------------|------------------|
|                                                                                          | March 31, 2014         | March 31, 2013   |
| Cash Flows From Operating Activities:                                                    |                        |                  |
| Net income (loss)                                                                        | \$(19,778              | ) \$102,290      |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                        |                  |
| Net amortization of premium on Agency Securities                                         | 10,618                 | 60,698           |
| Realized gain on sale of Agency Securities                                               | (69,869                | ) (18,514 )      |
| Stock based compensation                                                                 | 292                    | 190              |
| Changes in operating assets and liabilities:                                             |                        |                  |
| Increase in accrued interest receivable                                                  | (3,150                 | ) (16,234 )      |
| (Increase) decrease in prepaid and other assets                                          | 68                     | (150 )           |
| (Increase) decrease in derivatives, at fair value                                        | 178,791                | (32,582 )        |
| Increase (decrease) in accrued interest payable                                          | (588                   | ) 238            |
| Decrease in accounts payable and other accrued expenses                                  | (19,694                | ) (970 )         |
| Net cash provided by operating activities                                                | \$76,690               | \$94,966         |
| Cash Flows From Investing Activities:                                                    |                        |                  |
| Purchases of Agency Securities                                                           | (7,385,813             | ) (8,944,656 )   |
| Principal repayments of Agency Securities                                                | 307,214                | 1,208,551        |
| Proceeds from sales of Agency Securities                                                 | 5,279,609              | 701,476          |
| (Increase) decrease in cash collateral                                                   | (136,949               | ) 45,256         |
| Net cash used in investing activities                                                    | \$(1,935,939           | ) \$(6,989,373 ) |
| Cash Flows From Financing Activities:                                                    |                        |                  |
| Issuance of Series A Preferred stock, net of expenses                                    | —                      | 4,381            |
| Issuance of Series B Preferred stock, net of expenses                                    | —                      | 136,571          |
| Issuance of common stock, net of expenses                                                | 75                     | 438,481          |
| Proceeds from repurchase agreements                                                      | 23,322,303             | 42,366,300       |
| Principal repayments on repurchase agreements                                            | (21,310,432            | ) (35,903,781 )  |
| Series A Preferred stock dividends paid                                                  | (1,124                 | ) (1,107 )       |
| Series B Preferred stock dividends paid                                                  | (2,781                 | ) (1,390 )       |
| Common stock dividends paid                                                              | (53,853                | ) (79,829 )      |
| Common stock repurchased                                                                 | (2,585                 | ) —              |
| Net cash provided by financing activities                                                | \$1,951,603            | \$6,959,626      |
| Net increase in cash                                                                     | 92,354                 | 65,219           |
| Cash - beginning of period                                                               | 496,478                | 771,282          |
| Cash - end of period                                                                     | \$588,832              | \$836,501        |
| Supplemental Disclosure:                                                                 |                        |                  |
| Cash paid during the period for interest                                                 | \$70,351               | \$55,254         |
| Non-Cash Investing and Financing Activities:                                             |                        |                  |
| Receivable for unsettled sales                                                           | \$296,378              | \$2,226,168      |
| Payable for unsettled purchases                                                          | \$382,833              | \$—              |
| Net unrealized gain (loss) on available for sale Agency Securities                       | \$116,165              | \$(180,055 )     |
| Amounts receivable for issuance of common stock                                          | \$6                    | \$5              |
| See notes to condensed financial statements                                              |                        |                  |



ARMOUR Residential REIT, Inc.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

Note 1 – Basis of Presentation

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 1001 of Regulation S-X promulgated by the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter ended March 31, 2014 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2014. These unaudited financial statements should be read in conjunction with the audited financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2013.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates affecting the accompanying condensed financial statements include the valuation of Agency Securities (as defined below) and derivative instruments.

Note 2 – Organization and Nature of Business Operations

References to “we,” “us,” “our,” “ARMOUR” or the “Company” are to ARMOUR Residential REIT, Inc. References to “ARRM” are to ARMOUR Residential Management LLC, a Delaware limited liability company.

We are an externally managed Maryland corporation organized in 2008, managed by ARRM (see Note 13, “Related Party Transactions” for additional discussion), an investment advisor registered with the SEC. We invest in residential mortgage backed securities issued or guaranteed by a United States (“U.S.”) Government-sponsored entity (“GSE”), such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) or guaranteed by the Government National Mortgage Administration (Ginnie Mae) (collectively, “Agency Securities”). We also may invest in other securities backed by residential mortgages for which the payment of principal and interest is not guaranteed by a GSE or government agency (collectively, “Non-Agency Securities”). While we remain committed to investing in Agency Securities for so long as an adequate supply and pricing exists, we have the flexibility to invest in Non-Agency Securities and respond to changes in GSE policy as needed. As of March 31, 2014 and December 31, 2013, Agency Securities accounted for 100% of our securities portfolio. It is expected that the percentage will continue to be 100% or close thereto. Our securities portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our assets may be invested in Agency Securities backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by GSEs, U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a real estate investment trust (“REIT”).

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

requirements for qualification as a REIT under the Code and our manner of operations enables us to meet the requirements for taxation as a REIT for federal income tax purposes.

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

### Note 3 – Summary of Significant Accounting Policies

#### Cash

Cash includes cash on deposit with financial institutions. We may maintain deposits in federally insured financial institutions in excess of federally insured limits. However, management believes we are not exposed to significant credit risk due to the financial position and creditworthiness of the depository institutions in which those deposits are held.

ARMOUR Residential REIT, Inc.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

#### Cash Collateral Posted/Held

Cash collateral posted (held) represents cash posted by us to counterparties or (held) by us from counterparties as collateral for our interest rate swap contracts, Eurodollar Futures Contracts (“Futures Contracts”) and repurchase agreements on our Agency Securities.

Agency Securities, at Fair Value

We generally intend to hold most of our Agency Securities for extended periods of time. We may, from time to time, sell any of our Agency Securities as part of the overall management of our securities portfolio. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. As of March 31, 2014 and December 31, 2013, all of our Agency Securities were classified as available for sale. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the condensed statements of comprehensive income (loss).

We evaluate Agency Securities for other than temporary impairment at least on a quarterly basis and more frequently when economic or market concerns warrant such evaluation. We consider an impairment to be other than temporary if we (1) have the intent to sell the Agency Securities, (2) believe it is more likely than not that we will be required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations) or (3) a credit loss exists. Impairment losses recognized establish a new cost basis for the related Agency Securities.

#### Accrued Interest Receivable and Payable

Accrued interest receivable includes interest accrued between payment dates on Agency Securities. Accrued interest payable includes interest payable on our repurchase agreements.

#### Repurchase Agreements

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

In addition to the repurchase agreement financing discussed above, at certain times we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same

securities in the future in exchange for a price that is higher than the original purchase price. The difference between the purchase price originally paid and the sale price represents interest received from the borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same master repurchase agreement ("MRA"), settlement through the same brokerage or clearing account and maturing on the same day. We did not have any reverse repurchase agreements outstanding during the quarters ended or at March 31, 2014 and March 31, 2013 or at December 31, 2013.

#### Obligations to Return Securities Received as Collateral, at Fair Value

At certain times, we also sell to third parties the U.S. Treasury Securities received as collateral for reverse repurchase agreements and recognize the resulting obligation to return said U.S. Treasury Securities as a liability on our condensed balance sheets. Interest is recorded on the repurchase agreements, reverse repurchase agreements and U.S. Treasury Securities on an accrual basis and presented as net interest expense. Both parties to the transaction have the right to make daily margin calls based on changes in the fair value of the collateral received and/or pledged. We did not have any reverse repurchase agreements outstanding during the quarters ended or at March 31, 2014 and March 31, 2013 or at December 31, 2013.

ARMOUR Residential REIT, Inc.  
NOTES TO CONDENSED FINANCIAL STATEMENTS  
(in thousands, except per share amounts)

(Unaudited)

#### Derivatives, at Fair Value

We recognize all derivatives as either assets or liabilities at fair value on our condensed balance sheets. Since we have not elected cash flow hedge accounting treatment as allowed by GAAP, all changes in the fair values of our derivatives are reflected in our condensed statements of operations. Accordingly, our operating results may reflect greater volatility than otherwise would be the case, because gains or losses on derivatives may not be offset by changes in the fair value or cash flows of the transaction within the same accounting period or ever. Consequently, any declines in the fair value of our derivatives result in a charge to earnings. We will continue to designate derivatives as hedges for tax purposes and any unrealized derivative gains or losses would not affect our distributable net taxable income.

#### Credit Risk

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

Fannie Mae and Freddie Mac remain in conservatorship of the U.S. Government. There can be no assurances as to how or when the U.S. Government will end these conservatorships or how the future profitability of Fannie Mae and Freddie Mac and any future credit rating actions may impact the credit risk associated with Agency Securities and, therefore, the value of the Agency Securities in our securities portfolio.

#### Market Risk

Weakness in the mortgage market may adversely affect the performance and market value of our investments. This could negatively impact our book value. Furthermore, if our lenders are unwilling or unable to provide additional financing, we could be forced to sell our Agency Securities at an inopportune time when prices are depressed.

#### Preferred Stock

At March 31, 2014, we were authorized to issue up to 50,000 shares of preferred stock, par value \$0.001 per share with such designations, voting and other rights and preferences as may be determined from time to time by our Board of Directors ("Board") or a committee thereof.

#### Series A Cumulative Preferred Shares ("Series A Preferred Stock")

On June 6, 2012, we filed with the Maryland State Department of Assessments and Taxation to designate 1,610 shares of the 50,000 authorized preferred stock as 8.250% Series A Preferred Stock with the powers, designations, preferences and other rights as set forth therein. On July 13, 2012, we entered into an At Market Issuance Sales Agreement with MLV & Co. LLC, as our agent, to offer and sell, from time to time, up to 6,000 shares of Series A Preferred Stock. On July 27, 2012, we entered into an Equity Distribution Agreement with Citadel Securities LLC, as our agent, to offer and sell, from time to time, up to 2,000 shares of Series A Preferred Stock. At March 31, 2014,

there were 9,610 shares designated as Series A Preferred Stock.

We had 2,181 shares of Series A Preferred Stock issued and outstanding at March 31, 2014 and December 31, 2013. Our Series A Preferred Stock has a par value of \$0.001 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends. The Series A Preferred Stock is entitled to a dividend at a rate of 8.250% per year based on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series A Preferred Stock is redeemable at \$25.00 per share plus accrued and unpaid dividends exclusively at our option commencing on June 7, 2017 (subject to our right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve our qualification as a REIT). The Series A Preferred Stock is senior to our common stock and therefore in the event of liquidation, dissolution or winding up, the Series A Preferred Stock will receive a liquidation preference of \$25.00 per share plus accumulated and unpaid dividends before distributions are paid to holders of our common stock, with no right or claim to any of our remaining assets thereafter. The Series A Preferred Stock generally does not have voting rights except if we fail to pay dividends on the Series A Preferred Stock for eighteen months, whether or not consecutive. Under such circumstances, the Series A Preferred Stock will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set aside for payment. The Series A Preferred Stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and will remain outstanding indefinitely unless repurchased or redeemed by us or converted into our common stock in connection with a change of control by the holders of Series A Preferred Stock.



ARMOUR Residential REIT, Inc.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

Series B Cumulative Preferred Shares ("Series B Preferred Stock")

On February 11, 2013, we filed with the Maryland State Department of Assessments and Taxation to designate 6,210 shares of the 50,000 authorized preferred stock as 7.875% Series B Preferred Stock with the powers, designations, preferences and other rights as set forth therein.

We had 5,650 shares of Series B Preferred Stock issued and outstanding at March 31, 2014 and December 31, 2013. Our Series B Preferred Stock has a par value of \$0.001 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends. The Series B Preferred Stock is entitled to a dividend at a rate of 7.875% per year based on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series B Preferred Stock is redeemable at \$25.00 per share plus accrued and unpaid dividends exclusively at our option commencing on February 12, 2018 (subject to our right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve our qualification as a REIT). The Series B Preferred Stock is senior to our common stock and rank on parity with the Series A Preferred Stock. In the event of liquidation, dissolution or winding up, the Series B Preferred Stock will receive a liquidation preference of \$25.00 per share plus accumulated and unpaid dividends before distributions are paid to holders of our common stock, with no right or claim to any of our remaining assets thereafter. The Series B Preferred Stock generally does not have voting rights except if we fail to pay dividends on the Series B Preferred Stock for eighteen months, whether or not consecutive. Under such circumstances, the Series B Preferred Stock will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set aside for payment. The Series B Preferred Stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and will remain outstanding indefinitely unless repurchased or redeemed by us or converted into our common stock in connection with a change of control by the holders of Series B Preferred Stock.

Common Stock

Common Stock

At March 31, 2014, we were authorized to issue up to 1,000,000 shares of common stock, par value \$0.001 per share, with such designations, voting and other rights and preferences as may be determined from time to time by our Board. We had 357,102 shares of common stock issued and outstanding at March 31, 2014 and 357,613 shares of common stock issued and outstanding at December 31, 2013.

Common Stock Repurchased

On December 17, 2012, we announced that our Board had authorized a stock repurchase program of up to \$100,000 of shares of our common stock outstanding (the "Repurchase Program"). On March 5, 2014, our Board increased the authorization to 50,000 shares of our common stock outstanding. Under the Repurchase Program shares may be purchased in the open market, including block trades, through privately negotiated transactions, or pursuant to a trading plan separately adopted in the future. The timing, manner, price and amount of any repurchases will be at our discretion, subject to the requirements of the Securities Exchange Act of 1934, as amended, and related rules. We are not required to repurchase any shares under the Repurchase Program and it may be modified, suspended or terminated at any time for any reason. We do not intend to purchase shares from our Board or other affiliates. Under Maryland

law, such repurchased shares are treated as authorized but unissued. For the quarter ended March 31, 2014, we repurchased 600 shares of our common stock under the Repurchase Program for an aggregate of \$2,585. At March 31, 2014, there were 49,400 remaining shares authorized for repurchase under our Repurchase Program.

#### Revenue Recognition

Interest income is earned and recognized on Agency Securities based on their unpaid principal amounts and their contractual terms. Premiums and discounts associated with the purchase of Agency Securities are amortized or accreted into interest income over the actual lives of the securities, reflecting actual prepayments as they occur.

#### Comprehensive Income (Loss)

Comprehensive income (loss) refers to changes in equity during a period from transactions and other events and circumstances from non-owner sources. It includes all changes in equity during a period except those resulting from investments by owners and distributions to owners.

ARMOUR Residential REIT, Inc.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

Note 4 – Fair Value of Financial Instruments

Our valuation techniques for financial instruments are based on observable and unobservable inputs. Observable inputs reflect readily obtainable data from third party sources, while unobservable inputs reflect management's market assumptions. The Accounting Standards Codification Topic No. 820 "Fair Value Measurement" classifies these inputs into the following hierarchy:

Level 1 Inputs - Quoted prices for identical instruments in active markets.

Level 2 Inputs - Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3 Inputs - Prices determined using significant unobservable inputs. Unobservable inputs may be used 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 reflect management's assumptions about the factors that market participants would use in pricing an asset or liability, and would be based on the best information available.

The following describes the valuation methodologies used for our assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy. Any transfers between levels are assumed to occur at the beginning of the reporting period.

Cash - Cash includes cash on deposit with financial institutions. The carrying amount of cash is deemed to be its fair value. Our cash balances are classified as Level 1. Cash balances posted by us to counterparties or held by us from counterparties counterparties as collateral are classified as Level 2.

Agency Securities, Available for Sale - Fair value for the Agency Securities in our securities portfolio is based on obtaining a valuation for each Agency Security from third party pricing services and/or dealer quotes. The third party pricing services use common market pricing methods that may include pricing models that may incorporate such factors as coupons, prepayment speeds, spread to the Treasury curves and interest rate swap curves, duration, periodic and life caps and credit enhancement. If the fair value of an Agency Security is not available from the third party pricing services or such data appears unreliable, we obtain quotes from up to three dealers who make markets in similar Agency Securities. In general, the dealers incorporate common market pricing methods, including a spread measurement to the Treasury curve or interest rate swap curve as well as underlying characteristics of the particular Agency Security including coupon, periodic and life caps, collateral type, rate reset period and seasoning or age of the Agency Security. Management reviews pricing used to ensure that current market conditions are properly reflected. This review includes, but is not limited to, comparisons of similar market transactions or alternative third party pricing services, dealer quotes and comparisons to a third party pricing model. Fair values obtained from the third party pricing services for similar instruments are classified as Level 2 securities if the inputs to the pricing methods used are consistent with the Level 2 definition. If quoted prices for a security are not reasonably available from the third party pricing service, but dealer quotes are, the security will be classified as a Level 2 security. If neither is available, management will determine the fair value based on characteristics of the security that we receive from the issuer and based on available market information received from dealers and classify it as a Level 3 security. At March 31, 2014

and December 31, 2013, all of our Agency Security fair values were based solely on third party pricing services and dealer quotes and therefore were classified as Level 2.

Repurchase Agreements - The fair value of repurchase agreements reflects the present value of the contractual cash flows discounted at the estimated LIBOR based market interest rates at the valuation date for repurchase agreements with a term equivalent to the remaining term to interest rate repricing, which may be at maturity, of our repurchase agreements. The fair value of the repurchase agreements approximates their carrying amount due to the short-term nature of these financial instruments. Our repurchase agreements are classified as Level 2.

Derivative Transactions - Our Futures Contracts are traded on the Chicago Mercantile Exchange (“CME”) and are classified as Level 1. The fair values of our interest rate swap contracts and interest rate swaptions are valued using third party pricing services that incorporate common market pricing methods that may include current interest rate curves, forward interest rate curves and market spreads to interest rate curves. Management compares pricing used to dealer quotes to ensure that the current market conditions are properly reflected. The fair values of our interest rate swap contracts and our interest rate swaptions are classified as Level 2.

The following tables provide a summary of our assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2014 and December 31, 2013.

ARMOUR Residential REIT, Inc.

## NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

|                                       | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Balance at<br>March 31,<br>2014 |
|---------------------------------------|----------------------------------------------------------------------------|--------------------------------------------------|----------------------------------------------------|---------------------------------|
| Assets at Fair Value:                 |                                                                            |                                                  |                                                    |                                 |
| Agency Securities, available for sale | \$—                                                                        | \$16,479,734                                     | \$—                                                | \$16,479,734                    |
| Derivatives                           | \$—                                                                        | \$310,370                                        | \$—                                                | \$310,370                       |
| Liabilities at Fair Value:            |                                                                            |                                                  |                                                    |                                 |
| Derivatives                           | \$1,094                                                                    | \$81,874                                         | \$—                                                | \$82,968                        |

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the quarter ended March 31, 2014.

|                                       | Quoted Prices<br>in Active<br>Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Balance at<br>December 31,<br>2013 |
|---------------------------------------|----------------------------------------------------------------------------|--------------------------------------------------|----------------------------------------------------|------------------------------------|
| Assets at Fair Value:                 |                                                                            |                                                  |                                                    |                                    |
| Agency Securities, available for sale | \$—                                                                        | \$14,648,178                                     | \$—                                                | \$14,648,178                       |
| Derivatives                           | \$—                                                                        | \$508,988                                        | \$—                                                | \$508,988                          |
| Liabilities at Fair Value:            |                                                                            |                                                  |                                                    |                                    |
| Derivatives                           | \$1,503                                                                    | \$101,292                                        | \$—                                                | \$102,795                          |

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the year ended December 31, 2013.

The following tables provide a summary of the carrying values and fair values of our financial assets and liabilities not carried at fair value but for which fair value is required to be disclosed as of March 31, 2014 and December 31, 2013.

ARMOUR Residential REIT, Inc.

## NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

|                                 | March 31, 2014    |              | Fair Value Measurements using:                                 |                                         |                                           |
|---------------------------------|-------------------|--------------|----------------------------------------------------------------|-----------------------------------------|-------------------------------------------|
|                                 | Carrying Value    | Fair Value   | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets:</b>        |                   |              |                                                                |                                         |                                           |
| Cash                            | \$588,832         | \$588,832    | \$588,832                                                      | \$—                                     | \$—                                       |
| Cash collateral posted          | \$23,873          | \$23,873     | \$—                                                            | \$23,873                                | \$—                                       |
| Receivable for unsettled sales  | \$296,378         | \$296,378    | \$—                                                            | \$296,378                               | \$—                                       |
| Principal payments receivable   | \$39              | \$39         | \$—                                                            | \$39                                    | \$—                                       |
| Accrued interest receivable     | \$45,492          | \$45,492     | \$—                                                            | \$45,492                                | \$—                                       |
| <b>Financial Liabilities:</b>   |                   |              |                                                                |                                         |                                           |
| Repurchase agreements           | \$15,163,375      | \$15,163,375 | \$—                                                            | \$15,163,375                            | \$—                                       |
| Cash collateral held            | \$238,852         | \$238,852    | \$—                                                            | \$238,852                               | \$—                                       |
| Payable for unsettled purchases | \$382,833         | \$382,833    | \$—                                                            | \$382,833                               | \$—                                       |
| Accrued interest payable        | \$6,041           | \$6,041      | \$—                                                            | \$6,041                                 | \$—                                       |
| <br>                            |                   |              |                                                                |                                         |                                           |
|                                 | December 31, 2013 |              | Fair Value Measurements using:                                 |                                         |                                           |
|                                 | Carrying Value    | Fair Value   | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Financial Assets:</b>        |                   |              |                                                                |                                         |                                           |
| Cash                            | \$496,478         | \$496,478    | \$496,478                                                      | \$—                                     | \$—                                       |
| Cash collateral posted          | \$35,917          | \$35,917     | \$—                                                            | \$35,917                                | \$—                                       |
| Principal payments receivable   | \$70              | \$70         | \$—                                                            | \$70                                    | \$—                                       |
| Accrued interest receivable     | \$42,034          | \$42,034     | \$—                                                            | \$42,034                                | \$—                                       |
| <b>Financial Liabilities:</b>   |                   |              |                                                                |                                         |                                           |
| Repurchase agreements           | \$13,151,504      | \$13,151,504 | \$—                                                            | \$13,151,504                            | \$—                                       |
| Cash collateral held            | \$387,845         | \$387,845    | \$—                                                            | \$387,845                               | \$—                                       |
| Payable for unsettled purchases | \$159,159         | \$159,159    | \$—                                                            | \$159,159                               | \$—                                       |
| Accrued interest payable        | \$6,629           | \$6,629      | \$—                                                            | \$6,629                                 | \$—                                       |

## Note 5 – Agency Securities, Available for Sale

All of our Agency Securities are classified as available for sale and, as such, are reported at their estimated fair value and changes in fair value reported as part of the statements of comprehensive income (loss). As of March 31, 2014 and December 31, 2013, investments in Agency Securities accounted for 100% of our securities portfolio.

We evaluated our Agency Securities with unrealized losses as of March 31, 2014, March 31, 2013 and December 31, 2013, to determine whether there was an other than temporary impairment. The decline in value of our Agency Securities in 2013 was solely due to market conditions and not the credit quality of the assets. All of our Agency Securities are issued and guaranteed by GSEs or Ginnie Mae. The GSEs have a long term credit rating of AA+. As of March 31, 2014, March 31, 2013 and December 31, 2013, we also considered whether we intended to sell Agency Securities and whether it was more likely than not that we could meet our liquidity requirements and contractual obligations without selling Agency Securities. There was no other than temporary

ARMOUR Residential REIT, Inc.

## NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

impairment recognized for the quarters ended March 31, 2014 and March 31, 2013. At December 31, 2013, anticipating portfolio repositioning sales in the first quarter of 2014, we concluded that the December 31, 2013 unrealized losses on our 25-year and 30-year fixed rate Agency Securities represented an other than temporary impairment. Accordingly, at December 31, 2013, we recognized losses totaling \$401,500 in our 2013 statements of operations, thereby establishing a new cost basis for those Agency Securities with aggregate fair value of \$6,800,000 as of December 31, 2013. We also determined that at December 31, 2013, there was no other than temporary impairment of our other Agency Securities, which are primarily 20-year and 15-year fixed rate securities.

As of March 31, 2014, we had the following Agency Securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities as of March 31, 2014 are also presented below. Our Agency Securities had a weighted average coupon of 3.42% as of March 31, 2014.

| March 31, 2014          | Amortized Cost | Gross Unrealized Loss | Gross Unrealized Gain | Fair Value   | Percent of Total |   |
|-------------------------|----------------|-----------------------|-----------------------|--------------|------------------|---|
| <b>Fannie Mae</b>       |                |                       |                       |              |                  |   |
| ARMs & Hybrids          | \$51,194       | \$(39)                | ) \$1,197             | \$52,352     | 0.32             | % |
| Multi-Family MBS        | 212,544        | (624)                 | ) 83                  | 212,003      | 1.29             | % |
| 10 Year Fixed           | 1,105          | —                     | ) 26                  | 1,131        | 0.00             | % |
| 15 Year Fixed           | 9,867,088      | (42,801)              | ) 5,342               | 9,829,629    | 59.65            | % |
| 20 Year Fixed           | 2,808,118      | (72,300)              | ) 827                 | 2,736,645    | 16.61            | % |
| 30 Year Fixed           | 863,463        | —                     | ) 8,262               | 871,725      | 5.29             | % |
| Total Fannie Mae        | \$13,803,512   | \$(115,764)           | ) \$15,737            | \$13,703,485 | 83.16            | % |
| <b>Freddie Mac</b>      |                |                       |                       |              |                  |   |
| ARMs & Hybrids          | 16,888         | (34)                  | ) 458                 | 17,312       | 0.11             | % |
| 10 Year Fixed           | 368            | (5)                   | ) 2                   | 365          | 0.00             | % |
| 15 Year Fixed           | 282,343        | (2,024)               | ) 1,414               | 281,733      | 1.71             | % |
| 20 Year Fixed           | 2,047,929      | (50,261)              | ) 1,909               | 1,999,577    | 12.13            | % |
| 30 Year Fixed           | 337,873        | —                     | ) 3,180               | 341,053      | 2.07             | % |
| Total Freddie Mac       | \$2,685,401    | \$(52,324)            | ) \$6,963             | \$2,640,040  | 16.02            | % |
| <b>Ginnie Mae</b>       |                |                       |                       |              |                  |   |
| ARMs & Hybrids          | 134,588        | (52)                  | ) 1,233               | 135,769      | 0.82             | % |
| 15 Year Fixed           | 417            | —                     | ) 23                  | 440          | 0.00             | % |
| Total Ginnie Mae        | \$135,005      | \$(52)                | ) \$1,256             | \$136,209    | 0.82             | % |
| Total Agency Securities | \$16,623,918   | \$(168,140)           | ) \$23,956            | \$16,479,734 | 100.00           | % |

Included in the table above are unsettled purchases with an aggregate cost of \$382,833 and estimated fair value of \$381,109 at March 31, 2014.



ARMOUR Residential REIT, Inc.

## NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

As of December 31, 2013, we had the following securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities as of December 31, 2013 are also presented below. Our Agency Securities had a weighted average coupon of 3.52% as of December 31, 2013.

| December 31, 2013       | Amortized Cost | Gross<br>Unrealized Loss | Gross<br>Unrealized Gain | Fair Value   | Percent of<br>Total |   |
|-------------------------|----------------|--------------------------|--------------------------|--------------|---------------------|---|
| <b>Fannie Mae</b>       |                |                          |                          |              |                     |   |
| ARMs&Hybrids            | \$55,266       | \$(48)                   | \$1,174                  | \$56,392     | 0.40                | % |
| 10 Year Fixed           | 1,144          | —                        | 25                       | 1,169        | 0.01                | % |
| 15 Year Fixed           | 2,556,986      | (20,420)                 | 2,257                    | 2,538,823    | 17.33               | % |
| 20 Year Fixed           | 2,876,743      | (104,357)                | 56                       | 2,772,442    | 18.93               | % |
| 25 Year Fixed           | 207,946        | —                        | —                        | 207,946      | 1.42                | % |
| 30 Year Fixed           | 5,230,008      | —                        | —                        | 5,230,008    | 35.70               | % |
| Total Fannie Mae        | \$10,928,093   | \$(124,825)              | \$3,512                  | \$10,806,780 | 73.79               | % |
| <b>Freddie Mac</b>      |                |                          |                          |              |                     |   |
| ARMs&Hybrids            | 17,281         | (29)                     | 428                      | 17,680       | 0.12                | % |
| 10 Year Fixed           | 406            | (6)                      | 2                        | 402          | 0.00                | % |
| 15 Year Fixed           | 295,357        | (3,287)                  | 1,560                    | 293,630      | 2.00                | % |
| 20 Year Fixed           | 2,093,482      | (69,617)                 | 694                      | 2,024,559    | 13.82               | % |
| 25 Year Fixed           | 67,436         | —                        | —                        | 67,436       | 0.46                | % |
| 30 Year Fixed           | 1,290,623      | —                        | —                        | 1,290,623    | 8.81                | % |
| Total Freddie Mac       | \$3,764,585    | \$(72,939)               | \$2,684                  | \$3,694,330  | 25.21               | % |
| <b>Ginnie Mae</b>       |                |                          |                          |              |                     |   |
| ARMs&Hybrids            | 145,558        | (64)                     | 1,129                    | 146,623      | 1.00                | % |
| 15YrFixed               | 422            | —                        | 23                       | 445          | 0.00                | % |
| Total Ginnie Mae        | \$145,980      | \$(64)                   | \$1,152                  | \$147,068    | 1.00                | % |
| Total Agency Securities | \$14,838,658   | \$(197,828)              | \$7,348                  | \$14,648,178 | 100.00              | % |

We apply trade date accounting. Included in the table above are unsettled purchases with an aggregate cost of \$159,159 and estimated fair value of \$158,850 at December 31, 2013.

Actual maturities of Agency Securities are generally shorter than stated contractual maturities because actual maturities of Agency Securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal and prepayments of principal.

The following table summarizes the weighted average lives of our Agency Securities as of March 31, 2014 and December 31, 2013.

| Weighted Average Life of all Agency Securities | March 31, 2014 |                   | December 31, 2013 |                   |
|------------------------------------------------|----------------|-------------------|-------------------|-------------------|
|                                                | Fair Value     | Amortized<br>Cost | Fair Value        | Amortized<br>Cost |
| Less than one year                             | \$1            | \$1               | \$2               | \$2               |
|                                                | 56,730         | 56,662            | 20,289            | 20,127            |

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

|                                                               |              |              |              |              |
|---------------------------------------------------------------|--------------|--------------|--------------|--------------|
| Greater than or equal to one year and less than three years   |              |              |              |              |
| Greater than or equal to three years and less than five years | 11,796,745   | 11,886,476   | 3,809,418    | 3,837,530    |
| Greater than or equal to five years                           | 4,626,258    | 4,680,779    | 10,818,469   | 10,980,999   |
| Total Agency Securities                                       | \$16,479,734 | \$16,623,918 | \$14,648,178 | \$14,838,658 |

ARMOUR Residential REIT, Inc.

## NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

We use a third party model to calculate the weighted average lives of our Agency Securities. Weighted average life is calculated based on expectations for estimated prepayments for the underlying mortgage loans of our Agency Securities. These estimated prepayments are based on assumptions such as interest rates, current and future home prices, housing policy and borrower incentives. The weighted average lives of our Agency Securities as of March 31, 2014 and December 31, 2013 in the table above are based upon market factors, assumptions, models and estimates from the third party model and also incorporate management's judgment and experience. The actual weighted average lives of our Agency Securities could be longer or shorter than estimated.

The following table presents the unrealized losses and estimated fair value of our Agency Securities by length of time that such securities have been in a continuous unrealized loss position as of March 31, 2014 and December 31, 2013.

| As of             | Unrealized Loss Position For: |                   |                   |                   |              |                   |
|-------------------|-------------------------------|-------------------|-------------------|-------------------|--------------|-------------------|
|                   | Less than 12 Months           |                   | 12 Months or More |                   | Total        |                   |
|                   | Fair Value                    | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value   | Unrealized Losses |
| March 31, 2014    | \$11,503,901                  | \$(98,162 )       | \$1,746,638       | \$(69,978 )       | \$13,250,539 | \$(168,140 )      |
| December 31, 2013 | \$7,175,317                   | \$(197,536 )      | \$17,737          | \$(292 )          | \$7,193,054  | \$(197,828 )      |

During the quarter ended March 31, 2014, we sold \$5,575,987 of Agency Securities to reposition our portfolio, which resulted in realized gains of \$69,869. During the quarter ended March 31, 2013, we sold \$2,281,616 of Agency Securities resulting in realized gains of \$18,514.

## Note 6 – Repurchase Agreements

The following table represents the contractual repricing regarding our repurchase agreements to finance Agency Security purchases as of March 31, 2014 and December 31, 2013.

|                           | March 31, 2014        |                                   | December 31, 2013     |                                   |  |   |
|---------------------------|-----------------------|-----------------------------------|-----------------------|-----------------------------------|--|---|
|                           | Repurchase Agreements | Weighted Average Contractual Rate | Repurchase Agreements | Weighted Average Contractual Rate |  |   |
| Within 30 days            | \$(6,112,258 )        | 36.50                             | % \$3,990,434         | 0.41                              |  | % |
| 31 days to 60 days        | (6,006,880 )          | 36.90                             | % 7,098,298           | 0.41                              |  | % |
| 61 days to 90 days        | (1,552,907 )          | 35.80                             | % 1,226,694           | 0.44                              |  | % |
| Greater than 90 days      | (1,491,330 )          | 46.10                             | % 836,078             | 0.43                              |  | % |
| Total or Weighted Average | \$(15,163,375 )       | 37.50                             | % \$13,151,504        | 0.42                              |  | % |

The following table represents the MRAs and other information regarding our repurchase agreements to finance Agency Security purchases as of March 31, 2014 and December 31, 2013.

|                                                                 | March 31, 2014 | December 31, 2013 |
|-----------------------------------------------------------------|----------------|-------------------|
| Number of MRAs                                                  | 37             | 35                |
| Number of counterparties with repurchase agreements outstanding | 29             | 27                |

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

|                                       |     |       |   |
|---------------------------------------|-----|-------|---|
| Weighted average maturity in days     | 54  | 45    |   |
| Haircut for repurchase agreements (1) | 4.9 | % 5.0 | % |

(1) The Haircut represents the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount.

We have 8 repurchase agreement counterparties that individually account for between 5% and 10% of our aggregate borrowings. In total, these counterparties accounted for approximately 50.82% of our repurchase agreement borrowings outstanding at March 31, 2014.

ARMOUR Residential REIT, Inc.

## NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

## Note 7 – Derivatives

We enter into derivative transactions to manage our interest rate risk exposure. These transactions include entering into interest rate swap contracts and interest rate swaptions as well as purchasing or selling Futures Contracts. These transactions are designed to lock in funding costs for repurchase agreements associated with our assets in such a way to help assure the realization of net interest margins. Such transactions are based on assumptions about prepayments which, if not realized, will cause transaction results to differ from expectations. Our derivatives are carried on our condensed balance sheets, as assets or as liabilities at their fair value. We do not designate our derivatives as cash flow hedges and as such, we recognize changes in the fair value of these derivatives through earnings.

We have agreements with our swap (including swaption) counterparties that provide for the posting of collateral based on the fair values of our interest rate swap contracts. Through this margin process, either we or our swap counterparty may be required to pledge cash or Agency Securities as collateral. Collateral requirements vary by counterparty and change over time based on the market value, notional amount and remaining term of the contracts. Certain interest rate swap contracts provide for cross collateralization and cross default with repurchase agreements and other contracts with the same counterparty.

Interest rate swaptions generally provide us the option to enter into an interest rate swap agreement at a certain point of time in the future with a predetermined notional amount, stated term and stated rate of interest in the fixed leg and interest rate index on the floating leg.

Our Futures Contracts are traded on the CME which requires the use of daily mark-to-market collateral and the CME provides substantial credit support. The collateral requirements of the CME require us to pledge assets under a bi-lateral margin arrangement, including either cash or Agency Securities and these requirements may vary and change over time based on the market value, notional amount and remaining term of the Futures Contracts. In the event we are unable to meet a margin call under one of our Futures Contracts, the counterparty to such agreement may have the option to terminate or close-out all of the outstanding Futures Contracts with us. In addition, any close-out amount due to the counterparty upon termination of the counterparty's transactions would be immediately payable by us pursuant to the applicable agreement.

The following tables present information about interest rate swap contracts, interest rate swaptions and Futures Contracts which are included in derivatives on the accompanying condensed balance sheets as of March 31, 2014 and December 31, 2013.

March 31, 2014

| Derivative Type              | Remaining /<br>Underlying Term | Weighted<br>Average<br>Remaining<br>Swap /<br>Option Term<br>(Months) | Weighted<br>Average<br>Rate | Notional<br>Amount | Asset Fair<br>Value (1) | Liability Fair<br>Value (1) |
|------------------------------|--------------------------------|-----------------------------------------------------------------------|-----------------------------|--------------------|-------------------------|-----------------------------|
| Interest rate swap contracts | 0-12 Months                    | 11                                                                    | 1.59                        | % \$305,000        | —                       | \$(4,545 )                  |
| Interest rate swap contracts | 13-24 Months                   | 21                                                                    | 0.94                        | % 2,325,000        | —                       | (31,644 )                   |

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

|                              |                |     |      |   |              |           |           |   |
|------------------------------|----------------|-----|------|---|--------------|-----------|-----------|---|
| Interest rate swap contracts | 25-36 Months   | 27  | 1.63 | % | 1,200,000    | —         | (45,685   | ) |
| Interest rate swap contracts | 37-48 Months   | 43  | 0.80 | % | 650,000      | 6,578     | —         |   |
| Interest rate swap contracts | 49-60 Months   | 0   | 0.00 | % | —            | —         | —         |   |
| Interest rate swap contracts | 61-72 Months   | 70  | 1.48 | % | 300,000      | 9,646     | —         |   |
| Interest rate swap contracts | 73-84 Months   | 0   | 0.00 | % | —            | —         | —         |   |
| Interest rate swap contracts | 85-96 Months   | 0   | 0.00 | % | —            | —         | —         |   |
| Interest rate swap contracts | 97-108 Months  | 103 | 1.79 | % | 5,250,000    | 274,917   | —         |   |
| Interest rate swap contracts | 109-120 Months | 0   | 0.00 | % | —            | —         | —         |   |
| Futures Contracts            | 0-21 Months    | 10  | 1.97 | % | 55,000       | —         | (1,094    | ) |
| Interest rate swaptions      | 60 Months      | 6   | 2.73 | % | 4,000,000    | 14,044    | —         |   |
| Interest rate swaptions      | 120 Months     | 6   | 3.63 | % | 1,250,000    | 5,185     | —         |   |
| Total or Weighted Average    |                | 46  | 1.99 | % | \$15,335,000 | \$310,370 | \$(82,968 | ) |

(1) See Note 4, "Fair Value of Financial Instruments" for additional discussion.

ARMOUR Residential REIT, Inc.

## NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

December 31, 2013

| Derivative Type              | Remaining /<br>Underlying Term | Weighted<br>Average<br>Remaining<br>Swap /<br>Option Term<br>(Months) | Weighted<br>Average<br>Rate | Notional<br>Amount | Asset Fair<br>Value (1) | Liability<br>Fair Value<br>(1) |
|------------------------------|--------------------------------|-----------------------------------------------------------------------|-----------------------------|--------------------|-------------------------|--------------------------------|
| Interest rate swap contracts | 0-12 Months                    | 2                                                                     | 1.14                        | % \$200,000        | —                       | \$(2,089 )                     |
| Interest rate swap contracts | 13-24 Months                   | 17                                                                    | 1.13                        | % 920,000          | —                       | (18,095 )                      |
| Interest rate swap contracts | 25-36 Months                   | 28                                                                    | 1.23                        | % 2,900,000        | —                       | (81,108 )                      |
| Interest rate swap contracts | 37-48 Months                   | 43                                                                    | 0.63                        | % 350,000          | 2,614                   | —                              |
| Interest rate swap contracts | 49-60 Months                   | 49                                                                    | 1.00                        | % 300,000          | 3,817                   | —                              |
| Interest rate swap contracts | 61-72 Months                   | 0                                                                     | 0.00                        | % —                | —                       | —                              |
| Interest rate swap contracts | 73-84 Months                   | 73                                                                    | 1.48                        | % 300,000          | 11,112                  | —                              |
| Interest rate swap contracts | 85-96 Months                   | 0                                                                     | 0.00                        | % —                | —                       | —                              |
| Interest rate swap contracts | 97-108 Months                  | 103                                                                   | 1.47                        | % 2,450,000        | 195,221                 | —                              |
| Interest rate swap contracts | 109-120 Months                 | 110                                                                   | 2.08                        | % 2,800,000        | 184,456                 | —                              |
| Futures Contracts            | 0-21 Months                    | 13                                                                    | 1.97                        | % 55,000           | —                       | (1,503 )                       |
| Interest rate swaptions      | 60 Months                      | 9                                                                     | 2.73                        | % 4,000,000        | 35,937                  | —                              |
| Interest rate swaptions      | 120 Months                     | 6                                                                     | 3.16                        | % 1,750,000        | 75,831                  | —                              |
| Total or Weighted Average    |                                | 47                                                                    | 1.98                        | % \$16,025,000     | \$508,988               | \$(102,795 )                   |

(1) See Note 4, "Fair Value of Financial Instruments" for additional discussion.

We have netting arrangements in place with all derivative counterparties pursuant to standard documentation developed by the International Swap and Derivatives Association. We are also required to post or hold cash collateral based upon the net underlying market value of our open positions with the counterparty.

The following tables present information about interest rate swap contracts, interest rate swaptions and Futures Contracts and the potential effects of netting if we were to offset the assets and liabilities of these financial instruments on the accompanying condensed balance sheets. Currently, we present these financial instruments at their gross amounts and they are included in derivatives, at fair value on the accompanying condensed balance sheet as of March 31, 2014.

| Assets                       | Gross and Net<br>Amounts of Assets<br>Presented in the<br>Condensed<br>Balance Sheet | Gross Amounts Not Offset<br>in the Condensed Balance<br>Sheet |                                | Net Amount |
|------------------------------|--------------------------------------------------------------------------------------|---------------------------------------------------------------|--------------------------------|------------|
|                              |                                                                                      | Financial<br>Instruments                                      | Net Cash<br>Collateral<br>Held |            |
| Interest rate swap contracts | \$291,140                                                                            | \$(81,874 )                                                   | \$(164,162 )                   | \$45,104   |

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

|                         |           |           |              |            |
|-------------------------|-----------|-----------|--------------|------------|
| Interest rate swaptions | 19,230    | —         | —            | 19,230     |
| Totals                  | \$310,370 | \$(81,874 | ) \$(164,162 | ) \$64,334 |

19

---



ARMOUR Residential REIT, Inc.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

| March 31, 2014               | Gross Amounts Not Offset<br>in the Condensed Balance<br>Sheet                                |                          |                              |            |
|------------------------------|----------------------------------------------------------------------------------------------|--------------------------|------------------------------|------------|
| Liabilities                  | Gross and Net<br>Amounts of<br>Liabilities<br>Presented in the<br>Condensed<br>Balance Sheet | Financial<br>Instruments | Cash<br>Collateral<br>Posted | Net Amount |
| Interest rate swap contracts | \$(81,874                                                                                    | ) \$81,874               | \$—                          | \$—        |
| Futures Contracts            | (1,094                                                                                       | ) —                      | 1,159                        | 65         |
| Totals                       | \$(82,968                                                                                    | ) \$81,874               | \$1,159                      | \$65       |

The following tables present information about interest rate swap contracts, interest rate swaptions and Futures Contracts and the potential effects of netting if we were to offset the assets and liabilities of these financial instruments on the accompanying condensed balance sheets. Currently we present these financial instruments at their gross amounts and they are included in derivatives, at fair value on the accompanying condensed balance sheet as of December 31, 2013.

| December 31, 2013            | Gross Amounts Not Offset in<br>the Condensed Balance Sheet                           |                          |                            |             |
|------------------------------|--------------------------------------------------------------------------------------|--------------------------|----------------------------|-------------|
| Assets                       | Gross and Net<br>Amounts of<br>Assets Presented<br>in the Condensed<br>Balance Sheet | Financial<br>Instruments | Cash<br>Collateral<br>Held | Net Amount  |
| Interest rate swap contracts | \$397,219                                                                            | \$(101,292               | ) \$(313,229               | ) \$(17,302 |
| Interest rate swaptions      | 111,769                                                                              | —                        | —                          | 111,769     |
| Totals                       | \$508,988                                                                            | \$(101,292               | ) \$(313,229               | ) \$94,467  |

| December 31, 2013            | Gross Amounts Not Offset<br>in the Condensed Balance<br>Sheet                                |                          |                              |            |
|------------------------------|----------------------------------------------------------------------------------------------|--------------------------|------------------------------|------------|
| Liabilities                  | Gross and Net<br>Amounts of<br>Liabilities<br>Presented in the<br>Condensed<br>Balance Sheet | Financial<br>Instruments | Cash<br>Collateral<br>Posted | Net Amount |
| Interest rate swap contracts | \$(101,292                                                                                   | ) \$101,292              | \$—                          | \$—        |
| Futures Contracts            | (1,503                                                                                       | ) —                      | 1,599                        | 96         |
| Totals                       | \$(102,795                                                                                   | ) \$101,292              | \$1,599                      | \$96       |



ARMOUR Residential REIT, Inc.

## NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

The following table represents the location and information regarding our derivatives which are included in Other Income (Loss) in the accompanying condensed statements of operations for the quarters ended March 31, 2014 and March 31, 2013.

| Derivatives                   | Location on condensed statements of operations | Income (Loss) Recognized<br>For the Quarters<br>Ended |                   |
|-------------------------------|------------------------------------------------|-------------------------------------------------------|-------------------|
|                               |                                                | March 31,<br>2014                                     | March 31,<br>2013 |
| Interest rate swap contracts: |                                                |                                                       |                   |
| Interest income               | Realized loss on derivatives                   | \$3,236                                               | \$4,099           |
| Interest expense              | Realized loss on derivatives                   | (37,852 )                                             | (32,501 )         |
| Changes in fair value         | Unrealized gain (loss) on derivatives          | (103,306 )                                            | 16,953 )          |
|                               |                                                | \$ (137,922 )                                         | \$ (11,449 )      |
| Interest rate swaptions:      |                                                |                                                       |                   |
| Realized gain                 | Realized loss on derivatives                   | 23,317                                                | —                 |
| Changes in fair value         | Unrealized gain (loss) on derivatives          | (73,458 )                                             | (1,309 )          |
|                               |                                                | \$ (50,141 )                                          | \$ (1,309 )       |
| Futures Contracts:            |                                                |                                                       |                   |
| Realized loss                 | Realized loss on derivatives                   | (440 )                                                | (651 )            |
| Changes in fair value         | Unrealized gain (loss) on derivatives          | 409                                                   | 657               |
|                               |                                                | \$ (31 )                                              | \$ 6              |
| Totals                        |                                                | \$ (188,094 )                                         | \$ (12,752 )      |

## Note 8 – Commitments and Contingencies

## Management Agreement with ARRM

As discussed in Note 13 “Related Party Transactions,” we are externally managed by ARRM pursuant to a management agreement (the “Management Agreement”), which was most recently amended on February 25, 2014. The Management Agreement entitles ARRM to receive a management fee payable monthly in arrears. Currently, the monthly management fee is 1/12th of the sum of (a) 1.5% of gross equity raised up to \$1.0 billion plus (b) 0.75% of gross equity raised in excess of \$1.0 billion. The cost of repurchased stock and any dividend representing a return of capital for tax purposes will reduce the amount of gross equity raised used to calculate the monthly management fee. As of March 31, 2014, the effective management fee was 1.026% based on gross equity raised. The ARRM monthly management fee is not calculated based on the performance of our assets. Accordingly, the payment of our monthly management fee may not decline in the event of a decline in our earnings and may cause us to incur losses. We are also responsible for any costs and expenses that ARRM incurred solely on behalf of ARMOUR other than the various overhead expenses specified in the terms of the Management Agreement. ARRM is further entitled to receive a termination fee from us under certain circumstances.

Pursuant to a Sub-Management Agreement between ARMOUR, ARRM and Staton Bell Blank Check LLC (“SBBC”), ARRM is responsible for the monthly payment of a sub-management fee to SBBC in an amount equal to 25% of the monthly management fee earned by ARRM, net of expenses. On November 6, 2014, SBBC has the option of

terminating the Sub-Management Agreement. If the Sub-Management Agreement is terminated, we would be required to make a final payment to SBBC in the amount of 6.16 times the annualized rate of the sub-management fee for the prior three months. Thereafter, we will be entitled to receive the sub-management fee or, at the option of ARRM, reimbursement of the final payment by ARRM. The payments from ARRM to SBBC for the three months preceding March 31, 2014 totaled \$1,364. If the Sub-Management Agreement had been terminated on March 31, 2014, the payment due from ARMOUR would have been \$33,609.

#### Indemnifications and Litigation

We enter into certain contracts that contain a variety of indemnifications, principally with ARRM and underwriters, against third party claims for errors and omissions in connection with their services to us. We have not incurred any costs to defend lawsuits

ARMOUR Residential REIT, Inc.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements, as well as the maximum amount attributable to past events, is not material. Accordingly, we have no liabilities recorded for these agreements as of March 31, 2014 and December 31, 2013.

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

Note 9 – Stock Based Compensation

We adopted the 2009 Stock Incentive Plan (the “Plan”) to attract, retain and reward directors and other persons who provide services to us in the course of operations. The Plan authorizes the Board to grant awards including common stock, restricted shares of common stock (“Restricted Shares”), stock options, performance shares, performance units, stock appreciation rights and other equity and cash-based awards (collectively “Awards”), subject to terms as provided in the Plan.

On May 12, 2010, the Board allocated up to 250 shares to be available under the Plan. In considering such allocation, the Board considered the size of the Plan relative to our capital base and our current and potential future performance and capitalization. On July 18, 2011, our stockholders approved an amendment to the Plan to increase the number of shares issuable thereunder from 250 shares to 2,000 shares and the Plan was amended accordingly. As of March 31, 2014, all 2,000 shares allocated to the Plan have been awarded. Of these awards, approximately 150 shares vesting in 2017 were awarded subject to stockholder approval by June 30, 2017 of an increase to the number of shares issuable under the Plan.

Transactions related to Restricted Shares for the quarter ended March 31, 2014 are summarized below:

|                                                 | March 31, 2014   |                                                  |
|-------------------------------------------------|------------------|--------------------------------------------------|
|                                                 | Number of Awards | Weighted Average Grant Date Fair Value per Award |
| Unvested Awards Outstanding beginning of period | 1,329            | \$6.94                                           |
| Vested                                          | (106)            | ) \$7.11                                         |
| Unvested Awards Outstanding end of period       | 1,223            | \$6.94                                           |

As of March 31, 2014, there was approximately \$5,332 of unvested non-cash stock based compensation related to the Awards (based on the March 31, 2014 stock price of \$4.12 per share), that we expect to recognize as an expense over the remaining average service period of 2.6 years.

Note 10 – Stockholders’ Equity

Dividends

The following table presents our common stock dividend transactions for the quarter ended March 31, 2014.

| Record Date | Payment Date | Rate per common share | Aggregate amount paid to |
|-------------|--------------|-----------------------|--------------------------|
|-------------|--------------|-----------------------|--------------------------|

|                   |                   |        | holders of<br>record |
|-------------------|-------------------|--------|----------------------|
| January 15, 2014  | January 30, 2014  | \$0.05 | \$17,954             |
| February 14, 2014 | February 27, 2014 | \$0.05 | \$17,954             |
| March 17, 2014    | March 28, 2014    | \$0.05 | \$17,945             |

The following table presents our Series A Preferred Stock dividend transactions for the quarter ended March 31, 2014.

ARMOUR Residential REIT, Inc.  
 NOTES TO CONDENSED FINANCIAL STATEMENTS  
 (in thousands, except per share amounts)

(Unaudited)

| Record Date       | Payment Date      | Rate per Series A Preferred Share | Aggregate amount paid to holders of record |
|-------------------|-------------------|-----------------------------------|--------------------------------------------|
| January 15, 2014  | January 27, 2014  | \$0.17                            | \$375                                      |
| February 15, 2014 | February 27, 2014 | \$0.17                            | \$375                                      |
| March 15, 2014    | March 27, 2014    | \$0.17                            | \$375                                      |

The following table presents our Series B Preferred Stock dividend transactions for the quarter ended March 31, 2014.

| Record Date       | Payment Date      | Rate per Series B Preferred Share | Aggregate amount paid to holders of record |
|-------------------|-------------------|-----------------------------------|--------------------------------------------|
| January 15, 2014  | January 27, 2014  | \$0.16                            | \$927                                      |
| February 15, 2014 | February 27, 2014 | \$0.16                            | \$927                                      |
| March 15, 2014    | March 27, 2014    | \$0.16                            | \$927                                      |

#### Equity Capital Raising Activities

The following table presents our equity transactions for the quarter ended March 31, 2014.

| Transaction Type                                                         | Completion Date                         | Number of Shares | Per Share price | Net Proceeds |
|--------------------------------------------------------------------------|-----------------------------------------|------------------|-----------------|--------------|
| Common stock dividend reinvestment program<br>(1) Weighted average price | January 27, 2014 through March 28, 2014 | 19               | \$4.16          | (1) \$81     |

#### Common Stock Repurchases

The following table presents our common stock repurchases for the quarter ended March 31, 2014.

| Transaction Type                                        | Completion Date                       | Number of Shares | Per Share price | Net Cost    |
|---------------------------------------------------------|---------------------------------------|------------------|-----------------|-------------|
| Repurchased common shares<br>(1) Weighted average price | March 12, 2014 through March 14, 2014 | 600              | 4.31            | (1) \$2,585 |

#### Note 11 – Income (Loss) per Common Share

The following table presents a reconciliation of net income (loss) and the shares used in calculating weighted average basic and diluted earnings per common share for the quarters ended March 31, 2014 and March 31, 2013.





|                                                                                 | For the Quarters<br>Ended |                   |
|---------------------------------------------------------------------------------|---------------------------|-------------------|
|                                                                                 | March 31,<br>2014         | March 31,<br>2013 |
| Net Income (loss)                                                               | \$ (19,778 )              | \$ 102,290        |
| Less: Preferred dividends                                                       | (3,905 )                  | (2,497 )          |
| Net income (loss) available (related) to common stockholders                    | \$ (23,683 )              | \$ 99,793         |
| Weighted average common shares outstanding – basic                              | 357,496                   | 337,935           |
| Add: Effect of dilutive non-vested restricted stock unit awards, assumed vested | —                         | 1,787             |
| Weighted average common shares outstanding – diluted                            | 357,496                   | 339,722           |

## Note 12 – Income Taxes

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

The following table reconciles our GAAP net income to estimated REIT taxable income for the quarters ended March 31, 2014 and March 31, 2013.

|                                        | For the Quarters<br>Ended |                   |
|----------------------------------------|---------------------------|-------------------|
|                                        | March 31,<br>2014         | March 31,<br>2013 |
| GAAP net income (loss)                 | \$ (19,778 )              | \$ 102,290        |
| Book to tax differences:               |                           |                   |
| Changes in derivatives                 | 153,038                   | (16,301 )         |
| Gains on Agency Security Sales         | (69,869 )                 | —                 |
| Amortization of deferred hedging costs | 293                       | —                 |
| Net premium amortization differences   | (5,343 )                  | —                 |
| Other                                  | 6                         | —                 |
| Estimated taxable income               | \$ 58,347                 | \$ 85,989         |

The aggregate tax basis of our assets and liabilities was less than our total Stockholders' Equity at March 31, 2014 by approximately \$(125,680), or approximately \$(0.35) per common share (based on the 357,102 common shares then outstanding).

We are required and intend to timely distribute substantially all of our REIT taxable income in order to maintain our REIT status under the Code. Total dividend payments to stockholders were \$57,758 for the quarter ended March 31, 2014. Our estimated REIT taxable income available to pay dividends was \$58,347 for the quarter ended March 31, 2014. Realized losses on derivatives for the quarter ended March 31, 2014 include realized gains on swaptions of \$23,317, which are amortized for tax purposes over the ten year terms of the referenced interest rate swap contract. Our taxable REIT income and dividend requirements to maintain our REIT status are determined on an annual basis. Dividends in excess of taxable REIT income for the year (including amounts carried forward from prior years) will generally not be taxable to common stockholders.

Net capital losses realized in 2013 and 2014 totaling \$(579,322) and \$(303,749) will be available to offset future capital gains realized through 2018 and 2019, respectively.

Our management is responsible for determining whether tax positions taken by us are more likely than not to be sustained on their merits. We have no material unrecognized tax benefits or material uncertain tax positions.

ARMOUR Residential REIT, Inc.

NOTES TO CONDENSED FINANCIAL STATEMENTS

(in thousands, except per share amounts)

(Unaudited)

Note 13 – Related Party Transactions

We are externally managed by ARRM pursuant to the Management Agreement. All of our executive officers are also employees of ARRM. ARRM manages our day-to-day operations, subject to the direction and oversight of the Board. The Management Agreement expires after an initial term of ten years on June 18, 2022 and is thereafter automatically renewed for an additional five-year term unless terminated under certain circumstances. Either party must provide 180 days prior written notice of any such termination.

Under the terms of the Management Agreement, ARRM is responsible for costs incident to the performance of its duties, such as compensation of its employees and various overhead expenses. ARRM is responsible for the following primary roles:

- Advising us with respect to, arranging for and managing the acquisition, financing, management and disposition of, elements of our investment portfolio;

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

- Coordinating capital raising activities;

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

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

In accordance with the Management Agreement, we incurred \$6,965 in management fees for the quarter ended March 31, 2014. For the quarter ended March 31, 2013, we incurred \$6,633 in management fees.

We are required to take actions as may be reasonably required to permit and enable ARRM to carry out its duties and obligations. We are also responsible for any costs and expenses that ARRM incurred solely on behalf of ARMOUR other than the various overhead expenses specified in the terms of the Management Agreement. For the quarter ended March 31, 2014, we reimbursed ARRM \$460 for other expenses incurred on our behalf. We also reimbursed \$234 of compensation expense during the quarter ended March 31, 2014 related to Restricted Shares for ARRM employees. For the quarter ended March 31, 2013, we reimbursed ARRM \$396 for expenses incurred on our behalf and \$371 for stock based compensation expense (see Note 9, "Stock Based Compensation" for additional discussion).

See Note 8, "Commitments and Contingencies" for discussion of the Sub-Management Agreement.

Note 14 – Interest Rate Risk

Our primary market risk is interest rate risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned and the interest expense incurred in connection with the liabilities, by affecting the spread between the interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of Agency Securities and our ability to realize gains from the sale of these assets. A decline in the

value of the Agency Securities pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels.

Note 15 – Subsequent Events

On April 28, 2014, a cash dividend of \$0.17 per outstanding share of Series A Preferred Stock, or \$375 in the aggregate, and \$0.16 per outstanding share of Series B Preferred Stock, or \$927 in the aggregate, was paid to holders of record on April 15, 2014.

On April 29, 2014, a cash dividend of \$0.05 per outstanding common share, or \$17,924 in the aggregate, was paid to holders of record on April 15, 2014.

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

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

References to “we,” “us,” “our,” “ARMOUR” or the “Company” are to ARMOUR Residential REIT, Inc. References to “ARRM” are to ARMOUR Residential Management LLC, a Delaware limited liability company. Refer to the Glossary of Terms for definitions of capitalized terms and abbreviations used in this report.

Dollar amounts are presented in thousands, except per share amounts or as otherwise noted.

### Overview

We are a Maryland corporation formed to invest in and manage a leveraged portfolio of MBS and mortgage loans. The securities we invest in are issued or guaranteed by a GSE, such as Fannie Mae, the Freddie Mac, or guaranteed by Ginnie Mae (collectively, Agency Securities). Our securities portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our assets may be invested in Agency Securities backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by GSE's, U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a REIT. Our charter permits us to invest in Agency Securities and Non-Agency Securities. As of March 31, 2014 and December 31, 2013 Agency Securities account for 100% of our securities portfolio. It is expected that the percentage will continue to be 100% or close thereto.

We are externally managed by ARRM, pursuant to the Management Agreement, which was most recently amended on February 25, 2014. ARRM is an investment advisor registered with the SEC. ARRM is also the external manager of JAVELIN, a publicly traded REIT, which invests in and manages a leveraged portfolio of Agency Securities and Non-Agency Securities. Our executive officers also serve as the executive officers of JAVELIN.

We seek attractive long-term investment returns by investing our equity capital and borrowed funds in our targeted asset class of Agency Securities. We earn returns on the spread between the yield on our assets and our costs, including the interest cost of the funds we borrow, after giving effect to our hedges. We identify and acquire Agency Securities, finance our acquisitions with borrowings under a series of short-term repurchase agreements at the most competitive interest rates available to us and then cost-effectively hedge our interest rate and other risks based on our entire portfolio of assets, liabilities and derivatives and our management's view of the market. Successful implementation of this approach requires us to address interest rate risk, maintain adequate liquidity and effectively hedge interest rate risks. We believe that the residential mortgage market will undergo significant changes in the coming years as the role of GSEs, such as Fannie Mae and Freddie Mac, is diminished, which we expect will create attractive investment opportunities for us. We execute our business plan in a manner consistent with our intention of qualifying as a REIT under the Code and avoiding regulation as an investment company under the 1940 Act.

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

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

Our results of operations and financial condition are affected by various factors, many of which are beyond our control, including, among other things, our net interest income, the market value of our assets and the supply of and

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

For any period during which changes in the interest rates earned on our assets do not coincide with interest rate changes on our borrowings, such assets will tend to reprice more slowly than the corresponding liabilities. Consequently, changes in interest rates, particularly short-term interest rates, may significantly influence our net interest income. With the maturities of our assets

generally of longer term than those of our liabilities, interest rate increases will tend to decrease our net interest income and the market value of our assets (and therefore our book value). Such rate increases could possibly result in operating losses or adversely affect our ability to make distributions to our stockholders.

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

While we use strategies to economically hedge some of our interest rate risk, we do not hedge all of our exposure to changes in interest rates and prepayment rates, as there are practical limitations on our ability to insulate our securities portfolio from all potential negative consequences associated with changes in short-term interest rates in a manner that will allow us to seek attractive net spreads on our securities portfolio. Also, since we have not elected to use cash flow hedge accounting, earnings reported in accordance with GAAP will fluctuate even in situations where our derivatives are operating as intended. As a result of this mark-to-market accounting treatment, our results of operations are likely to fluctuate far more than if we were to designate our derivative activities as cash flow hedges. Comparisons with companies that use cash flow hedge accounting for all or part of their derivative activities may not be meaningful. For these and other reasons more fully described under the section captioned “Derivative Instruments” below, no assurance can be given that our derivatives will have the desired beneficial impact on our results of operations or financial condition.

In addition to the use of derivatives to hedge interest rate risk, a variety of other factors relating to our business may also impact our financial condition and operating performance; these factors include,

- our degree of leverage;
- our access to funding and borrowing capacity;
- the REIT requirements under the Code; and
- the requirements to qualify for an exemption under the 1940 Act and other regulatory and accounting policies related to our business.

#### Our Manager

We are externally managed by ARRM, pursuant to the Management Agreement (see Note 13 to the condensed financial statements). All of our executive officers are also employees of ARRM. ARRM manages our day-to-day operations, subject to the direction and oversight of the Board. The Management Agreement expires after an initial term of ten years on June 18, 2022 and is thereafter automatically renewed for an additional five-year term unless terminated under certain circumstances. Either party must provide 180 days prior written notice of any such termination. ARRM is entitled to receive a termination fee from us under certain circumstances.

Pursuant to the Management Agreement, ARRM is entitled to receive a management fee payable monthly in arrears in an amount equal to 1/12th of 1% of gross equity raised until gross equity raised was \$50.0 million. Currently, the monthly management fee is 1/12th of the sum of (a) 1.5% of gross equity raised up to \$1.0 billion plus (b) 0.75% of gross equity raised in excess of \$1.0 billion. The cost of repurchased stock and any dividend representing a return of capital for tax purposes will reduce the amount of gross equity raised used to calculate the monthly management fee.

As of March 31, 2014, the effective management fee was 1.026% based on gross equity raised. ARRM is entitled to receive a monthly management fee regardless of the performance of our securities portfolio. Accordingly, the payment of our monthly management fee may not decline in the event of a decline in our earnings and may cause us to incur losses. We incurred \$6,965 and \$6,633, respectively in management fees for the quarters ended March 31, 2014 and March 31, 2013.

We are required to take actions as may be reasonably required to permit and enable ARRM to carry out its duties and obligations. We are also responsible for any costs and expenses that ARRM incurred solely on behalf of ARMOUR other than the various overhead expenses specified in the terms of the Management Agreement. For the quarter ended March 31, 2014, we reimbursed ARRM \$460 for other expenses incurred on our behalf. We also reimbursed \$234 of compensation expense during the quarter ended March 31, 2014 related to Restricted Shares for ARRM employees. For the quarter ended March 31, 2013, we reimbursed ARRM \$396 for expenses incurred on our behalf and \$371 for stock based compensation expense (see Note 9 to the condensed financial statements).



Pursuant to a Sub-Management Agreement between ARMOUR, ARRM and SBBC, ARRM is responsible for the payment of a monthly sub-management fee to SBBC in an amount equal to 25% of the monthly management fee earned by ARRM, net of expenses. On November 6, 2014, SBBC has the option of terminating the Sub-Management Agreement. If the Sub-Management Agreement is terminated, we would be required to make a final payment to SBBC in the amount of 6.16 times the annualized rate of the sub-management fee for the prior three months. Thereafter, we will be entitled to receive the sub-management fee or, at the option of ARRM, reimbursement of the final payment by ARRM. The payments from ARRM to SBBC for the three months preceding March 31, 2014 totaled \$1,364. If the Sub-Management Agreement had been terminated on March 31, 2014, the payment due from ARMOUR would have been \$33,609.

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

### Developments at Fannie Mae and Freddie Mac

Payments of principal and interest on the Agency Securities in which we invest are guaranteed by Fannie Mae and Freddie Mac. Because of the guarantee and the underwriting standards associated with mortgages underlying Agency Securities, Agency Securities historically have had high stability in value and been considered to present low credit risk.

In February 2011, the U.S. Treasury along with the U.S. Department of Housing and Urban Development released a report entitled, "Reforming America's Housing Finance Market" to the U.S. Congress outlining recommendations for reforming the U.S. housing system, specifically Fannie Mae and Freddie Mac and transforming the U.S. Government's involvement in the housing market. It is unclear how future legislation may impact the housing finance market and the investing environment for Agency Securities as the method of reform is undecided and has not yet been defined by the regulators. Without U.S. Government support for residential mortgages, we may not be able to execute our current business model in an efficient manner.

In March 2011, the U.S. Treasury announced that it would begin the orderly wind down of Agency Securities it had purchased from Fannie Mae, Freddie Mac and Ginnie Mae to stabilize the housing market, with sales up to \$10.0 billion per month, subject to market conditions. We are unable to predict the timing or manner in which the U.S. Treasury or the Fed will liquidate their holdings or make further interventions in the Agency Securities markets, or what impact, if any, such action could have on the Agency Securities market, the Agency Securities we hold, our business, results of operations and financial condition.

On June 25, 2013, a bipartisan group of U.S. senators introduced a draft bill titled, "Housing Finance Reform and Taxpayer Protection Act of 2013" to the U.S. Senate, which would wind down Fannie Mae and Freddie Mac over a period of five years and replace the public securitization market used by the GSEs with a public-private alternative market. On July 11, 2013, members of the U.S. House Committee on Financial Services introduced a similar draft bill titled, "Protecting American Taxpayers and Homeowners Act" to the U.S. House of Representatives. While distinguishable in some respects from the Senate version, the House bill would also eliminate Fannie Mae and Freddie Mac and seek to increase the opportunities for private capital to participate in, and consequently bear the risk of loss in connection with, government guaranteed MBS.

In March 2014, a bipartisan group of U.S. senators led by members of the U.S. Senate Banking Committee announced that they had agreed on a bill to overhaul the nation's housing finance system and eliminate Fannie Mae and Freddie Mac. The bill would replace Fannie Mae and Freddie Mac with a new federal regulator, called the Federal Mortgage Insurance Corporation, to provide guarantees for government mortgages and regulate the system. As the insurer of last resort, the Federal Mortgage Insurance Corporation would require 10% in private capital reserves. The guarantee,

provided for a fee equivalent to 0.1% interest, would not kick in until the private reserves were exhausted. The bill would also set a minimum down payment of 5% for home buyers, except for first-time home buyers, who would instead be required to put down 3.5% for the mortgage to qualify for the guarantee.

The passage of any new legislation affecting Fannie Mae and Freddie Mac may create market uncertainty and reduce the actual or perceived credit quality of securities issued or guaranteed by the U.S. government through a new or existing successor entity to Fannie Mae and Freddie Mac. If Fannie Mae and Freddie Mac were reformed or wound down, it is unclear what effect, if any, this would have on the value of the existing Fannie Mae and Freddie Mac Agency Securities. It is also possible that the above-referenced proposed legislation, if made law, could adversely impact the market for securities issued or guaranteed by the U.S. Government and the spreads at which they trade. The foregoing could materially adversely affect the pricing, supply, liquidity and value of the Agency Securities in which we invest and otherwise materially adversely affect our business, operations and financial condition.

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

### U.S. Government Mortgage Related Securities Market Intervention

In September 2012, the Fed announced QE3, to purchase an additional \$40.0 billion of Agency Securities per month until the unemployment rate and other economic indicators improved. QE3 plus its existing investment programs grew the Fed's U.S. Treasury Securities and Agency Securities holdings by approximately \$85.0 billion per month at least through the end of 2013.

At its January 29, 2014 and March 19, 2014 meetings, the Fed decided to trim its monthly Agency Securities purchases to \$30.0 billion for February and March 2014, and \$25.0 billion for April 2014, respectively, down from \$40.0 billion in 2013. Longer term U.S. Treasury Securities purchases were trimmed at a pace of \$35.0 billion for February and March 2014, and \$30.0 billion for April 2014, respectively, down from \$45.0 billion in 2013. These actions were to keep in place the Fed's highly accommodative stance of monetary policy. As part of that policy, the Fed announced at its March 2014 meeting that it would keep the target range for the Federal Funds Rate between 0.0% and 0.25% toward its objectives of achieving maximum employment and curbing inflation to 2%.

Reduced purchase levels by the Fed may result in lower overall demand and therefore lower prices for Agency Securities. Lower Agency Securities prices will reduce our book value and the amounts that we can borrow under repurchase agreements.

### Financial Regulatory Reform Bill and Other Government Activity

We believe that we conduct our business in a manner that allows us to avoid being regulated as an investment company pursuant to the exclusion provided by Section 3(c)(5)(C) of the 1940 Act for entities that are primarily engaged in the business of purchasing or otherwise acquiring "mortgages and other liens on and interests in real estate." On August 31, 2011, the SEC issued a concept release (No. IC-29778; File No. SW7-34-11, Companies Engaged in the Business of Acquiring Mortgages and Mortgage Related Instruments) pursuant to which it is reviewing whether certain companies that invest in MBS and rely on the exclusion from registration under Section 3(c)(5)(C) of the 1940 Act (such as us) should continue to be allowed to rely on such exclusion from registration. If we fail to continue to qualify for this exclusion from registration as an investment company, or the SEC determines that companies that invest in MBS are no longer able to rely on this exclusion, our ability to use leverage would be substantially reduced and we would be unable to conduct our business as planned, or we may be required to register as an investment company under the 1940 Act, either of which could negatively affect the value of shares of our stock and our ability to make distributions to our stockholders.

Certain programs initiated by the U.S. Government, through FHFA and FDIC, to provide homeowners with assistance in avoiding residential mortgage loan foreclosures are currently in effect. The programs may involve, among other things, the modification of mortgage loans to reduce the principal amount of the loans or the rate of interest payable on the loans, or to extend the payment terms of the loans. While the effect of these programs has not been as extensive as originally expected, the effect of such programs for holders of Agency Securities could be that such holders would experience changes in the anticipated yields of their Agency Securities due to (i) increased prepayment rates and/or (ii) lower interest and principal payments.

In March 2009, HAMP was introduced to provide homeowners with assistance in avoiding residential mortgage loan foreclosures. HAMP is designed to help at risk homeowners, both those who are in default and those who are at imminent risk of default, by providing the borrower with affordable and sustainable monthly payments.

On July 21, 2010, President Obama signed the Dodd-Frank Act into law. The Dodd-Frank Act is extensive, complicated and comprehensive legislation that impacts practically all aspects of banking, and a significant overhaul

of many aspects of the regulation of the financial services industry. Although many provisions remain subject to further rulemaking, the Dodd-Frank Act implements numerous and far-reaching changes that affect financial companies, including our company, and other banks and institutions which are important to our business model. Certain notable rules are, among other things:

Requiring regulation and oversight of large, systemically important financial institutions by establishing an interagency council on systemic risk and implementation of heightened prudential standards and regulation by the Board of Governors of the Fed for systemically important financial institutions (including nonbank financial companies), as well as the implementation of the FDIC resolution procedures for liquidation of large financial companies to avoid market disruption;

Applying the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies, savings and loan holding companies and systemically important nonbank financial companies;

Limiting the Fed's emergency authority to lend to nondepository institutions to facilities with broad-based eligibility, and authorizing the FDIC to establish an emergency financial stabilization fund for solvent depository institutions and their holding companies, subject to the approval of Congress, the Secretary of the U.S. Treasury and the Fed;

- Creating regimes for regulation of over-the-counter derivatives and non-admitted property and casualty insurers and reinsurers;
- Implementing regulation of hedge fund and private equity advisers by requiring such advisers to register with the SEC;
- Providing for the implementation of corporate governance provisions for all public companies concerning proxy access and executive compensation; and
- Reforming regulation of credit rating agencies.

Many of the provisions of the Dodd-Frank Act, including certain provisions described above are subject to further study, rulemaking, and the discretion of regulatory bodies. As the hundreds of regulations called for by the Dodd-Frank Act are promulgated, we will continue to evaluate the impact of any such regulations. It is unclear how this legislation may impact the borrowing environment, investing environment for Agency Securities and interest rate swap contracts as much of the bill's implementation has not yet been defined by the regulators.

In addition, in 2010, the Group of Governors and Heads of Supervisors of the Basel Committee on Banking Supervision, the oversight body of the Basel Committee, published Basel III. Under which, when fully phased in on January 1, 2019, banking institutions will be required to maintain heightened Tier 1 common equity, Tier 1 capital and total capital ratios, as well as maintaining a "capital conservation buffer." Beginning with the Tier 1 common equity and Tier 1 capital ratio requirements, Basel III will be phased in incrementally between January 1, 2013 and January 1, 2019. The final package of Basel III reforms were approved by the Group of Twenty Finance Ministers and Central Bank Governors in November 2010 and are subject to individual adoption by member nations, including the U.S.

In October 2011, the FHFA announced changes to HARP to expand access to refinancing for qualified individuals and families whose homes have lost value, including increasing the HARP loan to value ratio above 125%. However, this would only apply to mortgages guaranteed by the GSEs. There are many challenging issues to this proposal, notably the question as to whether a loan with a loan to value ratio of 125% qualifies as a mortgage or an unsecured consumer loan. The chances of this initiative's success have created additional uncertainty in the Agency Securities market, particularly with respect to possible increases in prepayment rates.

On January 4, 2012, the Fed issued a white paper outlining additional ideas with regard to refinancings and loan modifications. It is likely that loan modifications would result in increased prepayments on some Agency Securities. These loan modification programs, as well as future legislative or regulatory actions, including amendments to the bankruptcy laws, that result in the modification of outstanding mortgage loans may adversely affect the value of, and the returns on, the Agency Securities in which we invest.

In an effort to continue to provide meaningful solutions to the housing crisis, effective June 1, 2012, the Obama administration expanded the population of homeowners that may be eligible for HAMP.

On September 28, 2012, the FSA released the Wheatley Review. Some of our derivative positions use various maturities of U.S. dollar LIBOR. Our borrowings in the repurchase market have also historically tracked these LIBOR rates. The Wheatley Review found, among other things, that potential conflicts of interests coupled with insufficient oversight and accountability resulted in some reported LIBOR rates that did not reflect the true cost of inter-bank borrowings they were meant to represent.

The Wheatley Review also proposes a number of remedial actions, including:

- New statutory authority for the FSA to supervise and regulate the LIBOR setting process;

- Establishing a new independent oversight body to administer the LIBOR setting process;
- Eliminating LIBOR rates for certain currencies and maturities where markets are not sufficiently deep and liquid;
- Ceasing immediate reporting of rates submitted by individual participating banks; and
- Establishing controls to ensure that submitted rates represent actual transactions.

In April 2013, all the recommendations of the Wheatley Review came into force through the Financial Services Act of 2012. In this new regulatory framework, the FCA and the PRA have replaced the FSA, the Bank of England has overall responsibility for financial stability, and a new FPC was created to assist the Bank in achieving its financial stability objective. Additionally, in September 2013, the European Commission proposed draft legislation that will enhance the robustness and reliability of benchmarks like LIBOR, facilitate the prevention and detection of their manipulation and clarify responsibility for and the supervision of benchmarks.

Our derivative and repurchase borrowings are conducted in U.S. dollars for maturities with historically deep and liquid markets. To date, implementation of the Wheatley Review recommendations have not had a material impact on the reported levels of LIBOR rates relevant to our derivative or repurchase borrowings.

On July 2, 2013, the Fed, in coordination with the FDIC and the OCC, approved a final rule that enhances bank regulatory capital requirements and implements certain elements of the Basel III capital reforms in the U.S. On July 9, 2013, the OCC approved the final rule and the FDIC approved the final rule as an interim rule. The final rule includes a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets that will apply to all supervised U.S. financial institutions. The final rule also raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% and includes a minimum leverage ratio of 4.0% for all U.S. banking organizations. The final rule will continue to apply existing risk-based capital standards with respect to residential loans, including a 50.0% risk weight for safely underwritten first-lien mortgages that are not past due. "Advanced approaches banking organizations," those with \$250.0 billion or more in total assets or \$10.0 billion or more in foreign exposures, were required to comply with the final rule starting on January 1, 2014. Other banking organizations will be required to comply with the final rule starting January 1, 2015.

On July 9, 2013, the Fed, the FDIC, and the OCC proposed a rule to change the leverage ratio standards for the largest U.S. banking organizations. Under the proposed rule, bank-holding companies with more than \$700.0 billion in consolidated total assets or \$10.0 trillion in assets under custody would be required to maintain a Tier 1 capital leverage buffer of at least 5.0%, which is 2.0% above the minimum supplementary leverage ratio requirement of 3.0% adopted by these three agencies in their Basel III capital reform rules on July 2, 2013. In addition to the leverage buffer, the proposed rule would require insured depository institutions of such large bank-holding companies to meet a 6.0% supplementary leverage ratio to be considered "well capitalized." The proposed rule would apply starting January 1, 2018. Adoption of these rules may increase cost and reduce availability of repurchase funding provided by institutions subject to the rules.

#### Credit Market Disruption and Current Conditions

The residential housing and mortgage markets in the U.S. have experienced a variety of difficulties and changed economic conditions including loan defaults, credit losses and decreased liquidity. These conditions have resulted in volatility in the value of the Agency Securities we purchase and an increase in the average collateral requirements under our repurchase agreements we have obtained. While these markets have recovered significantly, further increased volatility and deterioration in the broader residential mortgage and RMBS markets may adversely affect the performance and market value of the Agency Securities and other high quality RMBS.

#### Short-term Interest Rates and Funding Costs

In December 2008, the Fed stated that it was adopting a policy of "quantitative easing" and would target keeping the Federal Funds Rate between 0.00% and 0.25%. To date, the Fed has maintained that target range. Our funding costs, which traditionally have tracked the 30-day LIBOR have generally benefited by this easing of monetary policy, although to a somewhat lesser extent. Because of continued uncertainty in the credit markets and U.S. economic conditions, we expect that interest rates are likely to experience continued volatility, which will likely affect our financial results since our cost of funds is largely dependent on short-term rates.

Historically, 30-day LIBOR has closely tracked movements in the Federal Funds Rate and the Effective Federal Funds Rate. The Effective Federal Funds Rate can differ from the Federal Funds Rate in that the Effective index represents the volume weighted average of interest rates at which depository institutions lend balances at the Fed to other

depository institutions overnight (actual transactions, rather than target rate).

Our borrowings in the repurchase market have also historically closely tracked the Federal Funds Rate and LIBOR. Traditionally, a lower Federal Funds Rate has indicated a time of increased net interest margin and higher asset values. However, for the past several years, LIBOR and repurchase market rates have varied greatly and often have been significantly higher than the target and the Effective Federal Funds Rate. The difference between 30-day LIBOR and the Effective Federal Funds Rate has also been quite volatile, with the spread alternately returning to more normal levels and then widening out again. The continued volatility in these rates and divergence from the historical relationship among these rates could negatively impact our ability to manage our securities portfolio. If this were to occur, our net interest margin and the value of our securities portfolio might suffer as a result.



The following graph shows 30-day LIBOR as compared to the Effective Federal Funds Rate for the twelve month period from March 31, 2013 through March 31, 2014.

## Results of Operations

### Net Income (Loss) Summary

Our primary source of income is the interest income we earn on our securities portfolio. Our net loss for the quarter ended March 31, 2014 related to common stockholders was \$(23,683), or \$(0.07) per basic and diluted weighted average common share. These results compare to net income of \$99,793 available to common stockholders or \$0.30 and \$0.29 per basic and diluted weighted average common share, respectively, for the quarter ended March 31, 2013. The main factors for the difference between the quarter ended 2013 to the corresponding period in 2014, were the changes in value from our derivatives and increased management fees which were partially offset by gains on the sale of Agency Securities (which gains represent partial recovery of write-downs recorded in the fourth quarter of 2013).

As of March 31, 2014 and December 31, 2013, our Agency Securities in our securities portfolio were carried at a net premium to par value with a weighted average amortized cost of 104.62% and 102.57%, respectively, due to the average interest rates on these securities being higher than prevailing market rates.

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

| Quarter Ended      | Asset Yield | Cost of Funds | Net Interest Margin | Interest Expense on Repurchase Agreements |   |
|--------------------|-------------|---------------|---------------------|-------------------------------------------|---|
| March 31, 2014     | 3.19        | % 1.37        | % 1.82              | % 0.41                                    | % |
| December 31, 2013  | 2.98        | % 1.38        | % 1.60              | % 0.43                                    | % |
| September 30, 2013 | 2.60        | % 1.36        | % 1.24              | % 0.41                                    | % |
| June 30, 2013      | 2.52        | % 1.14        | % 1.38              | % 0.43                                    | % |
| March 31, 2013     | 2.33        | % 0.98        | % 1.35              | % 0.46                                    | % |

The yield on our assets is most significantly affected by the rate of repayments on our Agency Securities. The following graph shows the annualized CPR for the quarterly periods presented.

During the quarters ended March 31, 2014 and March 31, 2013, we realized (losses) of \$(11,739) and \$(29,053) respectively related to our derivatives. We decreased our total interest rate swap contracts aggregate notional balance from \$10,220,000 at December 31, 2013 to \$10,030,000 at March 31, 2014. At March 31, 2014 and December 31, 2013, our interest rate swap contracts had a weighted average swap rate of 1.50% and a weighted average term of 67 months and 69 months. We decreased our total interest rate swaptions notional balance from \$5,750,000 at December 31, 2013 to \$5,250,000 at March 31, 2014. Our interest rate swaptions had an underlying weighted average swap rate of 2.94% and 2.86%, respectively, and a weighted average term of 6 months and 8 months, respectively, at March 31, 2014 and December 31, 2013. Our total Futures Contracts notional amount was \$55,000 at December 31, 2013 and March 31, 2014. Our Futures Contracts had a weighted average swap equivalent rate of 1.97% and weighted average term of 10 months and 13 months as of March 31, 2014 and December 31, 2013. Unrealized gains (losses) on derivatives totaled \$(176,355) and \$16,301, respectively, during the quarters ended March 31, 2014 and March 31, 2013. The losses for the quarter ended March 31, 2014 were primarily the result of the decline in the benchmark 10 year U.S. Treasury interest rate. This resulted in unrealized (losses) of \$(104,760) on our interest rate swap contracts with original tenors of 10 years and \$(70,645) on our swaptions on 10 year interest rate swaps.

#### Net Interest Income

Our net interest income for the quarters ended March 31, 2014 and March 31, 2013 was \$108,335 and \$105,162, respectively. As of March 31, 2014 and December 31, 2013, our securities portfolio consisted of \$16,479,734 and \$14,648,178 of Agency Securities, respectively.

#### Gains and Losses on Sale of Agency Securities

During the quarter ended March 31, 2014, we sold \$5,575,987 of Agency Securities to reposition our portfolio, which resulted in realized gains of \$69,869 representing a partial recovery of prior quarter write-downs. During the quarter ended March 31, 2013, we sold \$2,281,616 of Agency Securities resulting in realized gains of \$18,514.

### Other Than Temporary Impairment of Agency Securities

We evaluated our Agency Securities with unrealized losses as of March 31, 2014, March 31, 2013 and December 31, 2013, to determine whether there was an other than temporary impairment. The decline in value of our Agency Securities in 2013, was solely due to market conditions and not the credit quality of the assets. All of our Agency Securities are issued and guaranteed by GSEs or Ginnie Mae. The GSEs have a long term credit rating of AA+. As of March 31, 2014, March 31, 2013 and December 31, 2013, we also considered whether we intended to sell Agency Securities and whether it was more likely than not that we could meet our liquidity requirements and contractual obligations without selling Agency Securities. There was no other than temporary impairment recognized for the quarters ended March 31, 2014 and March 31, 2013. At December 31, 2013, anticipating portfolio repositioning sales in the first quarter of 2014, we concluded that the December 31, 2013 unrealized losses on our 25-year and 30-year fixed rate Agency Securities represented an other than temporary impairment. Accordingly, at December 31, 2013, we recognized losses totaling \$401,500 in our 2013 statements of operations, thereby establishing a new cost basis for those Agency Securities with aggregate fair value of \$6,800,000 as of December 31, 2013. We also determined that at December 31, 2013, there was no other than temporary impairment of our other Agency Securities, which are primarily 20-year and 15-year fixed rate securities.

### Comprehensive Income (Loss)

Comprehensive income (loss) includes all changes in equity during a period except those resulting from investments by owners and distributions to owners. During the quarters ended March 31, 2014 and March 31, 2013, other comprehensive income (loss) totaled \$46,296 and \$(198,569), respectively, reflecting net unrealized gains or losses on available for sale Agency Securities net of amounts reclassified upon sale. The 2013 other comprehensive loss resulted from significant price declines in our Agency Securities. The increase in other comprehensive income for 2014 compared to 2013 resulted primarily from the increase in the size of our portfolio.

### Expenses

Our total expenses for the quarter ended March 31, 2014 were \$9,888 as compared to \$8,634 for the quarter ended March 31, 2013. The increase in expenses from year to year is primarily due to two factors. The first factor is due to increased management fees. Our total management fee expense for the quarter ended March 31, 2014, was \$6,965 compared to \$6,633 for the quarter ended March 31, 2013. Management fees are determined based on gross equity raised. Therefore, our management fee increases when we raise capital and declines when we repurchase previously issued stock. However, because the management fee rate decreased to 0.75% per annum for gross equity raised in excess of \$1.0 billion pursuant to the Management Agreement, the effective average management fee rate has generally declined over time. The second factor is an increase in professional fees and operating costs to support our current securities portfolio.

### Taxable Income

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

The following table reconciles our GAAP net income to estimated REIT taxable income for the quarters ended March 31, 2014 and March 31, 2013.

|                                        | For the Quarters           |                   |
|----------------------------------------|----------------------------|-------------------|
|                                        | Ended<br>March 31,<br>2014 | March 31,<br>2013 |
| GAAP net income (loss)                 | \$(19,778                  | ) \$102,290       |
| Book to tax differences:               |                            |                   |
| Changes in derivatives                 | 153,038                    | (16,301 )         |
| Gains on Agency Security Sales         | (69,869                    | ) —               |
| Amortization of deferred hedging costs | 293                        | —                 |
| Net premium amortization differences   | (5,343                     | ) —               |
| Other                                  | 6                          | —                 |
| Estimated taxable income               | \$58,347                   | \$85,989          |

The aggregate tax basis of our assets and liabilities was less than our total Stockholders' Equity at March 31, 2014 by approximately \$(125,680), or approximately \$(0.35) per common share (based on the 357,102 common shares then outstanding).

We are required and intend to timely distribute substantially all of our REIT taxable income in order to maintain our REIT status under the Code. Total dividend payments to stockholders were \$57,758 for the quarter ended March 31, 2014. Our estimated REIT taxable income available to pay dividends was \$58,347 for the quarter ended March 31, 2014. Realized losses on derivatives for the quarter ended March 31, 2014 include realized gains on swaptions of \$23,317, which are amortized for tax purposes over the ten year terms of the referenced interest rate swap contract. Our taxable REIT income and dividend requirements to maintain our REIT status are determined on an annual basis. Dividends in excess of taxable REIT income for the year (including amounts carried forward from prior years) will generally not be taxable to common stockholders.

Net capital losses realized in 2013 and 2014 totaling \$(579,322) and \$(303,749) will be available to offset future capital gains realized through 2018 and 2019, respectively.

Our management is responsible for determining whether tax positions taken by us are more likely than not to be sustained on their merits. We have no material unrecognized tax benefits or material uncertain tax positions.

#### Financial Condition

##### Agency Securities

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

The tables below summarize certain characteristics of our Agency Securities as of March 31, 2014 and December 31, 2013.

March 31, 2014

| Asset Type                | Principal Amount | Fair Value   | Weighted Average Coupon | CPR (1) | Weighted Average Month to Reset or Maturity | % of Total Agency Securities |
|---------------------------|------------------|--------------|-------------------------|---------|---------------------------------------------|------------------------------|
| ARMs & Hybrids            | \$193,505        | \$205,433    | 3.83                    | % 16.83 | % 12                                        | 1.20 %                       |
| Multi-Family MBS          | 205,929          | 212,003      | 3.58                    | % 0.00  | % 117                                       | 1.30 %                       |
| 10 Year Fixed             | 1,396            | 1,496        | 5.34                    | % 7.88  | % 99                                        | 0.00 %                       |
| 15 Year Fixed             | 9,721,809        | 10,111,803   | 3.29                    | % 2.81  | % 173                                       | 61.20 %                      |
| 20 Year Fixed             | 4,601,203        | 4,736,221    | 3.53                    | % 4.99  | % 214                                       | 29.00 %                      |
| 30 Year Fixed             | 1,165,640        | 1,212,778    | 4.00                    | % 2.95  | % 352                                       | 7.30 %                       |
| Total or Weighted Average | \$15,889,482     | \$16,479,734 | 3.42                    | % 3.68  | % 195                                       | 100.00 %                     |

(1) Weighted average for all prepayments during the quarter ended March 31, 2014, including prepayments related to Agency Securities purchased or sold during the quarter.

December 31, 2013

| Asset Type                | Principal Amount | Fair Value   | Weighted Average Coupon | CPR (1) | Weighted Average Month to Reset or Maturity | % of Total Agency Securities |
|---------------------------|------------------|--------------|-------------------------|---------|---------------------------------------------|------------------------------|
| ARMs & Hybrids            | \$208,216        | \$220,693    | 3.95                    | % 20.43 | % 16                                        | 1.40 %                       |
| 10 Year Fixed             | 1,469            | 1,572        | 5.35                    | % 14.52 | % 101                                       | 0.00 %                       |
| 15 Year Fixed             | 2,713,689        | 2,832,899    | 3.46                    | % 4.27  | % 170                                       | 18.80 %                      |
| 20 Year Fixed             | 4,709,297        | 4,797,001    | 3.53                    | % 5.07  | % 217                                       | 32.60 %                      |
| 25 Year Fixed             | 276,765          | 275,382      | 3.52                    | % 4.87  | % 279                                       | 1.90 %                       |
| 30 Year Fixed             | 6,557,784        | 6,520,631    | 3.53                    | % 4.32  | % 345                                       | 45.30 %                      |
| Total or Weighted Average | \$14,467,220     | \$14,648,178 | 3.52                    | % 4.83  | % 263                                       | 100.00 %                     |

(1) Weighted average for all prepayments during the quarter ended December 31, 2013, including prepayments related to Agency Securities purchased or sold during the quarter.

As of March 31, 2014, we had investment related receivables of \$296,378 with respect to unsettled sales of Agency Securities and investment related payables of \$382,833 with respect to unsettled purchases of Agency Securities. All investment related receivables and payables at March 31, 2014 were settled in April 2014. As of December 31, 2013, we had investment related payables of \$159,159 with respect to unsettled purchases of Agency Securities. We did not have any investment related receivables at December 31, 2013.

Our net interest income (loss) is primarily a function of the difference between the yield on our assets and the financing cost of owning those assets. Since we tend to purchase Agency Securities at a premium to par, the main item that can affect the yield on our Agency Securities after they are purchased is the rate at which the mortgage borrowers repay the loan. While the scheduled repayments, which are the principal portion of the homeowners' regular monthly payments, are fairly predictable, the unscheduled repayments, which are generally refinancing of the mortgage but can

also result from repurchases of delinquent, defaulted, or modified loans, are less so. Being able to accurately estimate and manage these repayment rates is a critical portion of the management of our securities portfolio, not only for estimating current yield but also for considering the rate of reinvestment of those proceeds into new securities, the yields which those new securities may add to our securities portfolio and our hedging strategy.

As of March 31, 2014 and December 31, 2013, the adjustable and hybrid adjustable rate mortgage loans underlying our Agency Securities have fixed-interest rates for an average period of approximately 12 months and 16 months, respectively, after

which time the interest rates reset and become adjustable. After a reset date, interest rates on our adjustable and hybrid adjustable Agency Securities float based on spreads over various indices, typically LIBOR or the one-year Constant Maturity Treasury rate. These interest rates are subject to caps that limit the amount the applicable interest rate can increase during any year, known as an annual cap and through the maturity of the security, known as a lifetime cap.

## Liabilities

We have entered into repurchase agreements to finance most of our Agency Securities. Our repurchase agreements are secured by our Agency Securities and bear interest at rates that have historically moved in close relationship to the Federal Funds Rate and LIBOR. We have established borrowing relationships with several investment banking firms and other lenders, 29 of which we had done repurchase trades with as of March 31, 2014 and 27 of which we had done repurchases trades with as of December 31, 2013. We had outstanding balances under our repurchase agreements as of March 31, 2014 and December 31, 2013 of \$15,163,375 and \$13,151,504, respectively, consistent with the increase in our Agency Securities in our securities portfolio.

## Derivative Instruments

We generally hedge our interest rate risk as we deem prudent in light of market conditions and the associated costs with counterparties that have a high quality credit rating and with futures exchanges. We generally pay a fixed rate and receive a floating rate with the objective of fixing a portion of our borrowing costs and hedging the change in our book value to some degree. The floating rate we receive is generally the Federal Funds Rate or LIBOR. While our policies do not contain specific requirements as to the percentages or amount of interest rate risk that we are required to hedge, we maintain an overall target of hedging at least 40% of our non-adjustable rate mortgages. As of March 31, 2014 and December 31, 2013, the notional value of our derivatives was 95.47% and 110.69%, respectively, of the fair market value of our non-adjustable rate mortgages. For interest rate risk mitigation purposes, we consider Agency Securities to be adjustable rate mortgages ARMs if their interest rate is either currently subject to adjustment according to prevailing rates or if they are within 18 months of the period where such adjustments will occur. No assurance can be given that our derivatives will have the desired beneficial impact on our results of operations or financial condition. We have not elected cash flow hedge accounting treatment as allowed by GAAP. Since we do not designate our derivative activities as cash flow hedges, realized as well as unrealized gains/losses from these transactions will impact our earnings.

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

- available derivatives may not correspond directly with the interest rate risk for which protection is sought (e.g., the difference in interest rate movements for long-term U.S. Treasury Securities compared to Agency Securities);
- the duration of the derivatives may not match the duration of the related liability;
- the counterparty to a derivative agreement with us may default on its obligation to pay or not perform under the terms of the agreement and the collateral posted may not be sufficient to protect against any consequent loss;
- we may lose collateral we have pledged to secure our obligations under a derivative agreement if the associated counterparty becomes insolvent or files for bankruptcy;
- we may experience a termination event under one or more of our derivative agreements related to our REIT status, equity levels and performance, which could result in a payout to the associated counterparty and a taxable loss to us;
- the credit-quality of the party owing money on the derivatives may be downgraded to such an extent that it impairs our ability to sell or assign our side of the hedging transaction; and
- the value of derivatives may be adjusted from time to time in accordance with GAAP to reflect changes in fair value; downward adjustments, or “mark-to-market losses,” would reduce our net income or increase any net loss.

As of March 31, 2014 and December 31, 2013, we had interest rate swap contracts with an aggregate notional balance of \$10,030,000 and \$10,220,000, respectively. As of March 31, 2014 and December 31, 2013, we had entered into interest rate swaptions with an aggregate notional balance of \$5,250,000 and \$5,750,000, respectively. In addition, as of March 31, 2014 and December 31, 2013, we had purchased or sold Futures Contracts with an aggregate notional balance of \$55,000. Futures Contracts are traded on the CME. Counterparty risk of interest rate swap contracts, interest rate swaptions and Futures Contracts are limited to some degree because of daily mark-to-market and collateral requirements. In addition, substantial credit support for the Futures Contracts is provided by the CME. These derivative transactions are designed to lock in some funding costs for financing activities associated with our assets in such a way as to help assure the realization of attractive net interest margins and to vary inversely in value with our Agency Securities. Such contracts are based on assumptions about prepayments which, if not realized, will cause results to differ from expectations.

Although we attempt to structure our derivatives to offset the changes in asset prices, they are not perfectly correlated and depend on the corresponding durations and sections of the yield curve that moves to offset each other. We recognized net



losses of \$(188,094) and \$(12,752) for the quarters ended March 31, 2014 and March 31, 2013, respectively, related to our derivatives. For the quarters ended March 31, 2014 and March 31, 2013, the net unrealized change in the fair value of our Agency Securities increased by \$116,165, compared to an decrease of \$(180,055), respectively.

As required by the Dodd-Frank Act, the Commodity Futures Trading Commission has adopted rules requiring certain interest rate swap contracts to be cleared through a derivatives clearing organization. We are required to clear certain new interest rate swap contracts. Cleared interest rate swaps may have higher margin requirements than un-cleared interest rate swaps previously had. We have established an account with a futures commission merchant for this purpose. To date, we have not entered into any cleared interest rate swap contracts.

### Liquidity and Capital Resources

During the quarter ended March 31, 2014, we issued 19 shares of common stock under our common stock DRIP and raised additional net proceeds of approximately \$81. During the quarter ended March 31, 2014, we repurchased 600 shares of our outstanding common stock under our Repurchase Program for an aggregate cost of \$2,585. At times, we purchased assets for forward settlement up to 90 days in the future to minimize purchase prices. Our management fee expense also increased in absolute terms under the provisions of the Management Agreement. However, pursuant to the Management Agreement, the average effective management fee rate declined because the management fee rate stepped down as the amounts of equity raised exceeded \$1.0 billion.

As of March 31, 2014, we financed our securities portfolio with approximately \$15,163,375 of borrowings under repurchase agreements. Our leverage ratio as of March 31, 2014, was 8.12 to 1. As of March 31, 2014, our liquidity totaled \$1,015,626, consisting of \$588,832 of cash plus \$426,794 of unpledged Agency Securities (including securities received as collateral). Our primary sources of funds are borrowings under repurchase arrangements, monthly principal and interest payments on our Agency Securities and cash generated from our operating results. Other sources of funds may include proceeds from equity and debt offerings and asset sales. We generally maintain liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of our borrowings can be adjusted on a daily basis, the level of cash carried on our balance sheet is significantly less important than our potential liquidity available under our borrowing arrangements.

In addition to the repurchase agreement financing discussed above, from time to time we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities back in the future. We then sell such U.S. Treasury Securities to third parties and recognize a liability to return the securities to the original borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same MRA, settlement through the same brokerage or clearing account and maturing on the same day. The practical effect of these transactions is to replace a portion of our repurchase agreement financing of our Agency Securities in our securities portfolio with short positions in U.S. Treasury Securities. We believe that this helps to reduce interest rate risk, and therefore counterparty credit and liquidity risk. We did not have any reverse repurchase agreements outstanding during the quarters ended or at March 31, 2014 and March 31, 2013 or at December 31, 2013.

Both parties to the repurchase and reverse repurchase transactions have the right to make daily margin calls based on changes in the value of the collateral obtained and/or pledged.

We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on repurchase borrowings, reacquisition of securities to be returned to borrowers and the payment of cash dividends as required for continued qualification as a REIT.

Our primary uses of cash are to purchase Agency Securities, pay interest and principal on our borrowings, fund our operations and pay dividends. During the quarter ended March 31, 2014, we purchased \$7,385,813 of Agency Securities using proceeds from repurchase agreements and principal repayments. During the quarter ended March 31, 2014, we received cash of \$307,214 from prepayments and scheduled principal payments on our Agency Securities. We received net proceeds of \$81 from common equity issuances under our common stock DRIP. We had a net cash increase from our repurchase agreements of \$2,011,871 for the quarter ended March 31, 2014 and made cash interest payments of approximately \$70,351 on our liabilities for the quarter ended March 31, 2014. Part of funding our operations includes providing margin cash to offset liability balances on our derivatives. We recovered \$12,044 of cash collateral posted with counterparties and decreased our liability by \$148,993 for cash collateral held as of March 31, 2014.

We have continued to pursue additional lending counterparties in order to help increase our financial flexibility and ability to withstand periods of contracting liquidity in the credit markets.

### Repurchase Agreements

The following table represents the contractual repricing regarding our repurchase agreements to finance Agency Security purchases as of March 31, 2014 and December 31, 2013.

|                      | March 31, 2014        |                                   | December 31, 2013     |                                   |   |
|----------------------|-----------------------|-----------------------------------|-----------------------|-----------------------------------|---|
|                      | Repurchase Agreements | Weighted Average Contractual Rate | Repurchase Agreements | Weighted Average Contractual Rate |   |
| Within 30 days       | \$ (6,112,258 )       | 36.50                             | % \$ 3,990,434        | 0.41                              | % |
| 31 days to 60 days   | (6,006,880 )          | 36.90                             | % 7,098,298           | 0.41                              | % |
| 61 days to 90 days   | (1,552,907 )          | 35.80                             | % 1,226,694           | 0.44                              | % |
| Greater than 90 days | (1,491,330 )          | 46.10                             | % 836,078             | 0.43                              | % |
| Total                | \$ (15,163,375 )      | 37.50                             | % \$ 13,151,504       | 0.42                              | % |

The following table represents the MRAs and other information regarding our repurchase agreements to finance Agency Security purchases as of March 31, 2014 and December 31, 2013.

|                                                                 | March 31, 2014 | December 31, 2013 |   |
|-----------------------------------------------------------------|----------------|-------------------|---|
| Number of MRAs                                                  | 37             | 35                |   |
| Number of counterparties with repurchase agreements outstanding | 29             | 27                |   |
| Weighted average maturity in days                               | 54             | 45                |   |
| Haircut for repurchase agreements (1)                           | 4.9            | % 5.0             | % |

(1) The Haircut represents the weighted average margin requirement, or the percentage amount by which the collateral value must exceed the loan amount.

We have 8 repurchase agreement counterparties that individually account for between 5% and 10% of our aggregate borrowings. In total, these counterparties accounted for approximately 50.82% of our repurchase agreement borrowings outstanding at March 31, 2014.

Declines in the value of our Agency Securities portfolio can trigger margin calls by our lenders under our repurchase agreements. An event of default or termination event under the standard MRA would give our counterparty the option to terminate all repurchase transactions existing with us and require any amount due to be payable immediately.

The residential mortgage market in the U.S. continues to experience difficult economic conditions including:

- increased volatility of many financial assets, including Agency Securities and other high-quality RMBS assets;
- increased volatility and deterioration in the broader residential mortgage and RMBS markets; and
- significant disruption in financing of RMBS.

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

financing.

Financial sector volatility can also lead to increased demand and prices for high quality debt securities, including Agency Securities. While increased prices may increase the value of our Agency Securities, higher values may also reduce the return on reinvestment of capital, thereby lowering our future profitability.

The following graph represents the month-end outstanding balances of our repurchase agreements (before the effect of netting reverse repurchase agreements), which finance most of our Agency Securities. Our repurchase agreements balance will

39

---

fluctuate based on our change in capital, leverage targets and the market prices of our assets. Over time, the level of our repurchase agreement financing has grown in conjunction with the growth of Agency Securities in our securities portfolio, which in turn has been the result of successful equity capital raising efforts. In 2013, declining security values and our decision to reduce leverage resulted in a substantial decline in our repurchase agreements. The balance of repurchase agreements outstanding will fluctuate within any given month based on changes in the market value of the particular Agency Security pledged as collateral (including the effects of principal paydowns) and the level and timing of investment and reinvestment activity.

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

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

We experience margin calls in the ordinary course of our business and under certain conditions, such as during a period of declining market value for Agency Securities and we may experience margin calls as frequently as daily. In seeking to effectively manage the margin requirements established by our lenders, we maintain a position of cash and unpledged securities. We refer to this position as our liquidity. The level of liquidity we have available to meet margin calls is directly affected by our leverage levels, our haircuts and the price changes on our securities. If interest rates increase as a result of a yield curve shift or for another reason or if credit spreads widen, the prices of our collateral (and our unpledged assets that constitute our liquidity) will decline and we may experience margin calls. We will use our liquidity to meet such margin calls. There can be no assurance that we will maintain sufficient levels of liquidity to meet any margin calls. If our haircuts increase, our liquidity will proportionately decrease.

If we increase our borrowings, our liquidity will decrease by the amount of additional haircut on the increased level of indebtedness. In addition, certain of our MRAs contain a restriction that prohibits our leverage from exceeding twelve times our stockholders' equity as well as termination events in the case of significant reductions in equity capital.

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

We generally seek to borrow (on a recourse basis) between six and ten times the amount of our total stockholders' equity. At March 31, 2014 and December 31, 2013, our total net borrowings were approximately \$15,163,375 and \$13,151,504 (excluding accrued interest), respectively. As of March 31, 2014 and December 31, 2013 we had a leverage ratio of approximately 8.12:1 and 6.92:1, respectively.

#### Forward-Looking Statements Regarding Liquidity

Based on our current portfolio, leverage rate and available borrowing arrangements, we believe that our cash flow from operations and our ability to make timely portfolio adjustments, will be sufficient to enable us to meet anticipated short-term (one year or less) liquidity requirements such as to fund our investment activities, meet our financing obligations, pay fees under the Management Agreement and fund our distributions to stockholders and pay general corporate expenses.

We may increase our capital resources by obtaining long-term credit facilities or making public or private offerings of equity or debt securities, including classes of preferred stock, common stock and senior or subordinated notes to meet our long-term (greater than one year) liquidity. Such financing will depend on market conditions for capital raises and for the investment of any proceeds and there can be no assurances that we will successfully obtain any such financing.

#### Stockholders' Equity

##### Dividends

The following table presents our common stock dividend transactions for the quarter ended March 31, 2014.

| Record Date       | Payment Date      | Rate per common share | Aggregate amount paid to holders of record |
|-------------------|-------------------|-----------------------|--------------------------------------------|
| January 15, 2014  | January 30, 2014  | \$0.05                | \$17,954                                   |
| February 14, 2014 | February 27, 2014 | \$0.05                | \$17,954                                   |
| March 17, 2014    | March 28, 2014    | \$0.05                | \$17,945                                   |

The following table presents our Series A Preferred Stock dividend transactions for the quarter ended March 31, 2014.

| Record Date      | Payment Date     | Rate per Series A Preferred Share | Aggregate amount paid to holders of record |
|------------------|------------------|-----------------------------------|--------------------------------------------|
| January 15, 2014 | January 27, 2014 | \$0.17                            | \$375                                      |

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

|                   |                   |        |       |
|-------------------|-------------------|--------|-------|
| February 15, 2014 | February 27, 2014 | \$0.17 | \$375 |
| March 15, 2014    | March 27, 2014    | \$0.17 | \$375 |

The following table presents our Series B Preferred Stock dividend transactions for the quarter ended March 31, 2014.

| Record Date       | Payment Date      | Rate per Series B Preferred Share | Aggregate amount paid to holders of record |
|-------------------|-------------------|-----------------------------------|--------------------------------------------|
| January 15, 2014  | January 27, 2014  | \$0.16                            | \$927                                      |
| February 15, 2014 | February 27, 2014 | \$0.16                            | \$927                                      |
| March 15, 2014    | March 27, 2014    | \$0.16                            | \$927                                      |

#### Equity Capital Raising Activities

The following table presents our equity transactions for the quarter ended March 31, 2014.

| Transaction Type                                                         | Completion Date                         | Number of Shares | Per Share price | Net Proceeds |
|--------------------------------------------------------------------------|-----------------------------------------|------------------|-----------------|--------------|
| Common stock dividend reinvestment program<br>(1) Weighted average price | January 27, 2014 through March 28, 2014 | 19               | \$4.16          | (1) \$81     |

#### Common Stock repurchases

The following table presents our common stock repurchases for the quarter ended March 31, 2014.

| Transaction Type                                        | Completion Date                       | Number of Shares | Per Share price | Net Cost    |
|---------------------------------------------------------|---------------------------------------|------------------|-----------------|-------------|
| Repurchased common shares<br>(1) Weighted average price | March 12, 2014 through March 14, 2014 | 600              | 4.31            | (1) \$2,585 |

#### Off-Balance Sheet Arrangements

As of March 31, 2014 and December 31, 2013, we had not maintained any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, or special purpose or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Furthermore, as of March 31, 2014 and December 31, 2013, we had not guaranteed any obligations of any unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

#### Critical Accounting Policies

Our financial statements are prepared in conformity with GAAP. In preparing the financial statements, management is required to make various judgments, estimates and assumptions that affect the reported amounts. Changes in these estimates and assumptions could have a material effect on our financial statements. The following is a summary of our policies most affected by management's judgments, estimates and assumptions.

**Revenue Recognition:** Interest income is earned and recognized based on the unpaid principal amount of the Agency Securities and their contractual terms. Premiums and discounts associated with the purchase of Agency Securities are amortized or accreted into interest income over the actual lives of the securities.



Fair Value of Agency Securities: We invest in Agency Securities representing interests in or obligations backed by pools of fixed rate, hybrid adjustable rate and adjustable rate mortgage loans. The authoritative literature requires us to classify our investments as either trading, available for sale or held to maturity securities. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. We currently classify all of our Agency Securities as available for sale. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the statements of

comprehensive income (loss). We utilize a third party pricing service to value our securities portfolio. The third party pricing service incorporates common market pricing methods including a spread measurement to the Treasury yield curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period and expected life of the security.

Security purchase and sale transactions, including purchase of when issued securities, are recorded on the trade date. Gains or losses realized from the sale of securities are included in income and are determined using the specific identification method.

**Impairment of Assets:** We evaluate Agency Securities for other than temporary impairment at least on a quarterly basis and more frequently when economic or market concerns warrant such evaluation. We consider an impairment to be other than temporary if we (1) have the intent to sell the Agency Securities, (2) believe it is more likely than not that we will be required to sell the securities before recovery (for example, because of liquidity requirements or contractual obligations) or (3) a credit loss exists. Impairment losses recognized establish a new cost basis for the related Agency Securities.

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

In addition to the repurchase agreement financing discussed above, at certain times we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities in the future in exchange for a price that is higher than the original purchase price. The difference between the purchase price originally paid and the sale price represents interest received from the borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same MRA, settlement through the same brokerage or clearing account and maturing on the same day. We did not have any reverse repurchase agreements outstanding during the quarters ended or at March 31, 2014 and March 31, 2013 or at December 31, 2013.

**Obligations to Return Securities Received as Collateral, at Fair Value:** At certain times, we also sell to third parties the U.S. Treasury Securities received as collateral for reverse repurchase agreements and recognize the resulting obligation to return said U.S. Treasury Securities as a liability on our balance sheet. Interest is recorded on the repurchase agreements, reverse repurchase agreements and U.S. Treasury Securities on an accrual basis and presented as net interest expense. Both parties to the transaction have the right to make daily margin calls based on changes in the fair value of the collateral received and/or pledged. We did not have any obligations to return securities as collateral during the quarters ended or at March 31, 2014 and March 31, 2013 or at December 31, 2013.

Derivative Instruments: We recognize all derivatives as either assets or liabilities at fair value on our condensed balance sheets. We have not elected cash flow hedge accounting treatment as allowed by GAAP, all changes in the fair values of our derivatives are reflected in our statements of operations. Accordingly, our operating results may reflect greater volatility than otherwise would be the case, because gains or losses on derivatives may not be offset by changes in the fair value or cash flows of the transaction within the same accounting period or ever. Consequently, any declines in the fair value of our derivatives result in a charge to earnings. We will continue to designate derivatives as hedges for tax purposes and any unrealized derivative gains or losses would not affect our distributable net taxable income.

#### Inflation

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

#### Subsequent Events

See Note 15 to the condensed financial statements.

## CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

- our business and investment strategy;
- our anticipated results of operations;
- statements about future dividends;
- our ability to obtain financing arrangements;
- our understanding of our competition and ability to compete effectively;
- market, industry and economic trends; and
- interest rates.

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

- the impact of the federal conservatorship of Fannie Mae and Freddie Mac and related efforts, along with any changes in laws and regulations affecting the relationship between Fannie Mae and Freddie Mac and the federal government and the Fed system;
- the possible material adverse effect on our business if the U.S. Congress passed legislation reforming or winding down Fannie Mae or Freddie Mac;
- mortgage loan modification programs and future legislative action;
- the impact of the continued delay or failure of the U.S. Government in reaching an agreement on the national debt ceiling;
- availability, terms and deployment of capital;
- changes in economic conditions generally;
- changes in interest rates, interest rate spreads and the yield curve or prepayment rates;
- general volatility of the financial markets, including markets for mortgage securities;
- inflation or deflation;
- availability of suitable investment opportunities;
- the degree and nature of our competition, including competition for Agency Securities from the U.S. Treasury;
- changes in our business and investment strategy;
- our dependence on ARRM and ability to find a suitable replacement if ARRM were to terminate their management relationship with us;
- the existence of conflicts of interest in our relationship with ARRM, certain of our directors and our officers, which could result in decisions that are not in the best interest of our stockholders;

- changes in personnel at ARRM or the availability of qualified personnel at ARRM;
- limitations imposed on our business by our status as a REIT under the Code;
- changes in GAAP, including interpretations thereof; and
- changes in applicable laws and regulations.

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

## GLOSSARY OF TERMS

“Agency Securities” means securities issued or guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae; interests in or obligations backed by pools of adjustable rate, hybrid adjustable rate and fixed rate mortgage loans

"ARMs" means Adjustable Rate Mortgage backed securities

“Basel III” means “calibrated” capital standards for major banking institutions

“Board” means ARMOUR’s Board of Directors

“common stock DRIP” means the Company's dividend reinvestment and stock purchase plan

"CME" means the Chicago Mercantile Exchange

“Code” means the Internal Revenue Code

“CPR” means constant prepayment rate

“Fannie Mae” means the Federal National Mortgage Association

“FCA” means the Financial Conduct Authority

“FDIC” means the Federal Deposit Insurance Corporation

“Fed” means the U.S. Federal Reserve

“FHFA” means the Federal Housing Finance Agency

“FPC” means the Financial Policy Committee

“Freddie Mac” means the Federal Home Loan Mortgage Corporation

“FSA” means the United Kingdom Financial Services Authority

“Futures Contracts” means Eurodollar Futures Contracts

“GAAP” means accounting principles generally accepted in the United States of America

“Ginnie Mae” means the Government National Mortgage Administration

“GSE” means U.S. Government Sponsored Entity. Obligations of agencies originally established or chartered by the U.S. government to serve public purposes as specified by the U.S. Congress; these obligations are not explicitly guaranteed as to the timely payment of principal and interest by the full faith and credit of the U.S. government.

“HAMP” means the Home Affordable Modification Program

“HARP” means the Home Affordable Refinance Program

“JAVELIN” means JAVELIN Mortgage Investment Corp.

“LIBOR” means the London Interbank Offered Rate

“Management Agreement” means the management agreement between ARR and ARRM whereby ARRM performs certain services for ARR in exchange for a specified fee

“MBS” means mortgage backed securities, a security representing a direct interest in a pool of mortgage loans. The pass-through issuer or servicer collects the payments on the loans in the pool and "passes through" the principal and interest to the security holders on a pro rata basis.



“MRA” means master repurchase agreement. A document that outlines standard terms between the Company and counterparties for repurchase agreement transactions.

“Non-Agency Securities” means securities backed by residential mortgages in which we invest, for which the payment of principal and interest is not guaranteed by a GSE or government agency.

"OCC" means the Office of the Comptroller of the Currency

“PRA” means the Prudential Regulation Authority

“QE3” means the Fed's third quantitative easing program

“REIT” means Real Estate Investment Trust. A special purpose investment vehicle that provides investors with the ability to participate directly in the ownership or financing of real-estate related assets by pooling their capital to purchase and manage mortgage loans and/or income property.

"Repurchase Program" means the Company's common stock repurchase program

“RMBS” means residential mortgage backed securities

“SEC” means the Securities and Exchange Commission

“SBBC” means Staton Bell Blank Check Company

“Sub-Management Agreement” means a Sub-Management Agreement between ARMOUR, ARRM and SBBC. ARRM is responsible for the payment of a monthly sub-management fee.

“1940 Act” means the Investment Company Act of 1940

“U.S.” means United States

“Wheatley Review” means the results of FSA's review of the process for setting LIBOR interest rate for various currencies and maturities

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

#### Interest Rate, Cap and Mismatch Risk

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

ARMs are typically subject to periodic and lifetime interest rate caps that limit the amount the interest rate can change during any given period. ARMs are also typically subject to a minimum interest rate payable. Our borrowings are not subject to similar restrictions. Hence, in a period of increasing interest rates, interest rates on our borrowings could increase without limitation, while the interest rates on our mortgage related assets could be limited. This exposure would be magnified to the extent we acquire fixed rate Agency Securities or ARMs that are not fully indexed. Furthermore, some ARMs may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. These factors could lower our net interest income or cause a net loss during periods of rising interest rates, which would negatively impact our liquidity, net income and our ability to make distributions to stockholders.

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

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

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

#### Prepayment Risk

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

prices below the principal balance of the mortgage loans underlying such Agency Securities. As of March 31, 2014, the substantially all of our Agency Securities were purchased at a premium.

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

Another component of interest rate risk is the effect changes in interest rates will have on the market value of our Agency Securities. We face the risk that the market value of our Agency Securities will increase or decrease at different rates than that of our liabilities, including our derivative instruments and obligations to return securities received as collateral.

We primarily assess our interest rate risk by estimating the effective duration of our assets and the effective duration of our liabilities and by estimating the time difference between the interest rate adjustment of our assets and the interest rate adjustment of our liabilities. Effective duration essentially measures the market price volatility of financial instruments as interest rates change.

We generally estimate effective duration using various financial models and empirical data. Different models and methodologies can produce different effective duration estimates for the same securities.

The sensitivity analysis tables presented below reflect the estimated impact of an instantaneous parallel shift in the yield curve, up and down 50 and 100 basis points, on the market value of our interest rate-sensitive investments and net interest income, at March 31, 2014 and December 31, 2013, assuming a static securities portfolio. It assumes that the spread between the interest rates on Agency Securities and long term U.S. Treasury Securities remains constant. Actual interest rate movements over time will likely be different, and such differences may be material. When evaluating the impact of changes in interest rates, prepayment assumptions and principal reinvestment rates are adjusted based on ARRM's expectations. The analysis presented utilized assumptions, models and estimates of ARRM based on ARRM's judgment and experience.

As of March 31, 2014

| Change in Interest Rates | Percentage Change in Projected Net Interest Income | Percentage Change in Projected Portfolio Value Including Derivatives |
|--------------------------|----------------------------------------------------|----------------------------------------------------------------------|
| 1.00%                    | 1.13%                                              | (0.57)%                                                              |
| 0.50%                    | 0.83%                                              | (0.18)%                                                              |
| (0.50)%                  | 7.78%                                              | 0.76%                                                                |
| (1.00)%                  | 6.58%                                              | 1.15%                                                                |

As of December 31, 2013

| Change in Interest Rates | Percentage Change in Projected Net Interest Income | Percentage Change in Projected Portfolio Value Including Derivatives |
|--------------------------|----------------------------------------------------|----------------------------------------------------------------------|
| 1.00%                    | 2.29%                                              | (0.71)%                                                              |
| 0.50%                    | 0.01%                                              | (0.44)%                                                              |
| (0.50)%                  | 6.65%                                              | 0.54%                                                                |
| (1.00)%                  | 5.35%                                              | 1.08%                                                                |

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

The above tables quantify the potential changes in net interest income and securities portfolio value, which includes the value of our derivatives, should interest rates immediately change. Given the low level of interest rates at March 31, 2014 and December 31, 2013, we applied a floor of 0% for all anticipated interest rates included in our

assumptions. Due to the presence of this floor, it is anticipated that any hypothetical interest rate decrease would have a limited positive impact on our funding costs beyond a certain level; however, because prepayments speeds are unaffected by this floor, it is expected that any increase in our prepayment speeds (occurring as a result of any interest rate decrease or otherwise) could result in an acceleration of our premium amortization and the reinvestment of such prepaid principal in lower yielding assets. As a result, the presence of this floor limits the positive impact of any interest rate decrease on our funding costs. Therefore, at some point, hypothetical interest rate decreases could cause the fair value of our financial instruments and our net interest income to decline.

#### Market Value Risk

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

#### Liquidity Risk

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

#### Item 4. Controls and Procedures

##### Evaluation of Disclosure Controls and Procedures

Our Co-Chief Executive Officers (“Co-CEOs”) and Chief Financial Officer (“CFO”) participated in an evaluation by our management of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of our fiscal quarter that ended on March 31, 2014. Based on their participation in that evaluation, our Co-CEOs and CFO concluded that our disclosure controls and procedures were effective as of March 31, 2014 to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and to ensure that information required to be disclosed in our reports filed or furnished under the Exchange Act, is accumulated and communicated to our management, including our Co-CEOs and CFO, as appropriate, to allow timely decisions regarding required disclosures.

##### Internal Control Over Financial Reporting

Our Co-CEOs and CFO also participated in an evaluation by our management of any changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended March 31, 2014. That evaluation did not identify any changes that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

#### Item 1. Legal Proceedings

Our company is not currently subject to any legal proceedings, as described in Item 103 of Regulation S-K.

#### Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013, filed on February 27, 2014.

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

Stock Repurchase Program

The following table presents information regarding our common stock repurchases made during the three months ended March 31, 2014 (in thousands, except per share price).

|                                       | Total<br>Number of<br>Shares<br>Purchased<br>(1) | Per Share<br>Price (2) | Total Number of<br>Shares Purchased<br>as Part of Publicly<br>Announced Plans<br>or Programs | Maximum Number of<br>Shares That May Yet<br>Be Purchased Under<br>the Publicly<br>Announced Plans or<br>Programs (3) |
|---------------------------------------|--------------------------------------------------|------------------------|----------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------|
| March 12, 2014 through March 25, 2014 | 600                                              | \$4.31                 | 600                                                                                          | 49,400                                                                                                               |

(1) All shares were repurchased pursuant to a stock repurchase program ("Repurchase Program") (see Note 3 to the condensed financial statements).

(2) Weighted average price.

(3) In December 2012, our Board authorized a Repurchase Program of up to \$100,000 of our common stock outstanding. On March 5, 2014, our Board increased the authorization to 50,000 shares of our common stock outstanding.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

See Exhibit Index.



SIGNATURES

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

May 5, 2014

ARMOUR RESIDENTIAL REIT, INC.

/s/ James R. Mountain  
James R. Mountain  
Chief Financial Officer, Duly Authorized  
Officer and Principal Financial and  
Accounting Officer

52

---

EXHIBIT INDEX

| Exhibit Number | Description                                                                           |
|----------------|---------------------------------------------------------------------------------------|
| 31.1           | Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14(a)/15d-14(a) (1) |
| 31.2           | Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14(a)/15d-14(a) (1) |
| 31.3           | Certification of Chief Financial Officer Pursuant to SEC Rule 13a14(a)/15d-14(a) (1)  |
| 32.1           | Certification of Chief Executive Officer Pursuant to 18 U.S.C. §1350 (2)              |
| 32.2           | Certification of Chief Executive Officer Pursuant to 18 U.S.C. §1350 (2)              |
| 32.3           | Certification of Chief Financial Officer Pursuant to 18 U.S.C. §1350 (2)              |
| 101.INS        | XBRL Instance Document (1)                                                            |
| 101.SCH        | XBRL Taxonomy Extension Schema Document (1)                                           |
| 101.CAL        | XBRL Taxonomy Extension Calculation Linkbase Document (1)                             |
| 101.DEF        | XBRL Taxonomy Extension Definition Linkbase Document (1)                              |
| 101.LAB        | XBRL Taxonomy Extension Label Linkbase Document (1)                                   |
| 101.PRE        | XBRL Taxonomy Extension Presentation Linkbase Document (1)                            |

(1) Filed herewith

(2) Furnished herewith