

American Capital Agency Corp  
Form 10-Q  
August 06, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 2010

OR

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

Commission file number 001-34057

**AMERICAN CAPITAL AGENCY CORP.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or Other Jurisdiction of  
Incorporation or Organization)

**26-1701984**  
(I.R.S. Employer  
Identification No.)

**2 Bethesda Metro Center, 14th Floor**

**Bethesda, Maryland 20814**

(Address of principal executive offices)

**(301) 968-9300**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports 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 earlier period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller Reporting Company

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

The number of shares of the issuer's common stock, \$0.01 par value, outstanding as of July 31, 2010, was 33,660,295.

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**AMERICAN CAPITAL AGENCY CORP.**

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|  | <b>June 30,<br/>2010<br/>(Unaudited)</b> | <b>December 31,<br/>2009</b> |
|--|--|------------------------------|
| <b>Assets:</b>   |  |                              |
| Agency securities, at fair value (including pledged assets of \$6,870,710 and \$4,136,596, respectively)                 | \$ 7,166,390                             | \$ 4,300,115                 |
| Cash and cash equivalents  | 150,081                                  | 202,803                      |
| Restricted cash  | 37,877                                   | 19,628                       |
| Interest receivable  | 35,932                                   | 22,872                       |
| Derivative assets, at fair value   | 7,391                                    | 11,960                       |
| Receivable for agency securities sold  | 311,794                                  | 47,076                       |
| Principal payments receivable  | 44,883                                   | 20,473                       |
| Other assets   | 1,139                                    | 757                          |
| <b>Total assets</b>  | <b>\$ 7,755,487</b>                      | <b>\$ 4,625,684</b>          |
| <b>Liabilities:</b>  |  |                              |
| Repurchase agreements  | \$ 6,634,342                             | \$ 3,841,834                 |
| Payable for agency securities purchased  | 201,799                                  | 180,345                      |
| Derivative liabilities, at fair value  | 76,220                                   | 17,798                       |
| Dividend payable   | 47,124                                   | 34,050                       |
| Accounts payable and other accrued liabilities   | 3,572                                    | 4,835                        |
| <b>Total liabilities</b>   | <b>6,963,057</b>                         | <b>4,078,862</b>             |
| <b>Stockholders' equity:</b>   |  |                              |
| Preferred stock, \$0.01 par value; 10,000 shares authorized, 0 shares issued and outstanding, respectively               |  |                              |
| Common stock, \$0.01 par value; 150,000 shares authorized, 33,660 and 24,322 shares issued and outstanding, respectively | 337                                      | 243                          |
| Additional paid-in capital   | 738,525                                  | 507,465                      |
| Retained earnings  | 25,359                                   | 19,940                       |
| Accumulated other comprehensive income   | 28,209                                   | 19,174                       |
| <b>Total stockholders' equity</b>  | <b>792,430</b>                           | <b>546,822</b>               |
| <b>Total liabilities and stockholders' equity</b>  | <b>\$ 7,755,487</b>                      | <b>\$ 4,625,684</b>          |

See accompanying notes to consolidated financial statements.

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**AMERICAN CAPITAL AGENCY CORP.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

**AND COMPREHENSIVE INCOME**

(unaudited)

(in thousands, except per share data)

|   | For the three months ended June 30, |                  | For the six months ended June 30, |                  |
|---|-------------------------------------|------------------|-----------------------------------|------------------|
|   | 2010                                | 2009             | 2010                              | 2009             |
| <b>Interest income:</b>   |                                     |                  |                                   |                  |
| Interest income   | \$ 50,589                           | \$ 31,690        | \$ 89,386                         | \$ 54,041        |
| Interest expense  | 17,348                              | 9,585            | 32,858                            | 17,714           |
| Net interest income   | 33,241                              | 22,105           | 56,528                            | 36,327           |
| <b>Other income, net:</b>   |                                     |                  |                                   |                  |
| Gain from sale of agency securities, net                                      | 29,585                              | 9,530            | 56,993                            | 14,348           |
| (Loss) gain from derivative instruments and trading securities, net           | (21,867)                            | 1,226            | (15,947)                          | 868              |
| Total other income, net   | 7,718                               | 10,756           | 41,046                            | 15,216           |
| <b>Expenses:</b>  |                                     |                  |                                   |                  |
| Management fees   | 2,314                               | 939              | 4,098                             | 1,842            |
| General and administrative expenses   | 1,787                               | 1,556            | 3,468                             | 3,024            |
| Total expenses  | 4,101                               | 2,495            | 7,566                             | 4,866            |
| <b>Net income</b>   | <b>\$ 36,858</b>                    | <b>\$ 30,366</b> | <b>\$ 90,008</b>                  | <b>\$ 46,677</b> |
| <b>Net income per common share basic and diluted</b>                          | <b>\$ 1.23</b>                      | <b>\$ 2.02</b>   | <b>\$ 3.28</b>                    | <b>\$ 3.11</b>   |
| <b>Weighted average number of common shares outstanding basic and diluted</b> | <b>29,872</b>                       | <b>15,005</b>    | <b>27,451</b>                     | <b>15,005</b>    |
| <b>Dividends declared per common share</b>                                    | <b>\$ 1.40</b>                      | <b>\$ 1.50</b>   | <b>\$ 2.80</b>                    | <b>\$ 2.35</b>   |
| <b>Comprehensive income:</b>  |                                     |                  |                                   |                  |
| <b>Net income</b>   | <b>\$ 36,858</b>                    | <b>\$ 30,366</b> | <b>\$ 90,008</b>                  | <b>\$ 46,677</b> |
| <b>Other comprehensive income:</b>  |                                     |                  |                                   |                  |
| Unrealized gain on available-for-sale securities, net                         | 59,484                              | 3,547            | 61,417                            | 32,831           |
| Unrealized (loss) gain on derivative instruments, net                         | (38,906)                            | 11,068           | (52,382)                          | 9,030            |
| Other comprehensive income  | 20,578                              | 14,615           | 9,035                             | 41,861           |
| <b>Comprehensive income</b>   | <b>\$ 57,436</b>                    | <b>\$ 44,981</b> | <b>\$ 99,043</b>                  | <b>\$ 88,538</b> |

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See accompanying notes to consolidated financial statements.

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## AMERICAN CAPITAL AGENCY CORP.

## CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

(in thousands)

|  | Preferred Stock |        | Common Stock |        |        | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total      |
|--|-----------------|--------|--------------|--------|--------|----------------------------------|----------------------|---|------------|
|  | Shares          | Amount | Shares       | Amount | Amount |                                  |                      |   |            |
| <b>Balance, December 31, 2009</b>                        |                 | \$     | 24,322       | \$ 243 |        | \$ 507,465                       | \$ 19,940            | \$ 19,174                                       | \$ 546,822 |
| Net income   |                 |        |              |        |        |                                  | 53,150               |   | 53,150     |
| Other comprehensive income:                              |                 |        |              |        |        |                                  |                      |   |            |
| Unrealized gain on available-for-sale securities,<br>net |                 |        |              |        |        |                                  |                      | 1,933   | 1,933      |
| Unrealized loss on derivative instruments, net           |                 |        |              |        |        |                                  |                      | (13,476)  | (13,476)   |
| Issuance of common stock                                 |                 |        | 2,434        | 24     |        | 62,114                           |                      |   | 62,138     |
| Issuance of restricted common stock                      |                 |        | 4            | 1      |        |                                  |                      |   | 1          |
| Stock-based compensation                                 |                 |        |              |        |        | 16                               |                      |   | 16         |
| Common dividends declared                                |                 |        |              |        |        |                                  | (37,465)             |   | (37,465)   |
| <b>Balance, March 31, 2010 (Unaudited)</b>               |                 | \$     | 26,760       | \$ 268 |        | \$ 569,595                       | \$ 35,625            | \$ 7,631  | \$ 613,119 |
| Net income   |                 |        |              |        |        |                                  | 36,858               |   | 36,858     |
| Other comprehensive income:                              |                 |        |              |        |        |                                  |                      |   |            |
| Unrealized gain on available-for-sale securities,<br>net |                 |        |              |        |        |                                  |                      | 59,484  | 59,484     |
| Unrealized loss on derivative instruments, net           |                 |        |              |        |        |                                  |                      | (38,906)  | (38,906)   |
| Issuance of common stock                                 |                 |        | 6,900        | 69     |        | 168,904                          |                      |   | 168,973    |
| Stock-based compensation                                 |                 |        |              |        |        | 26                               |                      |   | 26         |
| Common dividends declared                                |                 |        |              |        |        |                                  | (47,124)             |   | (47,124)   |
| <b>Balance, June 30, 2010 (Unaudited)</b>                |                 | \$     | 33,660       | \$ 337 |        | \$ 738,525                       | \$ 25,359            | \$ 28,209                                       | \$ 792,430 |

See accompanying notes to consolidated financial statements.

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(unaudited)****(in thousands)**

|  | <b>For the six months ended June 30,</b> |                  |
|--|--|------------------|
|  | <b>2010</b>                              | <b>2009</b>      |
| <b>Operating activities:</b>   |  |                  |
| Net income   | \$ 90,008                                | \$ 46,677        |
| Adjustments to reconcile net income to net cash provided by operating activities:          |  |                  |
| Amortization of agency securities premiums and discounts, net                              | 35,192                                   | 6,514            |
| Amortization of interest rate swap termination fee   | 6,278                                    | 2,995            |
| Ineffectiveness of derivative instruments  | 314                                      | (715)            |
| Stock-based compensation   | 42                                       | 15               |
| Gain on sale of agency securities, net   | (56,993)                                 | (14,348)         |
| Loss (gain) on derivative instruments and trading securities, net                          | 15,633                                   | (925)            |
| Purchases of trading securities  | (279,164)                                |                  |
| Proceeds from sale of trading securities   | 280,607                                  |                  |
| Increase in interest receivable  | (13,060)                                 | (6,154)          |
| Increase in other assets   | (382)                                    | (5)              |
| Decrease in accounts payable and other accrued liabilities                                 | (1,263)                                  | (2,390)          |
| <b>Net cash provided by operating activities</b>   | <b>77,212</b>                            | <b>31,664</b>    |
| <b>Investing activities:</b>   |  |                  |
| Purchases of agency securities   | (8,191,504)                              | (3,628,403)      |
| Proceeds from sale of agency securities  | 4,534,061                                | 2,413,084        |
| Net (payments on) proceeds from derivative instruments not designated as qualifying hedges | (6,122)                                  | 1,566            |
| Principal collections on agency securities   | 599,776                                  | 228,550          |
| <b>Net cash used in investing activities</b>   | <b>(3,063,789)</b>                       | <b>(985,203)</b> |
| <b>Financing activities:</b>   |  |                  |
| Cash dividends paid  | (71,515)                                 | (30,760)         |
| (Increase) decrease in restricted cash   | (18,249)                                 | 13,489           |
| Payments made on interest rate swap terminations   |  | (16,586)         |
| Proceeds from repurchase arrangements, net   | 2,792,508                                | 1,000,610        |
| Net proceeds from common stock issuances   | 231,111                                  |                  |
| <b>Net cash provided by financing activities</b>   | <b>2,933,855</b>                         | <b>966,753</b>   |
| <b>Net change in cash and cash equivalents</b>   | <b>(52,722)</b>                          | <b>13,214</b>    |
| Cash and cash equivalents at beginning of period   | 202,803                                  | 56,012           |
| <b>Cash and cash equivalents at end of period</b>  | <b>\$ 150,081</b>                        | <b>\$ 69,226</b> |

See accompanying notes to consolidated financial statements.





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**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**Note 1. Unaudited Interim Consolidated Financial Statements**

The interim consolidated financial statements of American Capital Agency Corp. (together with its consolidated subsidiary, is referred throughout this report as the Company, we, us and our) are prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X. 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 income and expenses during the reporting period. Actual results could differ from those estimates.

Our unaudited consolidated financial statements include the accounts of our wholly-owned subsidiary, American Capital Agency TRS, LLC. Significant intercompany accounts and transactions have been eliminated. In the opinion of management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair presentation of financial statements for the interim period have been included. The current period's results of operations are not necessarily indicative of results that ultimately may be achieved for the year. There has been no activity in American Capital Agency TRS, LLC during the six months ended June 30, 2010 and 2009.

**Note 2. Organization**

We were organized in Delaware on January 7, 2008, and commenced operations on May 20, 2008 following the completion of our initial public offering (IPO). Our common stock is traded on The NASDAQ Global Select Market under the symbol AGNC.

We have elected to be taxed as a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended (the Code). As such, we are required to distribute annually 90% of our taxable net income. As long as we qualify as a REIT, we will generally not be subject to U.S. federal or state corporate taxes on our taxable net income to the extent that we distribute all of our annual taxable net income to our stockholders. We are managed by American Capital Agency Management, LLC (our Manager), a subsidiary of a wholly-owned portfolio company of American Capital, Ltd. (American Capital).

We earn income primarily from investing in residential mortgage pass-through securities and collateralized mortgage obligations (CMOs) on a leveraged basis. These investments consist of securities for which the principal and interest payments are guaranteed by U.S. Government-sponsored entities such as the Federal National Mortgage Association, or Fannie Mae, and the Federal Home Loan Mortgage Corporation, or Freddie Mac, or by a U.S. Government agency such as the Government National Mortgage Association, or Ginnie Mae. We refer to these types of securities as agency securities and the specific agency securities in which we invest as our investment portfolio.

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Our principal goal is to generate net income for distribution to our stockholders through regular quarterly dividends from our net interest income, which is the spread between the interest income earned on our interest earning assets and the interest costs of our borrowings and hedging activities, and realized gains on our investments. We fund our investments primarily through short-term borrowings structured as repurchase agreements.

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**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

**Note 3. Summary of Significant Accounting Policies**

***Investments in Agency Securities***

Accounting Standards Codification ( ASC ) Topic 320, *Investments Debt and Equity Securities* ( ASC 320 ), requires that at the time of purchase, we designate a security as held-to-maturity, available-for-sale or trading, depending on our ability and intent to hold such security to maturity. Securities classified as trading and available-for-sale are reported at fair value, while securities classified as held-to-maturity are reported at amortized cost. We may, from time to time, sell any of our agency securities as part of our overall management of our investment portfolio. Accordingly, we typically designate our agency securities as available-for-sale. All securities classified as available-for-sale are reported at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income (loss) ( OCI ), a component of stockholders' equity. We determine the cost of the security and the amount to reclassify out of accumulated OCI into earnings based on the specific identification method.

Interest-only strips represent our right to receive a specified proportion of the contractual interest flows of specific agency and CMO securities. Interest-only strips are measured at fair value through earnings in gain (loss) on derivative instruments and trading securities, net in our consolidated statements of operations and comprehensive income. Our investments in interest-only strips are included in agency securities, at fair value on the accompanying consolidated balance sheets.

We evaluate securities for other-than-temporary impairment ( OTTI ) on at least a quarterly basis, and more frequently when economic or market conditions warrant such evaluation. Based on the criteria in ASC 320, the determination of whether a security is other-than-temporarily impaired involves judgments and assumptions based on subjective and objective factors. When an agency security is impaired, an OTTI is considered to have occurred if (i) we intend to sell the agency security or (ii) it is more likely than not that we will be required to sell the agency security before recovery of its amortized cost basis. If we intend to sell the security or if it is more likely than not that we will be required to sell the agency security before recovery of its amortized cost basis, the entire amount of the impairment loss is recognized in earnings as an unrealized loss and the cost basis of the security is adjusted.

We did not recognize any OTTI charges on any of our agency securities for the six months ended June 30, 2010 and 2009.

***Derivative Instruments***

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We maintain an interest rate risk management strategy under which we use derivative financial instruments to manage the adverse impact of interest rate changes on the value of our investment portfolio as well as our cash flows. In particular we attempt to mitigate the risk of the cost of our short-term variable rate liabilities increasing at a faster rate than the earnings of our long-term assets during a period of rising interest rates. The principal derivative instruments that we use are interest rate swaps, options to enter into interest rate swap agreements ( interest rate swaptions ), to-be-announced agency securities ( TBAs ), options and futures. We account for derivatives in accordance with ASC Topic 815, *Derivatives and Hedging* ( ASC 815 ). ASC 815 requires an entity to recognize all derivatives as either assets or liabilities in the balance sheet and to measure those instruments at fair value.

The accounting for changes in the fair value of derivatives depends on the intended use of the derivative and the resulting designation. Derivatives that are intended to hedge exposure to variability in expected future cash flows are considered cash flow hedges. For derivatives designated in qualifying cash flow hedging relationships, the effective portion of the fair value adjustments are initially recorded in OCI (a component of stockholders

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**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

equity) and reclassified to income at the time that the hedged transactions affect earnings. The ineffective portion of the fair value adjustments is recognized in gain (loss) on derivative instruments and trading securities, net immediately. When the underlying hedged transaction ceases to exist, all changes in the fair value of the instrument are included in gain (loss) on derivative instruments and trading securities, net for each period until the derivative instrument matures or is settled. Any amounts that have been previously recorded in accumulated OCI may need to be reclassified to net income. For derivatives not designated in hedging relationships under ASC 815, the fair value adjustments are recorded in gain (loss) on derivative instruments and trading securities, net. Derivatives in a gain position are reported as derivative assets at fair value, and derivatives in a loss position are reported as derivative liabilities at fair value in our consolidated balance sheet. Any gain (loss) on derivative instruments and trading securities is included in the operating section in our consolidated statement of cash flows.

We use interest rate swaps to hedge the variable cash flows associated with short-term borrowings made under our repurchase agreement facilities. We generally enter into such derivatives with the intention of qualifying for hedge accounting.

We may purchase interest rate swaptions to help mitigate the potential impact of large increases or decreases in interest rates on the performance of our investment portfolio (referred to as convexity risk). The interest rate swaptions provide us the option to enter into an interest rate swap agreement for a predetermined notional amount, stated term and pay and receive interest rates in the future. The premium paid for interest rate swaptions is reported as an asset in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the swaption that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the swaption is reported in gain (loss) on derivative instruments and trading securities, net in our consolidated statement of operations and comprehensive income. If a swaption expires unexercised, the loss on the swaption would be equal to the premium paid. If we exercise a swaption, the realized gain or loss on the swaption would be equal to the difference between the fair value of the underlying interest rate swap and the premium paid.

A TBA security is a futures contract for the purchase or sale of agency securities at a predetermined price, face amount, issuer, coupon and stated maturity on an agreed-upon future date. The specific agency securities delivered into the contract upon the settlement date, published each month by the Securities Industry and Financial Markets Association, are not known at the time of the transaction. TBA securities are exempt from ASC 815 if there is no other way to purchase or sell that security, if delivery of that security and settlement will occur within the shortest period possible for that type of security and if it is probable at inception and throughout the term of the individual contract that physical delivery of the security will occur. For the TBA security contracts that we have entered into, we have not asserted that physical settlement is probable and therefore, we did not designate such forward commitments as hedging instruments. Accordingly, all realized and unrealized gains and losses are recognized in our consolidated statement of operations in the line item gain (loss) on derivative instruments and trading securities, net.

We may purchase put and call options on TBA securities to hedge against short-term changes in interest rates. Under a purchased put option, we have the right to sell the counterparty a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. Under a purchased call option, we have the right to purchase from the counterparty a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. The premium paid for a put or call option is reported as an asset in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the option that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the option is reported in gain (loss) on derivative



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**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

instruments and trading securities, net in our consolidated statement of operations and comprehensive income. When a purchased put or call option expires unexercised, a realized loss is reported in our consolidated statement of operations equal to the premium paid. When a purchased put or call option is exercised, a realized gain or loss is reported in our consolidated statement of operations equal to the difference between the premium paid and the fair value of the exercised put or call option. In addition, a derivative asset is recorded in our consolidated balance sheet for the TBA security resulting from the put or call option exercise.

We may also write put and call options on TBA securities to hedge against short-term changes in interest rates. Under a written put option, the counterparty has the right to sell us a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. Under a written call option, the counterparty has the right to purchase from us a specified TBA security at a predetermined price on the option exercise date in exchange for a premium at execution. The premium received from writing a put or call option is reported as a liability in our consolidated balance sheets. The premium is valued at an amount equal to the fair value of the option that would have the effect of closing the position adjusted for nonperformance risk, if any. The difference between the premium and the fair value of the option is reported in gain (loss) on derivative instruments and trading securities, net in our consolidated statement of operations and comprehensive income. When a written put or call option expires unexercised, a realized gain is reported in our consolidated statement of operations equal to the premium received. When we terminate a written put or call option, a realized gain or loss is reported in our consolidated statement of operations equal to the difference between the termination payment and the premium received. When a written put or call option is exercised, a realized gain or loss is reported in our consolidated statement of operations equal to the difference between the premium received and the fair value of the exercised put or call option. In addition, a derivative asset or liability is recorded in our consolidated balance sheet for the TBA security resulting from the put or call option exercise.

We may enter into a forward commitment to purchase or sell specified agency securities as a hedge against short-term changes in interest rates. Contracts for the purchase or sale of specified agency securities are accounted for as derivatives if the delivery of the specified agency security and settlement extends beyond the shortest period possible for that type of security. We may designate the forward commitment as a qualifying cash flow hedge if at the time of the purchase or sale of the security, and throughout the term of the individual contract, it is probable that physical delivery of the security will occur. Realized and unrealized gains and losses associated with forward commitments not designated as hedging instruments are recognized in our consolidated statement of operations in the line item gain (loss) on derivative instruments and trading securities, net.

We estimate the fair value of interest rate swaps and interest rate swaptions based on the estimated net present value of the future cash flows using a forward interest rate yield curve in effect as of the measurement period, adjusted for non-performance risk based on our credit risk and our counterparty's credit risk and, in the case of interest rate swaptions, on the future interest rate swap that we have the option to enter into as well as the remaining length of time that we have to exercise the option. We consider the impact of any collateral requirements, credit enhancements or netting arrangements on credit risk. TBA securities and forward settling contracts to purchase or sell securities are valued using a combination of third-party pricing services and dealer quotes. These third-party pricing services use pricing models that incorporate such factors as coupons, prepayment speeds, spread to the Treasury and swap curves, convexity, duration, periodic and life caps and credit enhancement. The dealer quotes incorporate similar pricing models as well as other common market pricing methods.



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The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We attempt to minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties.

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**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

***Variable Interest Entities***

In June 2009, the FASB issued SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)* ( SFAS No. 167 ). In December 2009, the FASB issued Accounting Standards Update ( ASU ) No. 2009-17, *Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, which codified SFAS No. 167 in FASB ASC Topic 810, *Consolidation* ( ASC 810 ). ASC 810, as amended by ASU 2009-17, revises the evaluation of whether entities represent variable interest entities ( VIEs ) and requires a qualitative assessment in determining the primary beneficiary of a VIE. Further, ASC 2009-17 requires ongoing assessments of control over such entities as well as additional disclosures for entities that have variable interests in VIEs. The amendments significantly affect the overall consolidation analysis under ASC 810 and change the way entities account for securitizations and special purpose entities as a result of the elimination of the qualifying special purpose entity ( QSPE ) scope exemption from ASC 810. The requirements of ASC 810 as they relate to ASU 2009-17 were effective for us as of January 1, 2010.

Prior to our adoption of ASC 810, as amended by ASU 2009-17, the CMO trusts we invested in were exempt from consolidation. Upon our adoption of ASC 810, as amended by ASU 2009-17, we evaluated such CMO trusts and determined that they are VIEs and our investments are variable interests. Generally, we will consolidate a CMO trust if we are its primary beneficiary, that is, if we have a variable interest (or combination of variable interests) that provides us with a controlling financial interest in the CMO trust. An entity is deemed to have a controlling financial interest if the entity has the power to direct the activities of a VIE that most significantly impacts the VIE's economic performance and the obligation to absorb losses of or right to receive benefits from the VIE that could potentially be significant to the VIE. In determining if we have a controlling financial interest, we evaluate whether we share the power to control the selection of financial assets transferred to the CMO trust with an unrelated party. While we believe there is shared power in the selection of the assets for certain of the CMO trusts (i.e. both we and the unrelated party must consent to the transfer of such assets to the CMO trust), if our economic interest in the CMO trust is disproportionate to the shared power, we may be deemed to be the primary beneficiary.

As of and during the three and six months ended June 30, 2010, we were the primary beneficiary of certain CMO trusts in which we hold a variable interest. However, we did not consolidate such CMO trusts because the impact of consolidating them was immaterial to our financial statements as of and for the periods then ended. Our investments in the securities issued by such CMO trusts are included in agency securities on the accompanying consolidated balance sheets.

***Recent Accounting Pronouncements***

In June 2009, the FASB issued SFAS No. 166, *Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140* ( SFAS No. 166 ). In December 2009, the FASB issued ASU No. 2009-16, *Accounting for Transfers of Financial Assets*, which codified SFAS No. 166 in FASB ASC Topic 860, *Transfers and Servicing* ( ASC 860 ). SFAS No. 166 amends the derecognition guidance in SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, eliminates the concept of a QSPE and requires more information about transfers of financial assets, including securitization transactions as well as a company's continuing exposure to the risks related to transferred financial assets. We adopted the requirements of ASC 860, as they relate to SFAS No. 166, on January 1, 2010. The

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requirements were effective for financial asset transfers occurring after January 1, 2010 and for substantive subsequent changes to transfers of financial assets that occurred prior to January 1, 2010.

In January 2010, the FASB issued ASU No. 2010-06, *Improving Disclosures about Fair Value Measurements* ( ASU 2010-06 ), which amended FASB ASC Topic 820, *Fair Value Measurements and*

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**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

*Disclosures* ( ASC 820 ), to require a number of additional disclosures regarding fair value measurements, including the amount of transfers between Levels 1 and 2 of the fair value hierarchy, the reasons for transfers in or out of Level 3 of the fair value hierarchy and activity for recurring Level 3 measures. ASU 2010-06 also clarifies certain existing disclosure requirements related to the level at which fair value disclosures should be disaggregated and the requirement to provide disclosures about the valuation techniques and inputs used in determining the fair value of assets or liabilities classified as Levels 2 or 3. The ASU was effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures related to the activity in Level 3 fair value measurements, which are effective for fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. Early adoption is permitted. We adopted the requirements of ASU 2010-06 in the first quarter of 2010 and the adoption did not have a material effect on our consolidated financial statements.

In February 2010, the FASB issued ASU No. 2010-09, *Amendments to Certain Recognition and Disclosure Requirements* ( ASU 2010-09 ), which amends FASB ASC Topic 855, *Subsequent Events* ( ASC 855 ). ASU No. 2010-09 removes the requirement for an SEC filer (as defined in ASU 2010-09) to disclose the date, in both issued and revised financial statements, through which it has evaluated subsequent events. This change alleviates potential conflicts with current SEC guidance. ASU No. 2010-09 is effective upon issuance for all entities other than conduit bond obligors. We adopted the requirements of ASU No. 2010-09 on the effective date. We do not have any material subsequent events that impact our consolidated financial statements.

***Reclassifications***

Certain prior period amounts in the consolidated financial statements and accompanying notes have been reclassified to conform to the current period presentation.

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Note 4. Agency Securities**

The following tables summarize our investments in agency securities as of June 30, 2010 and December 31, 2009 (dollars in thousands):

|  | As of June 30, 2010 |              |            |              |
|--|---------------------|--------------|------------|--------------|
|  | Fannie Mae          | Freddie Mac  | Ginnie Mae | Total        |
| <b>Available-for-sale securities:</b>                                    |                     |              |            |              |
| Agency securities, par   | \$ 4,236,720        | \$ 2,344,925 | \$ 149,147 | \$ 6,730,792 |
| Unamortized discount   | (187)               | (5)          |            | (192)        |
| Unamortized premium  | 176,419             | 126,262      | 5,678      | 308,359      |
| Amortized cost   | 4,412,952           | 2,471,182    | 154,825    | 7,038,959    |
| Gross unrealized gains   | 73,792              | 24,573       | 804        | 99,169       |
| Gross unrealized losses  | (1,045)             | (689)        |            | (1,734)      |
| Available-for-sale securities, at fair value                             | 4,485,699           | 2,495,066    | 155,629    | 7,136,394    |
| <b>Agency securities remeasured at fair value through earnings:</b>      |                     |              |            |              |
| Interest-only strips, amortized cost(2)                                  | 15,616              | 21,318       |            | 36,934       |
| Gross unrealized gains   |                     |              |            |              |
| Gross unrealized losses  | (2,523)             | (4,415)      |            | (6,938)      |
| Agency securities measured at fair value through earnings, at fair value | 13,093              | 16,903       |            | 29,996       |
| Total agency securities, at fair value                                   | \$ 4,498,792        | \$ 2,511,969 | \$ 155,629 | \$ 7,166,390 |
| Weighted average coupon(3)   | 4.99%               | 5.52%        | 4.02%      | 5.16%        |
| Weighted average yield as of June 30, 2010(1)                            | 3.53%               | 3.22%        | 2.67%      | 3.40%        |
| Weighted average yield for the six months ended June 30, 2010(1)         | 3.74%               | 2.52%        | 3.29%      | 3.58%        |

(1) Incorporates future prepayment assumptions based on forward rates.

(2) Interest-only strips represent the right to receive a specified portion of the contractual interest flows of the underlying unamortized principal balance of specific CMO securities. The underlying unamortized principal balance of our Fannie Mae and Freddie Mac interest-only strips was \$134.7 million and \$234.7 million, respectively, or a total of \$369.4 million, and the weighted average contractual interest was 3.71% of these amounts as of June 30, 2010.

(3) The weighted average coupon includes the interest cash flows from our interest-only strips taken together with the interest cash flows from our fixed-rate, adjustable-rate and CMO securities as a percentage of the par value of our agency securities (excluding the underlying unamortized principal balance of our interest-only strips) as of June 30, 2010.

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|                      | Amortized<br>Cost | Gross<br>Unrealized<br>Gain | Gross<br>Unrealized<br>Loss | Fair Value   |
|----------------------|-------------------|-----------------------------|-----------------------------|--------------|
| Fixed-Rate           | \$ 3,007,722      | \$ 55,799                   | \$ (505)                    | \$ 3,063,016 |
| Adjustable-Rate      | 3,556,961         | 33,958                      | (1,208)                     | 3,589,711    |
| CMO                  | 474,276           | 9,412                       | (21)                        | 483,667      |
| Interest-only strips | 36,934            |                             | (6,938)                     | 29,996       |
|                      | \$ 7,075,893      | \$ 99,169                   | \$ (8,672)                  | \$ 7,166,390 |

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

|  | As of December 31, 2009 |                              |                              |                   |
|--|-------------------------|------------------------------|------------------------------|-------------------|
|  | Fannie Mae              | Freddie Mac                  | Ginnie Mae                   | Total             |
| Available-for-sale securities:                                 |                         |                              |                              |                   |
| Agency securities, par   | \$ 2,853,278            | \$ 1,248,698                 | \$ 12,456                    | \$ 4,114,432      |
| Unamortized discount   | (92)                    |                              |                              | (92)              |
| Unamortized premium  | 99,709                  | 49,662                       | 386                          | 149,757           |
| Amortized cost   | 2,952,895               | 1,298,360                    | 12,842                       | 4,264,097         |
| Gross unrealized gains   | 36,750                  | 8,965                        | 340                          | 46,055            |
| Gross unrealized losses  | (6,335)                 | (3,702)                      |                              | (10,037)          |
| Agency securities, at fair value                               | \$ 2,983,310            | \$ 1,303,623                 | \$ 13,182                    | \$ 4,300,115      |
| Weighted average coupon  | 5.26%                   | 5.31%                        | 6.00%                        | 5.28%             |
| Weighted average yield as of December 31, 2009(1)              | 4.20%                   | 3.50%                        | 5.33%                        | 3.99%             |
| Weighted average yield for the year ended December 31, 2009(1) | 4.78%                   | 4.27%                        | 4.88%                        | 4.64%             |
|  |                         |                              |                              |                   |
|  | <b>Amortized Cost</b>   | <b>Gross Unrealized Gain</b> | <b>Gross Unrealized Loss</b> | <b>Fair Value</b> |
| Fixed-Rate   | \$ 1,863,261            | \$ 28,210                    | \$ (4,067)                   | \$ 1,887,404      |
| Adjustable-Rate  | 1,699,513               | 9,447                        | (3,473)                      | 1,705,487         |
| CMO  | 701,323                 | 8,398                        | (2,497)                      | 707,224           |
|  | \$ 4,264,097            | \$ 46,055                    | \$ (10,037)                  | \$ 4,300,115      |

(1) Incorporates future prepayment assumptions based on forward rates.

For the three and six months ended June 30, 2010, we recognized an unrealized loss of \$9.0 million and \$6.9 million, respectively, in (loss) gain on derivative instruments and trading securities, net in our consolidated statements of operations and comprehensive income for the change in value of investments in interest-only strips, which represent our right to receive a specified proportion of the contractual interest flows of specific agency and CMO securities. For the three and six months ended June 30, 2010, we realized a gain of \$0.5 million in gain from sale of agency securities, net on the sale of interest-only strips during the periods. We did not invest in interest-only strips during the six months ended June 30, 2009.

Actual maturities of agency securities are generally shorter than the stated contractual maturities. Actual maturities are affected by the contractual lives of the underlying mortgages, periodic principal payments and principal prepayments. The following table summarizes our agency securities as of June 30, 2010 and December 31, 2009, according to their estimated weighted average life classifications (dollars in thousands):

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| Weighted Average Life                             | As of June 30, 2010 |                     |                         | As of December 31, 2009 |                     |                         |
|---|---------------------|---------------------|-------------------------|-------------------------|---------------------|-------------------------|
|   | Fair Value          | Amortized Cost      | Weighted Average Coupon | Fair Value              | Amortized Cost      | Weighted Average Coupon |
| Less than one year                                | \$ 56,739           | \$ 55,515           | 3.42%                   | \$ 432                  | \$ 428              | 1.95%                   |
| Greater than one year and less than three years   | 1,896,384           | 1,860,576           | 5.72%                   | 281,721                 | 281,143             | 5.87%                   |
| Greater than three years and less than five years | 3,601,328           | 3,559,633           | 5.03%                   | 1,340,665               | 1,337,777           | 5.14%                   |
| Greater than or equal to five years               | 1,611,939           | 1,600,169           | 4.85%                   | 2,677,297               | 2,644,749           | 5.25%                   |
| <b>Total</b>                                      | <b>\$ 7,166,390</b> | <b>\$ 7,075,893</b> | <b>5.16%</b>            | <b>\$ 4,300,115</b>     | <b>\$ 4,264,097</b> | <b>5.28%</b>            |



**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

The weighted average lives of the agency securities as of June 30, 2010 and December 31, 2009 in the table above incorporates anticipated future prepayment assumptions. As of June 30, 2010, our expected constant prepayment rate ( CPR ) over the remaining life of our aggregate investment portfolio is 20%. Our estimates differ materially for different types of securities and thus individual holdings have a wide range of projected CPRs. We estimate long-term prepayment assumptions for different securities using third-party services, market data and internal estimates. These third-party services estimate prepayment speeds using models that incorporate the forward yield curve, current mortgage rates, mortgage rates of the outstanding loans, loan age, volatility and other factors. As market conditions are changing rapidly, we use our judgment in making adjustments to our models for different securities. Various market participants could use materially different assumptions.

The following table presents the gross unrealized loss and fair values of our available-for-sale agency securities by length of time that such securities have been in a continuous unrealized loss position as of June 30, 2010 and December 31, 2009 (dollars in thousands):

|                   | Unrealized Loss Position For |                 |                      |                 |                      |                 |
|-------------------|------------------------------|-----------------|----------------------|-----------------|----------------------|-----------------|
|                   | Less than 12 Months          |                 | 12 Months or More    |                 | Total                |                 |
|                   | Estimated Fair Value         | Unrealized Loss | Estimated Fair Value | Unrealized Loss | Estimated Fair Value | Unrealized Loss |
| June 30, 2010     | \$ 632,224                   | \$ (1,734)      | \$                   | \$              | \$ 632,224           | \$ (1,734)      |
| December 31, 2009 | \$ 1,683,452                 | \$ (10,037)     | \$                   | \$              | \$ 1,683,452         | \$ (10,037)     |

As of June 30, 2010, we did not intend to sell any of these agency securities and we believe it is not more likely than not we will be required to sell the agency securities before recovery of their amortized cost basis. We do not believe the unrealized losses on these agency securities are due to credit losses given the GSE guarantees, but are rather due to changes in interest rates and prepayment expectations.

The following table is a summary of our net gain on sale of agency securities for the three and six months ended June 30, 2010 and 2009 (in thousands):

|   | Three Months Ended |                | Six Months Ended |                |
|---|--------------------|----------------|------------------|----------------|
|   | June 30, 2010      | June 30, 2009  | June 30, 2010    | June 30, 2009  |
| Agency securities sold, at cost           | \$ (2,624,277)     | \$ (1,420,616) | \$ (4,741,787)   | \$ (2,472,241) |
| Proceeds from agency securities sold      | 2,653,862          | 1,430,146      | \$ 4,798,780     | 2,486,589      |
| Net gains on sale of agency securities    | \$ 29,585          | \$ 9,530       | \$ 56,993        | \$ 14,348      |
| Gross gains on sale of agency securities  | 31,327             | \$ 10,031      | \$ 61,381        | \$ 15,137      |
| Gross losses on sale of agency securities | (1,742)            | (501)          | (4,388)          | (789)          |

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|  |    |        |    |       |    |        |    |        |
|--|----|--------|----|-------|----|--------|----|--------|
| Net gains on sale of agency securities | \$ | 29,585 | \$ | 9,530 | \$ | 56,993 | \$ | 14,348 |
|--|----|--------|----|-------|----|--------|----|--------|

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## AMERICAN CAPITAL AGENCY CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

Our agency securities classified as available-for-sale are reported at fair value, with unrealized gains and losses excluded from earnings and reported in OCI, a component of stockholders' equity. The following table summarizes changes in accumulated OCI for available-for-sale agency securities for the three and six months ended June 30, 2010 and 2009 (in thousands):

|                                  | Beginning<br>Balance | Unrealized<br>Gains and<br>(Losses) | Reversal of<br>Prior Period<br>Unrealized<br>(Gains) and<br>Losses on<br>Realization | Ending<br>Balance |
|----------------------------------|----------------------|-------------------------------------|--|-------------------|
| Three months ended June 30, 2010 | \$ 37,951            | \$ 88,547                           | \$ (29,063)  | \$ 97,435         |
| Three months ended June 30, 2009 | \$ 32,588            | \$ 13,080                           | \$ (9,530)   | \$ 36,138         |
| Six months ended June 30, 2010   | \$ 36,018            | \$ 117,888                          | \$ (56,471)  | \$ 97,435         |
| Six months ended June 30, 2009   | \$ 3,304             | \$ 47,182                           | \$ (14,348)  | \$ 36,138         |

The following tables summarize our agency securities pledged as collateral under repurchase agreements, derivative agreements and prime broker agreements by type as of June 30, 2010 and December 31, 2009 (in thousands):

| Agency Securities Pledged(1)  | As of June 30, 2010 |                     |                  | Total               |
|---|---------------------|---------------------|------------------|---------------------|
|   | Fannie Mae          | Freddie<br>Mac      | Ginnie Mae       |                     |
| <b>Under Repurchase Agreements</b>  |                     |                     |                  |                     |
| Fair value  | \$ 4,579,907        | \$ 2,437,700        | \$ 28,622        | \$ 7,046,229        |
| Amortized cost  | 4,504,158           | 2,414,510           | 28,183           | 6,946,851           |
| Accrued interest on pledged agency securities                             | 17,055              | 9,669               | 103              | 26,827              |
| <b>Under Derivative Agreements</b>  |                     |                     |                  |                     |
| Fair value  | 28,460              | 26,194              |                  | 54,654              |
| Amortized cost  | 26,584              | 25,268              |                  | 51,852              |
| Accrued interest on pledged agency securities                             | 125                 | 70                  |                  | 195                 |
| <b>Under Prime Broker Agreements</b>                                      |                     |                     |                  |                     |
| Fair value  | 8,201               | 26,096              |                  | 34,297              |
| Amortized cost  | 8,075               | 25,914              |                  | 33,989              |
| Accrued interest on pledged agency securities                             | 35                  | 98                  |                  | 133                 |
| <b>Total Fair Value of Agency Securities Pledged and Accrued Interest</b> | <b>\$ 4,633,783</b> | <b>\$ 2,499,827</b> | <b>\$ 28,725</b> | <b>\$ 7,162,335</b> |

(1) Agency securities pledged include amounts for sold but not yet settled agency securities totaling a fair value of \$264.5 million, a cost of \$259.0 million and accrued interest of \$0.6 million as of June 30, 2010.



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(unaudited)

| Agency Securities Pledged   | As of December 31, 2009 |                     |                  | Total               |
|---|-------------------------|---------------------|------------------|---------------------|
|   | Fannie Mae              | Freddie Mac         | Ginnie Mae       |                     |
| <b>Under Repurchase Agreements</b>  |                         |                     |                  |                     |
| Fair value  | \$ 2,851,735            | \$ 1,240,830        | \$ 13,182        | \$ 4,105,747        |
| Amortized cost  | 2,821,792               | 1,207,952           | 12,843           | 4,042,587           |
| Accrued interest on pledged agency securities                             | 11,774                  | 4,799               | 62               | 16,635              |
| <b>Under Derivative Agreements</b>  |                         |                     |                  |                     |
| Fair value  | 12,719                  | 2,651               |                  | 15,370              |
| Amortized cost  | 12,409                  | 2,567               |                  | 14,976              |
| Accrued interest on pledged agency securities                             | 57                      | 12                  |                  | 69                  |
| <b>Under Prime Broker Agreements</b>                                      |                         |                     |                  |                     |
| Fair value  | 2,360                   | 13,119              |                  | 15,479              |
| Amortized cost  | 2,270                   | 13,270              |                  | 15,540              |
| Accrued interest on pledged agency securities                             | 12                      | 54                  |                  | 66                  |
| <b>Total Fair Value of Agency Securities Pledged and Accrued Interest</b> | <b>\$ 2,878,657</b>     | <b>\$ 1,261,465</b> | <b>\$ 13,244</b> | <b>\$ 4,153,366</b> |

The following table summarizes our agency securities pledged as collateral under repurchase agreements by remaining maturity as of June 30, 2010 and December 31, 2009 (in thousands):

| Remaining Maturity   | As of June 30, 2010(1) |                     |   | As of December 31, 2009 |                     |   |
|----------------------|------------------------|---------------------|---|-------------------------|---------------------|---|
|                      | Fair Value             | Amortized Cost      | Accrued Interest on Pledged Agency Securities | Fair Value              | Amortized Cost      | Accrued Interest on Pledged Agency Securities |
| 30 days or less      | \$ 5,777,234           | \$ 5,700,960        | \$ 21,882                                     | \$ 3,216,242            | \$ 3,177,975        | \$ 12,815                                     |
| 31 - 59 days         | 1,005,588              | 988,128             | 3,874   | 889,505                 | 864,612             | 3,820   |
| 60 - 90 days         | 263,407                | 257,763             | 1,071   |                         |                     |   |
| Greater than 90 days |                        |                     |   |                         |                     |   |
| <b>Total</b>         | <b>\$ 7,046,229</b>    | <b>\$ 6,946,851</b> | <b>\$ 26,827</b>                              | <b>\$ 4,105,747</b>     | <b>\$ 4,042,587</b> | <b>\$ 16,635</b>                              |

(1) Agency securities pledged include amounts for sold but not yet settled agency securities totaling a fair value of \$249.2 million, a cost of \$243.8 million and accrued interest of \$0.5 million as of June 30, 2010.

**Securizations**

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During 2009, we entered into CMO transactions whereby we transferred agency securities with a cost basis of \$831.0 million to various investment banks in exchange for cash proceeds of \$845.3 million and at the same time entered into a commitment with the same investment banks to purchase to-be-issued securities collateralized by the agency securities transferred for \$601.3 million. In each case, the investment bank contributed the transferred agency securities to a securitization trust held by either Fannie Mae or Freddie Mac in exchange for CMO securities held in the trust. Pursuant to the pre-existing commitment, the investment banks transferred to us certain of the CMO securities and interest-only strips held in the trust, typically representing the longer maturity classes, or 70 to 75 percent of the cash flows of the agency securities initially transferred by us. Our primary purpose for entering into these transactions was to reduce our exposure to short-term spikes in prepayments by holding the longer maturity classes. We typically will not receive any repayments of principal on these CMO securities until holders of securities entitled to the shorter maturity classes are repaid in full.

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All of our CMOs are backed by fixed or adjustable-rate agency securities and Fannie Mae or Freddie Mac guarantee the payment of interest and principal and act as the trustee and administrator of their respective securitization trusts. Our involvement with the trusts described above is limited to the agency securities transferred to them by the investment banks and the CMO securities subsequently held by us. As of June 30, 2010, the fair value of such CMO securities and interest-only strips was \$353.9 million. Including additional CMOs and interest-only strips purchased from third parties in separate transactions, the total fair value of our CMOs and interest-only strips was \$513.7 million as of June 30, 2010. As of December 31, 2009, the fair value of such CMO securities and interest-only strips was \$594.3 million. Including additional CMOs and interest-only strips purchased from third parties in separate transactions, the total fair value of our CMOs and interest-only strips was \$707.2 million as of December 31, 2009.

Our maximum exposure to loss as a result of our involvement with the trusts relates to the additional liquidity risk of holding CMO securities and interest-only strips in a period of severe market dislocations as compared to the underlying collateral transferred to the trusts. The maximum exposure related to this risk is the fair value of the CMO securities and interest-only strips.

**Note 5. Repurchase Agreements**

We pledge certain of our agency securities as collateral under repurchase arrangements with financial institutions, the terms and conditions of which are negotiated on a transaction-by-transaction basis. Interest rates on these borrowings are generally based on LIBOR plus or minus a margin and amounts available to be borrowed are dependent upon the fair value of the agency securities pledged as collateral, which fluctuates with changes in interest rates, type of security and liquidity conditions within the banking, mortgage finance and real estate industries. In response to declines in fair value of pledged agency securities, lenders may require us to post additional collateral or pay down borrowings to re-establish agreed upon collateral requirements, referred to as margin calls. As of June 30, 2010 and December 31, 2009, we have met all margin call requirements. Due to their short-term nature, repurchase agreements are carried at cost, which approximates fair value.

The following table summarizes our borrowings under repurchase arrangements and weighted average interest rates classified by original maturities as of June 30, 2010 and December 31, 2009 (dollars in thousands):

| Original Maturity        | As of June 30, 2010    |                       |                                   | As of December 31, 2009 |                       |                                   |
|--------------------------|------------------------|-----------------------|-----------------------------------|-------------------------|-----------------------|-----------------------------------|
|                          | Borrowings Outstanding | Average Interest Rate | Weighted Average Days to Maturity | Borrowings Outstanding  | Average Interest Rate | Weighted Average Days to Maturity |
| 30 days or less          | \$ 3,429,579           | 0.28%                 | 17                                | \$ 1,997,243            | 0.22%                 | 15                                |
| 31 - 60 days             | 1,475,854              | 0.28%                 | 22                                | 967,625                 | 0.25%                 | 20                                |
| 61 - 90 days             | 1,423,919              | 0.28%                 | 37                                | 327,945                 | 0.28%                 | 42                                |
| Greater than 90 days     | 304,990                | 0.30%                 | 55                                | 549,021                 | 0.27%                 | 52                                |
| Total / Weighted Average | \$ 6,634,342           | 0.28%                 | 24                                | \$ 3,841,834            | 0.24%                 | 24                                |

As of June 30, 2010, we did not have an amount at risk with any counterparty greater than 10% of our stockholders' equity. We do not anticipate any defaults by our repurchase agreement counterparties.

**Note 6. Derivative Instruments**

In connection with our risk management strategy, we hedge a portion of our interest rate risk by entering into derivative financial instrument contracts. We may enter into interest rate swap agreements, interest rate



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swaptions, TBA agency securities, caps, collars, floors, forward contracts, options or futures to attempt to manage the overall interest rate risk of the portfolio, reduce fluctuations in book value and generate additional income distributable to stockholders. For additional information regarding our derivative instruments and our overall risk management strategy, see discussion of derivative instruments in Note 3.

As of June 30, 2010 and December 31, 2009, our derivative instruments were comprised primarily of interest rate swaps, which have the effect of modifying the repricing characteristics of our repurchase agreements and cash flows on such liabilities. Our interest rate swaps are used to manage the interest rate risk created by our variable rate short-term repurchase agreements. Under our interest rate swaps, we typically pay a fixed-rate and receive a floating rate based on one month LIBOR with terms usually ranging up to 5 years. Our interest rate swaps are generally designated as cash flow hedges under ASC 815.

Derivative instruments entered into in addition to interest rate swap agreements are intended to supplement our use of interest rate swaps and we do not currently expect our use of these instruments to be the primary protection against interest rate risk for our portfolio. These instruments are accounted for as derivatives, but are not typically designated as hedges under ASC 815. Therefore, any changes in the fair values of the contracts prior to their settlement date are included in earnings. We do not use derivative instruments for speculative purposes.

***Derivatives Designated as Hedging Instruments***

As of June 30, 2010 and December 31, 2009, we had net interest rate swaps liabilities of \$70.1 million and \$10.5 million, respectively. The tables below summarize information about our outstanding interest rate swaps as of June 30, 2010 and December 31, 2009 (dollars in thousands):

| <b>Interest Rate Swaps Designated as Hedging Instruments</b> | <b>Balance Sheet Location</b>         | <b>June 30, 2010</b> | <b>As of December 31, 2009</b> |
|--|---------------------------------------|----------------------|--------------------------------|
| Interest rate swap assets                                    | Derivative assets, at fair value      | \$ 6                 | \$ 4,205                       |
| Interest rate swap liabilities                               | Derivative liabilities, at fair value | (70,124)             | (14,719)                       |
|  |                                       | \$ (70,118)          | \$ (10,514)                    |

| <b>Remaining Interest Rate Swap Term</b>  | <b>Notional Amount</b> | <b>Average Fixed Pay Rate</b> | <b>As of June 30, 2010</b>  |                                 |                                 |
|---|------------------------|-------------------------------|-----------------------------|---------------------------------|---------------------------------|
|   |                        |                               | <b>Average Receive Rate</b> | <b>Net Estimated Fair Value</b> | <b>Average Maturity (Years)</b> |
| 1 year or less                            | \$ 250,000             | 1.51%                         | 0.35%                       | \$ (2,367)                      | 1.0                             |
| Greater than 1 year and less than 3 years | 1,700,000              | 1.81%                         | 0.35%                       | (33,792)                        | 2.1                             |

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|  |              |       |       |             |     |
|--|--------------|-------|-------|-------------|-----|
| Greater than 3 years and less than 5 years | 1,050,000    | 2.39% | 0.35% | (33,959)    | 4.2 |
| Greater than 5 years                       |              |       |       |             |     |
| Total                                      | \$ 3,000,000 | 1.99% | 0.35% | \$ (70,118) | 2.7 |

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

| Remaining Interest Rate Swap Term          | As of December 31, 2009 |                        |                      |                          |                          |
|--|-------------------------|------------------------|----------------------|--------------------------|--------------------------|
|  | Notional Amount         | Average Fixed Pay Rate | Average Receive Rate | Net Estimated Fair Value | Average Maturity (Years) |
| 1 year or less                             | \$                      |                        |                      | \$                       |                          |
| Greater than 1 year and less than 3 years  | 1,500,000               | 1.71%                  | 0.23%                | (9,681)                  | 2.2                      |
| Greater than 3 years and less than 5 years | 550,000                 | 2.71%                  | 0.23%                | (833)                    | 4.5                      |
| Greater than 5 years                       |                         |                        |                      |                          |                          |
| <b>Total</b>                               | <b>\$ 2,050,000</b>     | <b>1.98%</b>           | <b>0.23%</b>         | <b>\$ (10,514)</b>       | <b>2.8</b>               |

The following table summarizes information about our outstanding interest rate swaps designated as hedging instruments for the three and six month periods ended June 30, 2010 and 2009 (in thousands):

| Interest Rate Swaps Designated as Hedging Instruments | Beginning       |            |              | Ending Notional Amount | Termination Fee |
|---|-----------------|------------|--------------|------------------------|-----------------|
|   | Notional Amount | Additions  | Terminations |                        |                 |
| Three months ended June 30, 2010                      | \$ 2,350,000    | \$ 650,000 | \$           | \$ 3,000,000           |                 |
| Three months ended June 30, 2009                      | \$ 700,000      | \$ 600,000 | \$ (350,000) | \$ 950,000             | \$ 9,969        |
| Six months ended June 30, 2010                        | \$ 2,050,000    | \$ 950,000 | \$           | \$ 3,000,000           |                 |
| Six months ended June 30, 2009                        | \$ 650,000      | \$ 850,000 | \$ (550,000) | \$ 950,000             | \$ 16,417       |

The net settlements for terminated swaps were amortized into earnings over the remaining life of the terminated interest rate swaps and included in interest expense on our consolidated statements of operations and comprehensive income. Amortization expense for the terminated swaps was \$2.6 million and \$2.7 million for the three months ended June 30, 2010 and 2009, respectively, and \$6.3 million and \$3.0 million for the six months ended June 30, 2010 and 2009, respectively. As of June 30, 2010, there was no remaining unamortized costs associated with terminated swaps.

During the three months ended June 30, 2010 and 2009, we recorded no losses as a result of the reclassification from OCI of hedged forecasted transactions becoming probable not to occur. During the six months ended June 30, 2010, we recorded no losses and during the six months ended June 30, 2009, we recorded losses of \$1.0 million as a result of the reclassification from OCI of hedged forecasted transactions becoming probable not to occur.

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## AMERICAN CAPITAL AGENCY CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

The table below summarizes the effect of interest rate swaps designated as hedges under ASC 815 on our income statement for the three and six months ended June 30, 2010 and 2009 (in thousands):

|                                       | Derivatives<br>in Cash Flow<br>Hedging<br>Relationships | Amount of<br>Gain or (Loss)<br>Recognized<br>in<br>OCI<br>(Effective<br>Portion) | Location of Gain<br>or (Loss)<br>Reclassified from<br>OCI into<br>Earnings<br>(Effective<br>Portion) | Amount of<br>Gain or<br>(Loss)<br>Reclassified<br>from OCI<br>into<br>Earnings<br>(Effective<br>Portion) | Location of<br>Gain or (Loss)<br>Recognized in<br>Earnings (Ineffective<br>Portion and Amount<br>Excluded from<br>Effectiveness<br>Testing) | Amount of<br>Gain or (Loss)<br>Recognized<br>in Earnings<br>(Ineffective<br>Portion and<br>Amount<br>Excluded<br>from<br>Effectiveness<br>Testing) |
|---------------------------------------|---|--|--|--|---|--|
| Three months ended June 30,<br>2010   | Interest rate<br>swaps                                  | \$ (42,271)  | Interest Expense   | \$ (13,744)  | Loss (gain) on derivative<br>instruments and trading<br>securities, net   | \$ (123)   |
| Three months ended June 30,<br>2009   | Interest rate<br>swaps                                  | \$ 8,530   | Interest Expense   | \$ (6,394)   | Loss (gain) on derivative<br>instruments and trading<br>securities, net   | \$ 130   |
| Six months ended June 30,<br>2010     | Interest rate<br>swaps                                  | \$ (59,605)  | Interest Expense   | \$ (27,071)  | Loss (gain) on derivative<br>instruments and trading<br>securities, net   | \$ (314)   |
| Six months ended June 30,<br>2009 (1) | Interest rate<br>swaps                                  | \$ 6,748   | Interest Expense   | \$ (10,455)  | Loss (gain) on derivative<br>instruments and trading<br>securities, net   | \$ 716   |

(1) This amount excludes \$1.0 million for the six months ended June 30, 2009, recorded as a loss in gain (loss) on derivative instruments and trading securities, net in our consolidated statement of operations and comprehensive income as a result of the reclassification from OCI of hedged forecasted transactions becoming probable not to occur.

The amount of net interest expense expected to flow through our statement of operations over the next twelve months due to expected net settlements on our interest rate swaps is \$42.4 million.

Additionally, during the three and six months ended June 30, 2010, we entered into forward commitments of \$80.0 million and \$146.3 million notional value, respectively, to purchase specified agency securities that were designated as all-in-one cash flow hedges pursuant to ASC 815. The all-in-one cash flow hedges had gross and net unrealized appreciation (or a net asset) of \$0.6 million as of June 30, 2010. The amount of net gains recognized in OCI for the three and six months ended June 30, 2010 was \$0.6 million, which will be reclassified to OCI for available-for-sale securities upon the physical settlement of the all-in-one cash flow hedges. We did not enter into any forward commitments during the three and six months ended June 30, 2009.



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## AMERICAN CAPITAL AGENCY CORP.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(unaudited)

*Derivatives Not Designated as Hedging Instruments*

As of June 30, 2010, we had contracts to purchase and sell TBA agency securities and specified agency securities on a forward basis with notional amounts of \$181.1 million for the purchase of securities and \$270.0 million for the sale of securities. As of December 31, 2009, we had contracts to purchase and sell TBA agency securities and specified agency securities on a forward basis with notional amounts of \$596.5 million for the purchase of securities and \$616.7 million for the sale of securities.

As of June 30, 2010, our interest rate swaption agreements outstanding consisted of \$200.0 million in notional amount of options to enter into interest rate swaps in the future where we would pay a fixed rate ( Payer Swaptions ) and \$300.0 million in notional amount of options to enter into interest rate swaps in the future where we would receive a fixed rate ( Receiver Swaptions ) as summarized in the table below (dollars in thousands):

| Swaption | Cost     | Option<br>Fair<br>Value | Average<br>Months to<br>Expiration | As of June 30, 2010 |          |   |                            |  |
|----------|----------|-------------------------|------------------------------------|---------------------|----------|---|----------------------------|--|
|          |          |                         |                                    | Notional<br>Amount  | Pay Rate | Underlying Swap<br>Average<br>Receive<br>Rate | Average<br>Term<br>(Years) |  |
| Payer    | \$ 2,148 | \$ 7                    | 4                                  | \$ 200,000          | 4.23%    | 1M Libor                                      | 5                          |  |
| Receiver | 1,440    | 3,734                   | 3                                  | 300,000             | 1M Libor | 2.42%   | 6.7                        |  |
|          | \$ 3,588 | \$ 3,741                |                                    | \$ 500,000          |          |   |                            |  |

As of December 31, 2009, our interest rate swaption agreements outstanding consisted of \$200 million in notional amount of options to enter into Payer Swaptions and \$100 million in notional amount of options to enter into Receiver Swaptions as summarized in the table below (dollars in thousands):

| Swaption | Cost     | Option<br>Fair<br>Value | Months to<br>Expiration | As of December 31, 2009 |          |                                    |                 |  |
|----------|----------|-------------------------|-------------------------|-------------------------|----------|------------------------------------|-----------------|--|
|          |          |                         |                         | Notional<br>Amount      | Pay Rate | Underlying Swap<br>Receive<br>Rate | Term<br>(Years) |  |
| Payer    | \$ 2,148 | \$ 2,389                | 10                      | \$ 200,000              | 4.23%    | 1M Libor                           | 5               |  |
| Receiver | 243      | 169                     | 2                       | 100,000                 | 1M Libor | 2.54%                              | 5               |  |
|          | \$ 2,391 | \$ 2,558                |                         | \$ 300,000              |          |                                    |                 |  |



**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

The table below summarizes information about our derivatives outstanding that were not designated as hedging instruments as of June 30, 2010 and December 31, 2009 (in thousands):

| <b>Derivatives Not Designated as Hedging Instruments</b> | <b>Balance Sheet Location</b>         | <b>June 30, 2010</b> | <b>As of<br/>December 31, 2009</b> |
|--|---------------------------------------|----------------------|------------------------------------|
| Purchase of TBA and forward settling agency securities   | Derivative assets, at fair value      | \$ 2,194             | \$ 172                             |
| Sale of TBA and forward settling agency securities       | Derivative assets, at fair value      | 824                  | 5,025                              |
| Payer Swaptions  | Derivative assets, at fair value      | 7                    | 2,389                              |
| Receiver Swaptions                                       | Derivative assets, at fair value      | 3,734                | 169                                |
|  |                                       | <b>\$ 6,759</b>      | <b>\$ 7,755</b>                    |
| Purchase of TBA and forward settling agency securities   | Derivative liabilities, at fair value | \$                   | \$ (3,069)                         |
| Sale of TBA and forward settling agency securities       | Derivative liabilities, at fair value | (6,096)              | (10)                               |
|  |                                       | <b>\$ (6,096)</b>    | <b>\$ (3,079)</b>                  |
|  |                                       | <b>\$ 663</b>        | <b>\$ 4,676</b>                    |

During the three and six months ended June 30, 2010 we recorded a loss of \$14.2 million and \$10.1 million, respectively, in gain (loss) on derivative instruments and trading securities, net in our consolidated statement of operations and comprehensive income for derivatives not designated as hedging instruments under ASC 815.

The tables below summarize the effect of derivative instruments not designated as hedges under ASC 815 on our income statement for the three and six months ended June 30, 2010 (in thousands):

| <b>Derivatives Not Designated as Hedging Instruments</b> | <b>Notional Amount</b>      |                  | <b>Settlement, Expiration or Exercise</b> | <b>Notional Amount as of June 30, 2010</b> | <b>Amount Recognized in (Loss) Gain on Derivative Instruments and Trading Securities, Net</b> |
|--|-----------------------------|------------------|---|--|---|
|  | <b>as of March 31, 2010</b> | <b>Additions</b> |   |  |   |
| Purchase of TBA and forward settling agency securities   | \$ 184,668                  | 253,213          | (256,739)                                 | \$ 181,142                                 | \$ 8,196  |
| Sale of TBA and forward settling agency securities       | \$ 335,000                  | 1,851,094        | (1,916,094)                               | \$ 270,000                                 | (23,623)  |
| Payer Swaptions  | \$ 200,000                  |                  |   | \$ 200,000                                 | (591)   |
| Receiver Swaptions                                       | \$ 100,000                  | 200,000          |   | \$ 300,000                                 | 2,502   |



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|                     |    |        |          |          |       |          |
|---------------------|----|--------|----------|----------|-------|----------|
| Put Options         | \$ | 75,000 | (75,000) | \$       | (365) |          |
| Interest rate swaps | \$ |        | 50,000   | (50,000) | \$    | (280)    |
|                     |    |        |          |          | \$    | (14,161) |

**Table of Contents****AMERICAN CAPITAL AGENCY CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

| <b>Derivatives Not Designated as Hedging<br/>Instruments</b> | <b>Notional Amount<br/>as of<br/>December 31, 2009</b> |         | <b>Additions</b> | <b>Settlement,<br/>Expiration<br/>or Exercise</b> | <b>Notional Amount<br/>as of<br/>June 30, 2010</b> |         | <b>Amount<br/>Recognized in<br/>(Loss) Gain on<br/>Derivative Instruments<br/>and Trading<br/>Securities, Net</b> |
|--|--|---------|------------------|---|--|---------|---|
| Purchase of TBA and forward settling agency securities       | \$   | 596,516 | 1,089,089        | (1,504,463)                                       | \$   | 181,142 | \$ 12,434   |
| Sale of TBA and forward settling agency securities           | \$   | 616,747 | 2,817,260        | (3,164,007)                                       | \$   | 270,000 | (20,877)  |
| Payer Swaptions  | \$   | 200,000 |                  |   | \$   | 200,000 | (2,382)   |
| Receiver Swaptions   | \$   | 100,000 | 300,000          | (100,000)   | \$   | 300,000 | 2,126   |
| Put Options  | \$   |         | 75,000           | (75,000)  | \$   |         | (328)   |
| Interest rate swaps  | \$   |         | 150,000          | (150,000)   | \$   |         | (1,111)   |
|  |  |         |                  |   |  |         | \$ (10,138)   |

- (1) This amount excludes \$8.5 million recorded as a loss for interest-only strips re-measured at fair value through earnings, a loss of \$0.1 million for hedge ineffectiveness on our outstanding interest rate swaps and a gain of \$1.4 million from trading securities in (loss) gain on derivative instruments and trading securities, net in our consolidated statements of operations and comprehensive for the three months ended June 30, 2010.
- (2) This amount excludes \$6.4 million recorded as a loss for interest-only strips re-measured at fair value through earnings, a loss of \$0.3 million for hedge ineffectiveness on our outstanding interest rate swaps and a gain of \$1.4 million from trading securities in (loss) gain on derivative instruments and trading securities, net in our consolidated statements of operations and comprehensive for the six months ended June 30, 2010.

During the three months ended June 30, 2009 we recorded a gain of \$1.1 million, in (loss) gain on derivative instruments and trading securities, net in our consolidated statement of operations and comprehensive income for derivatives not designated as hedging instruments under ASC 815. There were no derivative instruments not designated as hedges under ASC 815 during the three months ended March 31, 2009.

The table below summarizes the effect of derivative instruments not designated as hedges under ASC 815 on our income statement for the six months ended June 30, 2009 (in thousands):

| <b>Derivatives Not Designated as Hedging<br/>Instruments</b> | <b>Notional<br/>Amount<br/>as of<br/>December 31, 2008</b> |  | <b>Additions</b> | <b>Settlement,<br/>Expiration<br/>or Exercise</b> | <b>Notional Amount<br/>as of<br/>June 30, 2009</b> |        | <b>Amount of Gain/(Loss)<br/>Recognized in Income<br/>on Derivatives(1)</b> |
|--|--|--|------------------|---|--|--------|---|
| Sale of TBA and forward settling agency securities           | \$   |  | 350,000          | (275,000)   | \$   | 75,000 | \$ 1,101  |

- (1) This amount excludes a net loss of \$0.2 million for hedge ineffectiveness and missed forecasts on our outstanding interest rate swaps in (loss) gain on derivative instruments and trading securities, net in our consolidated statements of operations and comprehensive for the six months ended June 30, 2009.

*Credit Risk-Related Contingent Features*

The use of derivatives creates exposure to credit risk relating to potential losses that could be recognized in the event that the counterparties to these instruments fail to perform their obligations under the contracts. We minimize this risk by limiting our counterparties to major financial institutions with acceptable credit ratings and monitoring positions with individual counterparties. In addition, we may be required to pledge assets as collateral for our derivatives whose amounts vary over time based on the market value, notional amount and remaining term of the derivative contract. In the event of a default by a counterparty we may not receive payments provided for under the terms of our derivative agreement, and may have difficulty obtaining our assets pledged as

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**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

collateral for our derivatives. We do not anticipate any defaults by our derivative counterparties. The cash and cash equivalents and agency securities pledged as collateral for our derivative instruments is included in restricted cash and agency securities, respectively, on our consolidated balance sheets.

Each of our ISDA Master Agreements contains provisions under which we are required to fully collateralize our obligations under the interest rate swap instrument if at any point the fair value of the interest rate swap represents a liability greater than the minimum transfer amount contained within our agreements. We were also required to post initial collateral upon execution of certain of our interest rate swap transactions. If we breach any of these provisions we will be required to settle our obligations under the agreements at their termination values.

Further, each of our ISDA Master Agreements also contains a cross default provision under which a default under certain of our other indebtedness in excess of a certain threshold causes an event of default under the agreement. Threshold amounts range from \$10 million to \$25 million. Following an event of default, we could be required to settle our obligations under the agreements at their termination values. Additionally, under certain of our ISDA Master Agreements, we could be required to settle our obligations under the agreements at their termination values if we fail to maintain certain minimum shareholders' equity thresholds or our REIT status or comply with limits on our leverage above certain specified levels.

As of June 30, 2010, the fair value of our interest rate swaps in a liability position related to these agreements was \$70.1 million. We had agency securities with fair values of \$54.7 million, and cash and cash equivalents of \$34.3 million, or \$89.0 million in total agency securities and cash and cash equivalents, pledged as collateral against our interest rate swaps as of June 30, 2010. Termination values of interest rate swaps in a liability position totaled \$71.4 million as of June 30, 2010. The difference between the fair value liability and the termination liability represents accrued interest and an adjustment for nonperformance risk of us and our counterparties.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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**Note 7. Fair Value Measurements**

FASB ASC Topic 820, *Fair Value Measurements and Disclosures* ( ASC 820 ) defines fair value, establishes a framework for measuring fair value and establishes a three-level valuation hierarchy for disclosure of fair value measurement. The valuation hierarchy is based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument's categorization within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The three levels of hierarchy established by ASC 820 are defined as follows:

Level 1 Inputs Quoted prices (unadjusted) for identical unrestricted assets and liabilities in active markets that are accessible at the measurement date.

Level 2 Inputs Quoted prices for similar assets and liabilities 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 Instruments with primarily unobservable market data that cannot be corroborated.

There were no transfers between hierarchy levels during the six months ended June 30, 2010 and 2009.

***Repurchase Agreements***

Due to their short-term nature, repurchase agreements are carried at cost, which approximates fair value.

***Agency Securities***

Agency securities are valued based on a market approach using Level 2 Inputs from third-party pricing services and dealer quotes. The third-party pricing services use pricing models that incorporate such factors as coupons, primary and secondary mortgage rates, prepayment speeds, spread to the Treasury and interest rate swap curves, convexity, duration, periodic and life caps and credit enhancement. The dealer

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quotes incorporate common market pricing methods, including a spread measurement to the Treasury or interest rate swap curve as well as underlying characteristics of the particular security including coupon, periodic and life caps, rate reset period, issuer, additional credit support and expected life of the security. Management reviews the fair values determined by the third-party pricing models and dealer quotes and compares the results, if available, to values from the repurchase agreement counterparties and internal pricing models on each investment to validate reasonableness.

### *Derivative Instruments*

Interest rate swaps and swaptions are valued based on an income and market approach using Level 2 Inputs from a third-party pricing model. The third-party pricing model incorporates such factors as the Treasury curve, LIBOR rates, the pay rate on the interest rate swaps and, in the case of interest rate swaptions, on the future

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**AMERICAN CAPITAL AGENCY CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

interest rate swap that we have the option to enter into as well as the remaining length of time we have to exercise the option. We also incorporate both our own and our counterparties' nonperformance risk in estimating the fair value of our interest rate swap and swaption agreements. In considering the effect of nonperformance risk, we considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and have concluded that our own and our counterparty risk is not significant to the overall valuation of these agreements.

Contracts to purchase or sell TBA securities and specified agency securities on a forward basis and options to purchase or sell TBA securities are valued using Level 2 Inputs at June 30, 2010 and December 31, 2009 based on a market approach using the same methods to value agency securities described above.

**Note 8. Stockholders' Equity**

***Equity Offering***

In May 2010, we completed a public offering in which 6.9 million shares of our common stock, including the over-allotment option, were sold at a public offering price of \$25.75 per share. Upon completion of the offering we received proceeds, net of underwriters' discount and other offering costs, of approximately \$169.0 million.

***Dividend Reinvestment and Direct Stock Purchase Plan***

We sponsor a dividend reinvestment and direct stock purchase plan through which stockholders may purchase additional shares of our common stock by reinvesting some or all of the cash dividends received on shares of our common stock. Stockholders may also make optional cash purchases of shares of our common stock subject to certain limitations detailed in the plan prospectus. We did not issue any shares under the plan during the three months ended June 30, 2010. During the three months ended March 31, 2010, we issued approximately 2.4 million shares under the plan for cash proceeds of \$62.1 million. We did not issue any shares under the plan prior to December 31, 2009. As of June 30, 2010 and December 31, 2009, there were approximately 10.6 million and 3.0 million shares available for issuance under this plan, respectively.

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

Management's Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) is designed to provide a reader of American Capital Agency Corp.'s consolidated financial statements with a narrative from the perspective of management. Our MD&A is presented in five sections:

Executive Overview

Financial Condition

Results of Operations

Liquidity and Capital Resources

Forward-Looking Statements

## **EXECUTIVE OVERVIEW**

American Capital Agency Corp. (together with its consolidated subsidiary, is referred throughout this report as the *Company* , *we* , *us* and *our* ) is a real estate investment trust ( REIT ) that invests exclusively in residential mortgage pass-through securities and collateralized mortgage obligations on a leveraged basis. These investments consist of securities for which principal and interest are guaranteed by government-sponsored entities such as the Federal National Mortgage Association ( *Fannie Mae* ) and the Federal Home Loan Mortgage Corporation ( *Freddie Mac* ), or by a U.S. Government agency such as the Government National Mortgage Association ( *Ginnie Mae* ). We refer to these types of securities as agency securities and the specific agency securities in which we invest as our investment portfolio.

We were organized on January 7, 2008, and commenced operations on May 20, 2008 following the completion of our IPO. Our common stock is traded on The NASDAQ Global Select Market under the symbol *AGNC* .

We are externally managed by American Capital Agency Management, LLC (our *Manager* ). Our Manager is a wholly-owned subsidiary of American Capital, LLC, which is a wholly-owned portfolio company of American Capital. We do not have any employees.

Our principal objective is to generate net income for distribution to our stockholders through regular quarterly dividends from our net interest income, which is the spread between the interest income earned on our investment portfolio and the interest costs of our borrowings and hedging activities, and realized gains on our investments. We fund our investments through short-term borrowings structured as repurchase agreements. Since our IPO, we have declared or paid dividends of \$10.46 per share.



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We have elected to be taxed as a REIT under the Internal Revenue Code of 1986, as amended (the Code ). As long as we qualify as a REIT, we generally will not be subject to federal income taxes on our taxable income to the extent that we annually distribute all of our taxable income to stockholders.

### *Our Manager*

We are externally managed and advised by our Manager pursuant to the terms of a management agreement. Because we have no employees or separate facilities, we rely on our Manager to administer our business activities and day-to-day operations, subject to the supervision and oversight of our Board of Directors. Our Manager is a subsidiary of a wholly-owned portfolio company of American Capital. American Capital is a publicly traded private equity firm and global asset manager. American Capital, both directly and through its asset management business, originates, underwrites and manages investments in middle market private equity, leveraged finance, real estate and structured products. Founded in 1986, American Capital has \$15 billion in capital resources under management, as of June 30, 2010, and eight offices in the U.S., Europe and Asia. Gary Kain is the President of our Manager and also serves as our Senior Vice President and Chief Investment Officer.

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### *Our Investment Strategy*

Our investment strategy is to manage an investment portfolio consisting exclusively of agency securities (other than for hedging purposes) that seeks to generate attractive, risk-adjusted returns. Our Manager has established an investment committee comprised of certain of its officers. The investment committee has established investment guidelines, certain of which have been approved by our Board of Directors. The investment committee can change those investment guidelines at any time with the approval of our Board of Directors. The following are our investment guidelines approved by our Board of Directors:

no investment shall be made in any non-agency securities (other than for hedging purposes);

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

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

prior to entering into any proposed investment transaction with American Capital or any of its affiliates, a majority of our independent directors must approve the terms of the transaction.

Agency securities consist of residential pass-through certificates and collateralized mortgage obligations for which the principal and interest are guaranteed by a U.S. Government agency or a U.S. Government sponsored entity.

***Residential Pass-Through Certificates.*** Residential pass-through certificates are securities representing interests in pools of mortgage loans secured by residential real property where payments of both interest and principal, plus pre-paid principal, on the securities are made monthly to holders of the securities, in effect passing through monthly payments made by the individual borrowers on the mortgage loans that underlie the securities, net of fees paid to the issuer/guarantor and servicers of the securities. Holders of the securities also receive guarantor advances of principal and interest for delinquent loans in the mortgage pools.

***Collateralized Mortgage Obligations.*** CMOs are structured instruments representing interests in residential pass-through certificates. CMOs consist of multiple classes of securities, with each class having specified characteristics, including stated maturity dates, weighted average lives and rules governing principal and interest distribution. Monthly payments of interest and principal, including prepayments, are typically returned to different classes based on rules described in the trust documents. Principal and interest payments may also be divided between holders of different securities in the CMO and some securities may only receive interest payments while others receive only principal payments.

These securities are collateralized by pools of fixed-rate mortgage loans ( FRMs ), adjustable-rate mortgage loans ( ARMs ) or hybrid ARMs. Hybrid ARMs are mortgage loans that have interest rates that are fixed for an initial period (typically three, five, seven or 10 years) and, thereafter, reset at regular intervals subject to interest rate caps. Our allocation of investments among securities collateralized by FRMs, ARMs or hybrid ARMs will depend on our assessment of the relative value of the securities, which will be based on numerous factors including, but not limited to, expected future prepayment trends, supply and demand, costs of financing, costs of hedging, expected future interest rate volatility and the overall shape of the U.S. Treasury and interest rate swap yield curves.

As of June 30, 2010, our \$7.2 billion investment portfolio was financed with \$6.6 billion of repurchase agreements and \$0.8 billion of equity capital, resulting in a leverage ratio of approximately 8.4 times our stockholders' equity. When adjusted for net payables and receivables for

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unsettled agency securities, the leverage ratio was approximately 8.2 times our stockholders' equity as of June 30, 2010. Financing spreads (the difference between yields on our investments and rates on related borrowings, including amortization expense related to terminated swaps) averaged 218 basis points and 216 basis points, respectively, for the three and six months ended June 30, 2010.

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

### ***Our Active Portfolio Management Strategy***

Our Manager employs on our behalf an active management strategy to achieve our principal objectives of generating attractive risk-adjusted returns and preserving our net asset value. Our active management strategy involves buying and selling securities in all sectors of the agency securities market, including fixed-rate agency securities, adjustable-rate agency securities, options on agency securities, interest-only strips and agency CMOs, based on our Manager's continual assessment of the relative value and risk and return of these securities. Therefore, the composition of our portfolio will vary as our Manager believes changes to market conditions, risks and valuations warrant. Consequently, we may experience investment gains or losses when we sell securities that our Manager no longer believes provide attractive risk-adjusted returns or when our Manager believes more attractive alternatives are available in the agency security market. We may also experience fluctuations in leverage as we pursue our active management strategy, but we generally would expect our leverage to be within six to eleven times the amount of our stockholders' equity.

### ***Our Financing Strategy***

As part of our investment strategy, we leverage our investment portfolio pursuant to master repurchase agreements. A repurchase transaction acts as a financing arrangement under which we effectively pledge our agency securities as collateral to secure a short-term loan. Our borrowings pursuant to these repurchase transactions generally have maturities that range from 30 to 90 days, but may have maturities of less than 30 days or up to 364 days. Our leverage may vary periodically depending on market conditions and our assessment of risk and returns. We generally would expect our leverage to be within six to eleven times the amount of our stockholders' equity. However, under certain market conditions, we may operate at leverage levels outside of this range for extended periods of time. We also cannot assure you that we will continue to be successful in borrowing sufficient amounts to fund our intended acquisitions of agency securities.

### ***Our Hedging Strategy***

As part of our risk management strategy, we may hedge our exposure to interest rate and prepayment risk as our Manager determines is in our best interest given our investment strategy, the cost of the hedging transactions and our intention to qualify as a REIT. As a result, we may elect to bear a level of interest rate or prepayment risk that could otherwise be hedged when our Manager believes, based on all relevant facts, that bearing the risk enhances our risk/return profile. Our Manager designs an interest rate risk management program consistent with its outlook for the market to attempt to mitigate the impact of changes in interest rates on our investment portfolio and related borrowings. We may enter into interest rate swap agreements, interest rate swaptions, caps, collars, floors, forward contracts, options or futures to attempt to manage the overall interest rate risk of the portfolio, reduce fluctuations in book value and generate additional income distributable to stockholders.

### ***Our Option Strategy***

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As part of our risk management strategy, we may purchase or sell TBA securities or purchase or write put or call options on TBA securities as a method of insulating our stockholders' equity and enhancing our risk/return profile. Our Manager implements this strategy based upon overall market conditions, the level of volatility in the mortgage market, size of our agency securities portfolio, notional value of our swap positions outstanding and our intention to qualify as a REIT.

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**Summary of Critical Accounting Policies**

Our critical accounting policies relate to investment accounting, revenue recognition, securities valuation, derivative accounting and income taxes. Each of these items involves estimates that will require management to make judgments that are subjective in nature. We rely on our Manager's experience and analysis of historical and current market data in order to arrive at what we believe to be reasonable estimates. Under different conditions, we could report materially different amounts using these critical accounting policies. All of our critical accounting policies are fully described in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2009.

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**FINANCIAL CONDITION**

As of June 30, 2010 and December 31, 2009, our investment portfolio consisted of \$7.2 billion and \$4.3 billion, respectively, of agency securities. The following tables summarize certain characteristics of our investment portfolio as of June 30, 2010 (dollars in thousands):

|   | Par Value           | Amortized Cost      | As of June 30, 2010  |                     | Weighted Average |              |
|---|---------------------|---------------------|----------------------|---------------------|------------------|--------------|
|   |                     |                     | Amortized Cost Basis | Fair Value          | Coupon           | Yield(1)     |
| <b>Available-For-Sale Agency Securities:</b>                          |                     |                     |                      |                     |                  |              |
| Fannie Mae  | \$ 4,236,720        | \$ 4,412,952        | 104.2%               | \$ 4,485,699        | 4.88%            | 3.52%        |
| Freddie Mac   | 2,344,925           | 2,471,182           | 105.4%               | 2,495,066           | 5.15%            | 3.09%        |
| Ginnie Mae  | 149,147             | 154,825             | 103.8%               | 155,629             | 4.02%            | 2.67%        |
| <b>Total / Weighted Average Available- For-Sale Agency Securities</b> | <b>\$ 6,730,792</b> | <b>\$ 7,038,959</b> | <b>104.6%</b>        | <b>\$ 7,136,394</b> | <b>4.95%</b>     | <b>3.35%</b> |
| <b>Fixed-Rate</b>   |                     |                     |                      |                     |                  |              |
| Fixed-Rate  | \$ 2,888,108        | \$ 3,007,722        | 104.1%               | \$ 3,063,016        | 4.95%            | 3.96%        |
| <b>Adjustable-Rate</b>  |                     |                     |                      |                     |                  |              |
| Adjustable-Rate   | 3,381,009           | 3,556,961           | 105.2%               | 3,589,711           | 5.05%            | 2.82%        |
| <b>CMO</b>  |                     |                     |                      |                     |                  |              |
| CMO   | 461,675             | 474,276             | 102.7%               | 483,667             | 4.27%            | 3.48%        |
| <b>Total / Weighted Average Available- For-Sale Securities</b>        | <b>\$ 6,730,792</b> | <b>\$ 7,038,959</b> | <b>104.6%</b>        | <b>\$ 7,136,394</b> | <b>4.95%</b>     | <b>3.35%</b> |

|   | Underlying Unamortized Principal Balance | Amortized Cost   | As of June 30, 2010 |              | Weighted Average |  |
|---|--|------------------|---------------------|--------------|------------------|--|
|   |  |                  | Fair Value          | Coupon       | Yield(1)         |  |
|   |  |                  |                     |              |                  |  |
| <b>Agency Securities Remeasured at Fair Value Through Earnings:</b>                         |  |                  |                     |              |                  |  |
| <b>Interest-Only Strips</b>   |  |                  |                     |              |                  |  |
| Fannie Mae  | \$ 134,706                               | \$ 15,616        | \$ 13,093           | 3.65%        | 7.66%            |  |
| Freddie Mac   | 234,704                                  | 21,318           | 16,903              | 3.75%        | 18.05%           |  |
| <b>Total / Weighted Average Agency Securities Remeasured at Fair Value Through Earnings</b> | <b>\$ 369,410</b>                        | <b>\$ 36,934</b> | <b>\$ 29,996</b>    | <b>3.71%</b> | <b>13.66%</b>    |  |

Interest-only strips represent the right to receive a specified portion of the contractual interest flows of the underlying unamortized principal balance of specific CMO securities. The interest cash flows from our interest-only strips taken together with interest cash flows from our fixed-rate, adjustable-rate and CMO securities, total 5.16% of the combined par value our agency securities (excluding the underlying unamortized principal balance of our interest-only strips) as of June 30, 2010. The combined weighted average yield of our agency portfolio was 3.40% as of June 30, 2010.

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The following table summarizes certain characteristics of our investment portfolio as of December 31, 2009 (dollars in thousands):

|  | As of December 31, 2009 |                     |                      |                     |                         |                           |
|--|-------------------------|---------------------|----------------------|---------------------|-------------------------|---------------------------|
|  | Par Value               | Amortized Cost      | Amortized Cost Basis | Fair Value          | Weighted Average Coupon | Weighted Average Yield(1) |
| <b>Available-For-Sale Securities:</b>                          |                         |                     |                      |                     |                         |                           |
| Fannie Mae   | \$ 2,853,278            | \$ 2,952,895        | 103.5%               | \$ 2,983,310        | 5.26%                   | 4.20%                     |
| Freddie Mac  | 1,248,698               | 1,298,360           | 104.0%               | 1,303,623           | 5.31%                   | 3.50%                     |
| Ginnie Mae   | 12,456                  | 12,842              | 103.1%               | 13,182              | 6.00%                   | 5.33%                     |
| <b>Total / Weighted Average Available- For-Sale Securities</b> | <b>\$ 4,114,432</b>     | <b>\$ 4,264,097</b> | <b>103.6%</b>        | <b>\$ 4,300,115</b> | <b>5.28%</b>            | <b>3.99%</b>              |
| <b>Available-For-Sale Securities:</b>                          |                         |                     |                      |                     |                         |                           |
| Fixed-Rate   | \$ 1,806,559            | \$ 1,863,261        | 103.1%               | \$ 1,887,404        | 5.40%                   | 4.77%                     |
| Adjustable-Rate  | 1,625,477               | 1,699,513           | 104.6%               | 1,705,487           | 5.17%                   | 3.18%                     |
| CMO  | 682,396                 | 701,323             | 102.8%               | 707,224             | 5.23%                   | 3.90%                     |
| <b>Total / Weighted Average Available- For-Sale Securities</b> | <b>\$ 4,114,432</b>     | <b>\$ 4,264,097</b> | <b>103.6%</b>        | <b>\$ 4,300,115</b> | <b>5.28%</b>            | <b>3.99%</b>              |

(1) Average yield incorporates future prepayment assumptions based on the forward yield curve.

As of June 30, 2010 and December 31, 2009, we held fixed-rate pass-through agency securities, pass-through agency securities collateralized by ARMs and hybrid ARMs, with coupons linked to various indices, and CMOs. The following tables detail the characteristics of our ARMs and hybrid ARMs portfolio by index as of June 30, 2010 and December 31, 2009 (dollars in thousands):

|   | As of June 30, 2010 |                |                   |                               | As of December 31, 2009 |                |                   |                               |
|---|---------------------|----------------|-------------------|-------------------------------|-------------------------|----------------|-------------------|-------------------------------|
|   | Six-Month Libor     | One-Year Libor | One-Year Treasury | Twelve-Month Treasury Average | Six-Month Libor         | One-Year Libor | One-Year Treasury | Twelve-Month Treasury Average |
| Weighted average term to next reset (months)    | 51                  | 78             | 66                | 38                            | 56                      | 69             | 54                | 41                            |
| Weighted average margin                         | 1.56%               | 1.77%          | 2.08%             | 1.83%                         | 1.60%                   | 1.72%          | 2.24%             | 1.83%                         |
| Weighted average annual period cap              | 1.16%               | 2.00%          | 1.74%             | 1.00%                         | 1.20%                   | 2.00%          | 2.00%             | 1.00%                         |
| Weighted average lifetime cap                   | 10.67%              | 10.04%         | 10.20%            | 10.13%                        | 10.65%                  | 10.28%         | 10.22%            | 10.12%                        |
| Principal amount                                | \$ 115,797          | \$ 2,440,147   | \$ 555,608        | \$ 269,456                    | \$ 123,088              | \$ 750,375     | \$ 467,996        | \$ 284,018                    |
| Percentage of investment portfolio at par value | 2%                  | 36%            | 8%                | 4%                            | 3%                      | 18%            | 11%               | 7%                            |

The following tables detail the number of months to the next reset for our pass-through securities collateralized by ARMs and hybrid ARMs as of June 30, 2010 and December 31, 2009 (dollars in thousands):

|  | As of June 30, 2010 |         | As of December 31, 2009 |         |
|--|---------------------|---------|-------------------------|---------|
|  | Fair Value          | % Total | Fair Value              | % Total |



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|  |    |           | Average<br>Reset |    |              | Average<br>Reset |
|--|----|-----------|------------------|----|--------------|------------------|
| Less than one year                                   | \$ |           |                  | \$ |              |                  |
| Greater than one year and less than<br>three years   |    | 208,181   | 6%               | 29 | 277,076      | 16%              |
| Greater than three years and less than<br>five years |    | 1,138,554 | 32%              | 44 | 648,093      | 38%              |
| Greater than or equal to five years                  |    | 2,242,977 | 62%              | 90 | 780,318      | 46%              |
| Total / Weighted Average                             | \$ | 3,589,712 | 100%             | 72 | \$ 1,705,487 | 100%             |

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Actual maturities of agency securities are generally shorter than stated contractual maturities primarily as a result of prepayments of principal of the underlying mortgages. The stated contractual final maturity of the mortgage loans underlying our portfolio of agency securities ranges up to 40 years, but the expected maturity is subject to change based on the actual and expected future prepayments of the underlying loans. As of June 30, 2010 and December 31, 2009, the average final contractual maturity of the agency securities in our investment portfolio was 26 and 27 years, respectively. The estimated weighted average months to maturity of the agency securities in the tables below are based upon our prepayment expectations, which are estimated based on assumptions for different securities using a combination of third-party services, market data and internal models. The third-party services estimate prepayment speeds using models that incorporate the forward yield curve, mortgage rates, current mortgage rates of the outstanding loans, loan age, volatility and other factors. As market conditions are changing rapidly, we use judgment in making adjustments to our models for some products. Various market participants could use materially different assumptions.

The following tables summarize our agency securities, at fair value, according to their estimated weighted average life classifications as of June 30, 2010 and December 31, 2009 (in thousands):

|   | June 30,<br>2010    | December 31,<br>2009 |
|---|---------------------|----------------------|
| Less than one year                                | \$ 56,739           | \$ 432               |
| Greater than one year and less than three years   | 1,896,384           | 281,721              |
| Greater than three years and less than five years | 3,601,328           | 1,340,665            |
| Greater than or equal to five years               | 1,611,939           | 2,677,297            |
| <b>Total</b>                                      | <b>\$ 7,166,390</b> | <b>\$ 4,300,115</b>  |

The constant prepayment rate ( CPR ) reflects the percentage of principal that is prepaid over a period of time on an annualized basis. In general, while there are various factors that impact the rate of prepayments, as interest rates rise, the rate of refinancings typically declines, which may result in lower rates of prepayment and, as a result, a lower portfolio CPR. Conversely, as interest rates fall, the rate of refinancings typically increases, which we expect may result in higher rates of prepayment and, as a result, a higher portfolio CPR. As of June 30, 2010, our portfolio was purchased at a net premium. The actual CPR was approximately 28% and 17% for the three months ended June 30, 2010 and 2009, respectively. The actual CPR was approximately 24% and 19% for the six months ended June 30, 2010 and 2009, respectively. In determining the yield on our agency securities, we have assumed that the CPR over the remaining projected life of our aggregate investment portfolio is 20% as of June 30, 2010. We make different prepayment assumptions for the individual securities that comprise the investment portfolio and these individual assumptions can differ materially from the average. There is also considerable uncertainty around prepayment speeds in this environment and actual speeds could differ materially from our estimates. Furthermore, U.S. Government agency or U.S. Government entity buyouts of loans in imminent risk of default, loans that have been modified, or loans that have defaulted will generally be reflected as prepayments on agency securities and also increase the uncertainty around these estimates. In addition, securities were purchased with different amounts of premiums and therefore the yield on some securities is more sensitive to changes in prepayment speeds.

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

The following analysis of our financial condition and results of operations should be read in conjunction with our interim consolidated financial statements and the notes thereto. The table below presents our condensed consolidated statements of operations and key portfolio statistics for the three and six months ended June 30, 2010 and 2009 (in thousands, except per share amounts):

|  | For the three months ended<br>June 30, |              | For the six months ended<br>June 30, |              |
|--|--|--------------|--------------------------------------|--------------|
|  | 2010                                   | 2009         | 2010                                 | 2009         |
| <b>Consolidated Statement of Operations Data:</b>                      |  |              |                                      |              |
| Interest income  | \$ 50,589                              | \$ 31,690    | \$ 89,386                            | \$ 54,041    |
| Interest expense   | 17,348                                 | 9,585        | 32,858                               | 17,714       |
| Net interest income  | 33,241                                 | 22,105       | 56,528                               | 36,327       |
| Gain from sale of agency securities, net                               | 29,585                                 | 9,530        | 56,993                               | 14,348       |
| (Loss) gain from derivative instruments and trading securities, net    | (21,867)                               | 1,226        | (15,947)                             | 868          |
| Total other income, net  | 7,718                                  | 10,756       | 41,046                               | 15,216       |
| Management fees  | 2,314                                  | 939          | 4,098                                | 1,842        |
| General and administrative expenses                                    | 1,787                                  | 1,556        | 3,468                                | 3,024        |
| Total expenses   | 4,101                                  | 2,495        | 7,566                                | 4,866        |
| Net income   | \$ 36,858                              | \$ 30,366    | \$ 90,008                            | \$ 46,677    |
| Net income per common share basic and diluted                          | \$ 1.23                                | \$ 2.02      | \$ 3.28                              | \$ 3.11      |
| Weighted average number of common shares outstanding basic and diluted | 29,872                                 | 15,005       | 27,451                               | 15,005       |
| <b>Key Portfolio Statistics*:</b>                                      |  |              |                                      |              |
| Average agency securities, at cost                                     | \$ 5,886,806                           | \$ 2,367,303 | \$ 4,993,331                         | \$ 2,052,812 |
| Average total assets, at fair value                                    | \$ 6,498,247                           | \$ 2,676,006 | \$ 5,545,264                         | \$ 2,322,317 |
| Average repurchase agreements  | \$ 5,548,225                           | \$ 2,139,402 | \$ 4,670,611                         | \$ 1,840,262 |
| Average stockholders' equity   | \$ 705,466                             | \$ 305,866   | \$ 643,107                           | \$ 290,159   |
| Fixed-rate agency securities at fair value as of period end            | \$ 3,063,016                           | \$ 1,203,261 | \$ 3,063,016                         | \$ 1,203,261 |
| Adjustable-rate agency securities at fair value as of period end       | \$ 3,589,711                           | \$ 1,307,430 | \$ 3,589,711                         | \$ 1,307,430 |
| CMO agency securities at fair value as of period end                   | \$ 483,667                             | \$ 121,202   | \$ 483,667                           | \$ 121,202   |
| Interest-only strips agency securities, at fair value as of period end | \$ 29,996                              | \$           | \$ 29,996                            | \$           |
| Average coupon(1)  | 5.20%                                  | 6.04%        | 5.19%                                | 6.05%        |
| Average asset yield(2)   | 3.44%                                  | 5.35%        | 3.58%                                | 5.26%        |
| Average cost of funds(3)   | 1.07%                                  | 1.30%        | 1.15%                                | 1.61%        |
| Average cost of funds terminated swap amortization expense(4)          | 0.19%                                  | 0.50%        | 0.27%                                | 0.33%        |
| Average net interest rate spread(5)                                    | 2.18%                                  | 3.55%        | 2.16%                                | 3.32%        |
| Net return on average stockholders' equity(6)                          | 20.96%                                 | 39.82%       | 28.22%                               | 32.44%       |
| Leverage (average during the period)(7)                                | 7.9:1                                  | 7.0:1        | 7.3:1                                | 6.3:1        |
| Leverage (as of period end)(8)   | 8.2:1                                  | 7.7:1        | 8.2:1                                | 7.7:1        |
| Expenses % of average assets(9)  | 0.25%                                  | 0.37%        | 0.28%                                | 0.42%        |
| Expenses % of average stockholders' equity(10)                         | 2.33%                                  | 3.27%        | 2.37%                                | 3.38%        |
| Book value per common share as of period end(11)                       | \$ 23.54                               | \$ 20.76     | \$ 23.54                             | \$ 20.76     |

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\* Average numbers for each period are weighted based on days on our books and records, all percentages are annualized.

- (1) Weighted average coupon for the period was calculated by dividing our total coupon (or cash) interest income on our agency securities by our weighted average agency securities.

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- (2) Weighted average asset yield for the period was calculated by dividing our total interest income on our agency securities, including amortization of premiums and discounts, by our weighted average agency securities.
- (3) Weighted average cost of funds for the period was calculated by dividing our total interest expense by our weighted average repurchase agreements. Total interest expense excludes amortization expense related to the costs of the previously terminated interest rate swaps during the periods presented.
- (4) Represents amortization expense associated with the termination of interest rate swaps of \$2.6 million and \$2.7 million for the three months ended June 30, 2010 and 2009, respectively, and \$6.3 million and \$3.0 million for the six months ended June 30, 2010 and 2009, respectively.
- (5) Average net interest rate spread for the period was calculated by subtracting our weighted average cost of funds, net of interest rate swaps and terminated swap amortization expense, from our weighted average asset yield.
- (6) Net return on average stockholders' equity for the period was calculated by dividing our net income by our average stockholders' equity.
- (7) Leverage during the period was calculated by dividing our average repurchase agreements outstanding by our average stockholders' equity.
- (8) Leverage at period end was calculated by dividing the amount outstanding under our repurchase agreements and net receivables/liabilities for unsettled agency securities by our total stockholders' equity at period end.
- (9) Expenses as a percentage of average total assets was calculated by dividing our total expenses by our average total assets.
- (10) Expenses as a percentage of average stockholders' equity was calculated by dividing our total expenses by our average stockholders' equity.
- (11) Book value per common share was calculated by dividing our total stockholders' equity by our number of shares outstanding.

### ***Interest Income and Asset Yield***

Interest income was \$50.6 million and \$31.7 million for the three months ended June 30, 2010 and 2009, which is net of \$22.9 million and \$3.1 million for net amortization of premiums and discounts on our investment portfolio, respectively. Interest income was \$89.4 million and \$54.0 million for the six months ended June 30, 2010 and 2009, which is net of \$35.2 million and \$6.5 million for net amortization of premiums and discounts on our investment portfolio, respectively. Our average agency securities at cost for the three months ended June 30, 2010 and 2009 was \$5,886.8 million and \$2,367.3 million, respectively, and we had an average asset yield of 3.44% and 5.35% for the respective periods. Our average agency securities at cost for the six months ended June 30, 2010 and 2009 was \$4,993.3 million and \$2,052.8 million, respectively, and we had an average asset yield of 3.58% and 5.26% for the respective periods. We had \$7.2 billion and \$2.6 billion of agency securities and an unamortized net premium balance of \$345.1 million (including the unamortized cost basis of our interest-only strips) and \$79.2 million as of June 30, 2010 and 2009, respectively. We amortize premiums and discounts associated with agency securities into interest income over the life of such securities using the effective yield method.

The decline in our average asset yield for each of the comparative periods was partially driven by a decline in the average coupon of our investment portfolio of 5.20% from 6.04% for the three months ended June 30, 2010 and 2009, respectively, and 5.19% from 6.05% for the six months ended June 30, 2010 and 2009, respectively, and an increase in the average amortized cost basis of our investment portfolio of 104.1% from 103.0% for the three months ended June 30, 2010 and 2009, respectively, and 104.0% from 102.6% for the six months ended June 30, 2010 and 2009, respectively, as a result of changes in portfolio composition. In addition, the decline in average asset yield was impacted by increases in the actual CPRs of our investment portfolio of approximately 28% from 17% for the three months ended June 30, 2010 and 2009, respectively, and approximately 24% from 19% for the six months ended June 30, 2010 and 2009, respectively, which was partially offset by a decline in the projected CPRs over the remaining life of our investment portfolio of approximately 20% from 21% as of June 30, 2010 and 2009, respectively. Actual CPRs for the three and six months ended June 30, 2010 reflect the impact of Fannie Mae and Freddie Mac's buyouts of accumulated severely delinquent loans from mortgage pools collateralizing agency securities (GSE Buyouts). The GSE Buyouts had the impact of increasing the average prepayment speed of our investment portfolio.

### ***Leverage***

Our leverage as of June 30, 2010 and 2009 was 8.4 and 7.5 times our stockholders' equity, respectively. When adjusted for the net amount of agency securities purchased and sold but not yet settled, our leverage ratio was 8.2 and 7.7 times our stockholders' equity as of June 30, 2010 and 2009, respectively. Our actual leverage



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will vary from time to time based on various factors, including our Manager’s opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity, over-collateralization levels required by lenders when we pledge agency securities to secure our borrowings and the current market value of our investment portfolio. In addition, certain of our master repurchase agreements and master swap agreements contain a restriction that prohibits our leverage from exceeding levels ranging from 12 to 16 times our stockholders equity.

The table below presents our average and period end repurchase agreement balance outstanding and leverage ratios for the six months ended June 30, 2010 and the year ended December 31, 2009 (dollars in thousands):

| Period Ended       | Repurchase Agreements |                  |                     | Leverage as of Period End, Net of Unsettled Trades(3) |                                 |
|--------------------|-----------------------|------------------|---------------------|---|---------------------------------|
|                    | Average               | As of Period End | Average Leverage(1) | Leverage as of Period End(2)                          | End, Net of Unsettled Trades(3) |
| March 31, 2009     | \$ 1,537,798          | \$ 1,849,473     | 5.6:1               | 6.4:1   | 7.0:1                           |
| June 30, 2009      | \$ 2,139,402          | \$ 2,346,875     | 7.0:1               | 7.5:1   | 7.7:1                           |
| September 30, 2009 | \$ 2,693,851          | \$ 2,949,010     | 7.2:1               | 6.9:1   | 7.3:1                           |
| December 31, 2009  | \$ 3,637,220          | \$ 3,841,834     | 6.8:1               | 7.0:1   | 7.3:1                           |
| March 31, 2010     | \$ 3,787,583          | \$ 4,651,115     | 6.5:1               | 7.6:1   | 7.9:1                           |
| June 30, 2010      | \$ 5,548,225          | \$ 6,634,342     | 7.9:1               | 8.4:1   | 8.2:1                           |

- (1) Average leverage during the period was calculated by dividing our average repurchase agreements outstanding for the period by our average stockholders equity for the period.
- (2) Leverage as of period end was calculated by dividing the amount outstanding under our repurchase agreements by our stockholder’s equity at period end.
- (3) Leverage as of period end, net of unsettled trades was calculated by dividing the amount outstanding under our repurchase agreements and net liabilities and receivables for unsettled agency securities by our total stockholder’s equity at period end.

For the quarter ended March 31, 2009, our ending repurchase agreement balance was greater than our average balance due to re-levering our balance sheet during the quarter as a result of improved conditions in the liquidity market following the peak of the liquidity crisis during the fourth quarter of 2008. Our leverage increased from 5.2:1 as of December 31, 2008 to 6.4:1 as of March 31, 2009.

For the quarter ended March 31, 2010, our ending repurchase agreement balance was greater than our average balance due to deploying new equity capital raised during the quarter through our direct stock purchase plan of \$62.1 million on a levered basis. In addition, we reduced leverage at the start of the quarter in anticipation of the GSE Buyout announcements by Fannie Mae and Freddie Mac and the resultant potential impact on our short-term liquidity needs. Later in the quarter, following the GSE buyout announcements in February 2010, we increased our leverage to 7.6:1.

For the quarter ended June 30, 2010, our ending repurchase agreement balance was greater than our average balance primarily due to deploying new equity capital raised during the quarter through a public offering of our common stock for proceeds of \$169.0 million, after underwriting discounts and offering expenses, on a levered basis.

**Interest Expense and Cost of Funds**

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Interest expense was \$17.3 million and \$9.6 million for the three months ended June 30, 2010 and 2009, respectively. Interest expense was \$32.9 million and \$17.7 million for the six months ended June 30, 2010 and 2009, respectively. The increase in interest was due to an increase in our average repurchase agreements outstanding, partially offset by a decline our total cost of funds for each of the comparative periods as described below.

For the three months ended June 30, 2010 and 2009, average repurchase agreements outstanding were \$5,548.2 million and \$2,139.4 million, respectively. For the six months ended June 30, 2010 and 2009, average



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repurchase agreements outstanding were \$4,670.6 million and \$1,840.3 million, respectively. The increase in the average repurchase agreement balance was primarily driven deploying new equity capital raised over the prior 12 month period ended June 30, 2010 on a levered basis.

The average interest rate on our repo agreements declined to 0.26% from 0.60% for the three months ended June 30, 2010 and 2009, respectively, and to 0.24% from 0.80% for the six months ended June 30, 2010 and 2009, respectively, primarily driven by the decline in the 30 day LIBOR interest rate. Including the net impact of interest rate swaps, the total average cost of funds for the three months ended June 30, 2010 and 2009 declined to 1.26% from 1.80%, which includes amortization expense for previously terminated interest rate swaps of 0.19% and 0.50%, respectively, and for the six months ended June 30, 2010 and 2009 to 1.42% from 1.94%, which includes amortization expense for previously terminated interest rate swaps of 0.27% and 0.33%, respectively.

We did not terminate any interest rate swaps accounted for as hedges under ASC 815 during the three or six months ended June 30, 2010. During the three and six months ended June 30, 2009 we terminated interest rate swaps with notional amounts of \$350.0 and \$550.0 million, respectively, resulting in net settlement payments of \$10.0 million and \$16.4 million, respectively, equal to their fair value on the date of termination. The net settlements were amortized into income over the remaining life of the terminated interest rate swaps through the second quarter of 2010 and included in interest expense on our consolidated statements of operations and comprehensive income. Amortization expense for terminated swaps was \$2.6 million and \$2.7 million for the three months ended June 30, 2010 and 2009, respectively, \$6.3 million and \$3.0 million for the six months ended June 30, 2010 and 2009, respectively.

As of June 30, 2010 and 2009, we had outstanding interest rate swap agreements for a total notional amount of \$3.0 billion and \$1.0 billion, or 45% and 40% of the outstanding balance under our repurchase agreements, respectively. For the three months ended June 30, 2010 and 2009 our interest rate swaps increased the cost of our borrowings by \$11.2 million and \$3.7 million, or 0.81% and 0.70% of interest bearing liabilities excluding the amortization expense associated with the termination of interest rate swaps, respectively, and for the six months ended June 30, 2010 and 2009 our interest rate swaps increased the cost of our borrowings by \$21.0 million and \$7.5 million, or 0.91% and 0.81% of interest bearing liabilities, excluding the amortization expense associated with the termination of interest rate swaps, respectively.

***Net Interest Income and Net Interest Rate Spread***

Net interest income, which equals interest income less interest expense, was \$33.2 million and \$22.1 million for the three months ended June 30, 2010 and 2009, respectively. Net interest income was \$56.5 million and \$36.3 million for the six months ended June 30, 2010 and 2009, respectively. The average net interest rate spread, which equals the average yield on our assets less the average cost of funds was 2.18% and 3.55% for the three months ended June 30, 2010 and 2009, respectively. Excluding the terminated swap amortization expense, the net interest rate spread for the three months ended June 30, 2010 and 2009 was 2.37% and 4.05%, respectively. The average net interest rate spread was 2.16% and 3.32% for the six months ended June 30, 2010 and 2009, respectively. Excluding the terminated swap amortization expense, the net interest rate spread for the six months ended June 30, 2010 and 2009 was 2.43% and 3.65%, respectively. As of June 30, 2010, the net interest rate spread was 2.38%.

The decrease in our average net interest rate spread for each of the comparative periods was due to a decline in our average asset yield, partially offset by a decrease in our cost of funds, as discussed above.

**Table of Contents*****Gain on Sale of Agency Securities, Net***

The following table is a summary of our net gain on sale of agency securities for the three and six months ended June 30, 2010 and 2009 (in thousands):

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | June 30,<br>2010   | June 30,<br>2009 | June 30,<br>2010 | June 30,<br>2009 |
| Agency securities sold, at cost           | \$ (2,624,277)     | \$ (1,420,616)   | \$ (4,741,787)   | \$ (2,472,241)   |
| Proceeds from agency securities sold      | 2,653,862          | 1,430,146        | \$ 4,798,780     | 2,486,589        |
| Net gains on sale of agency securities    | \$ 29,585          | \$ 9,530         | \$ 56,993        | \$ 14,348        |
| Gross gains on sale of agency securities  | 31,327             | \$ 10,031        | \$ 61,381        | \$ 15,137        |
| Gross losses on sale of agency securities | (1,742)            | (501)            | (4,388)          | (789)            |
| Net gains on sale of agency securities    | \$ 29,585          | \$ 9,530         | \$ 56,993        | \$ 14,348        |

The increase in the amount of agency securities sold for each of the comparative periods was due to an increase in the size of our investment portfolio as well as our Manager's execution of our active portfolio management strategy. Our strategy for the periods presented has largely focused on repositioning our portfolio towards securities with attributes our Manager believes reduce the level of prepayment risk in light of current and anticipated interest rates, federal government programs, general economic conditions and other factors.

***Loss (Gain) on Derivative Instruments and Trading Securities, Net***

The following table is a summary of our (loss) gain on derivative instruments and trading securities, net for the three and six months ended June 30, 2010 and 2009 (in thousands):

|   | For the three months<br>ended June 30, |          | For the six months<br>ended June 30, |          |
|---|--|----------|--------------------------------------|----------|
|   | 2010                                   | 2009     | 2010                                 | 2009     |
| Realized (loss) gain from derivative instruments and trading securities:                                    |  |          |                                      |          |
| TBAs and forward settling agency securities   | \$ (5,686)                             | \$ 1,566 | \$ (3,239)                           | \$ 1,566 |
| Interest rate swaptions   |  |          | (243)                                |          |
| Put options   | (328)                                  |          | (328)                                |          |
| Hedge ineffectiveness related to missed forecasts on interest rate swaps designated as hedges under ASC 815 |  | (4)      |                                      | (948)    |
| Interest rate swaps not designated as hedges under ASC 815  | (281)                                  |          | (1,111)                              |          |
| Government securities   | 1,443                                  |          | 1,443                                |          |
| Total realized (loss) gain from derivative instruments and trading securities, net                          | (4,852)                                | 1,562    | (3,478)                              | 618      |
| Unrealized loss (gain) from derivative instruments and trading securities:(1)                               |  |          |                                      |          |
| TBAs and forward settling agency securities   | (9,740)                                | (465)    | (5,204)                              | (466)    |

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|   |                    |                 |                    |               |
|---|--------------------|-----------------|--------------------|---------------|
| Interest-only strips  | (9,026)            |                 | (6,938)            |               |
| Interest rate swaptions   | 1,911              |                 | (13)               |               |
| Put options   | (37)               |                 |                    |               |
| Hedge ineffectiveness on interest rate swaps accounted for as hedges under ASC 815          | (123)              | 129             | (314)              | 716           |
| <b>Total unrealized (loss) gain from derivative instruments and trading securities, net</b> | <b>(17,015)</b>    | <b>(336)</b>    | <b>(12,469)</b>    | <b>250</b>    |
| <b>Total (loss) gain from derivative instruments and trading securities, net</b>            | <b>\$ (21,867)</b> | <b>\$ 1,226</b> | <b>\$ (15,947)</b> | <b>\$ 868</b> |

- (1) Unrealized (loss) gain from derivatives and trading securities includes reversals of prior period amounts for settled or expired derivatives and trading securities.

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The net loss from derivatives and trading securities for the three and six month periods ended June 30, 2010 is due to an increase in hedging activity involving derivative instruments that were not designated as hedges under ASC 815. These instruments, while not designated as hedges under ASC 815, were entered into to manage the potential adverse impact of interest rate changes on the value of our investment portfolio and cash flows as a result of the federal government's conclusion of its agency security purchase program in March 2010, the European debt crisis and overall economic volatility.

Further details regarding our derivatives and related hedging activity for the three and six months ended June 30, 2010 and 2009 are discussed in Note 3 and 6 to our consolidated financial statements in this Quarterly Report on Form 10-Q.

### ***Management Fees and General and Administrative Expenses***

We pay our Manager a base management fee payable monthly in arrears in an amount equal to one twelfth of 1.25% of our Equity. Our Equity is defined as our month-end stockholders' equity, adjusted to exclude the effect of any unrealized gains or losses included in either retained earnings or OCI, each as computed in accordance with GAAP. There is no incentive compensation payable to our Manager pursuant to the management agreement. We incurred management fees of \$2.3 million and \$0.9 million during the three months ended June 30, 2010 and 2009, respectively, and \$4.1 million and \$1.8 million during the six months ended June 30, 2010 and 2009, respectively. The increase in management fees compared to prior periods was due to an increase in the amount of Equity outstanding as a result new equity capital raised during the 12 months ended June 30, 2010.

General and administrative expenses were \$1.8 million and \$1.6 million for the three months ended June 30, 2010 and 2009, respectively, and \$3.5 million and \$3.0 million for the six months ended June 30, 2010 and 2009, respectively. Our total expenses as a percentage of our average stockholders' equity declined to 2.33% for the three month period ended June 30, 2010 compared to 3.27% in the prior period and declined to 2.37% for the six months ended June 30, 2010 compared to 3.38% in the prior period due to improved operating leverage.

### ***Net Income and Net Return on Equity***

Net income was \$36.9 million, or \$1.23 and per basic and diluted share, for the three months ended June 30, 2010, compared to \$30.4 million, or \$2.02 per basic and diluted share, for the prior period. Our annualized net return on average equity declined to 21.0% for the current period compared to 39.8% for prior period. While many factors may affect net income per share and the annualized return on average equity, the primary factors impacting their decline for the current period were a reduction in net interest income of \$0.36 per share due the decline in our net asset yield, partially offset by a 13% increase in our average leverage, a decrease in net gains on derivatives and trading securities of \$0.81 per share, partially offset by an increase in our gains on our agency securities of \$0.35 per share.

Net income was \$90.0 million, or \$3.28 per basic and diluted share, for the six months ended June 30, 2010, compared to \$46.7 million, or \$3.11 per basic and diluted share, for the prior period. Our annualized net return on average equity declined to 28.2% for the current period compared to 32.4% for the prior period. The increase in net income per share of \$0.17 was driven by an increase in gains on agency securities of \$1.12 per share, partially offset by a reduction of net interest income of \$0.36 per share and a reduction in gains on derivative instruments and trading securities of \$0.64 per share. The decrease in our annualized return on average equity, despite the increase in our net income per share, was largely due to an increase of our average equity due to new equity capital raised during the twelve months ended June 30, 2010.



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### ***Dividends***

For the three months ended June 30, 2010 and 2009, we declared dividends of \$1.40 and \$1.50 per share, respectively. For the six months ended June 30, 2010 and 2009, we declared dividends of \$2.80 and \$2.35 per share, respectively. As a REIT, we are required to distribute annually 90% of our taxable income to maintain our status as a REIT and all of our taxable income to avoid Federal, state and local corporate income taxes. We can treat dividends declared by September 15 and paid by December 31 as having been a distribution of our taxable income for our prior tax year. As of June 30, 2010, we did not have any undistributed taxable income from 2009. Accordingly, we do not expect to incur any income tax liability on our 2009 taxable income. We intend to distribute sufficient dividends to eliminate our taxable income for 2010. However, we may elect not to distribute sufficient dividends to eliminate our taxable income so long as we distribute at least 90% of our taxable income in order to maintain our qualification as a REIT. Income as determined under GAAP differs from income as determined under tax rules because of both temporary and permanent differences in income and expense recognition. Examples include temporary differences for unrealized gains and losses on derivative instruments and trading securities recognized in income for GAAP but are excluded from taxable income until realized or settled, differences in the CPR used to amortize premiums or accrete discounts as well as treatment of start-up organizational costs, hedge ineffectiveness, and stock-based compensation and permanent differences for excise tax expense.

As a REIT, if we fail to distribute in any calendar year at least the sum of (i) 85% of our ordinary income for such year, (ii) 95% of our capital gain net income for such year, and (iii) any undistributed taxable income from the prior year, we would be subject to a non-deductible 4% federal excise tax on the excess of such required distribution over the sum of (i) the amounts actually distributed and (ii) the amounts of income we retained and on which we have paid corporate income tax. For the three and six months ended June 30, 2010, we did not accrue a federal tax because we intend to distribute sufficient dividends to eliminate any federal excise tax for 2010.

### **LIQUIDITY AND CAPITAL RESOURCES**

Our primary sources of funds are borrowings under master repurchase agreements and monthly principal and interest payments on our investment portfolio. Other sources of funds may include proceeds from equity offerings and asset sales. We generally use our liquidity to pay down borrowings under repurchase arrangements to reduce borrowing costs and otherwise efficiently manage our long-term investment capital. Because the level of these borrowings can be adjusted on a daily basis, the level of cash and cash equivalents carried on the balance sheet is significantly less important than the potential liquidity available under our borrowing arrangements. We currently believe that we have sufficient liquidity and capital resources available for the acquisition of additional investments, repayments on borrowings and the payment of cash dividends as required for our continued qualification as a REIT. To qualify as a REIT, we must distribute annually at least 90% of our taxable income. To the extent that we annually distribute all of our taxable income in a timely manner, we will generally not be subject to federal and state income taxes. We currently expect to distribute all of our taxable income. This distribution requirement limits our ability to retain earnings and thereby replenish or increase capital for operations.

During the six months ended June 30, 2010, we issued 2.4 million shares of our common stock under our direct stock purchase plan for proceeds of \$62.1 million and we completed a public offering May 2010 in which 6.9 million shares of our common stock, including the over-allotment option, were sold at a public offering price of \$25.75 per share. Upon completion of the offering we received proceeds, net of underwriters discount and other offering costs, of \$169.0 million.

To the extent we raise additional equity capital through secondary equity offerings or under our direct stock purchase plan, we currently anticipate using cash proceeds from such transactions to purchase additional agency securities, to make scheduled payments of principal and interest on our repurchase agreements and for other general corporate purposes. There can be no assurance, however, that we will be able to raise additional equity capital at any particular time or on any particular terms.



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As part of our investment strategy, we borrow against our investment portfolio pursuant to master repurchase agreements. We expect that our borrowings pursuant to repurchase transactions under such master repurchase agreements generally will have maturities that range from 30 to 90 days, but may have maturities of less than 30 days or up to 364 days. When adjusted for net payables and receivables for agency securities purchased but not yet settled, our leverage ratio was 8.2 times the amount of our stockholders' equity as of June 30, 2010. Our cost of borrowings under master repurchase agreements generally corresponds to LIBOR plus or minus a margin. We have master repurchase agreements with 22 financial institutions, subject to certain conditions. Borrowings under repurchase arrangements secured by agency securities totaled \$6.6 billion as of June 30, 2010. As of June 30, 2010, we did not have an amount at risk with any counterparty greater than 10% of our stockholders' equity. Refer to Note 5 to our consolidated financial statements in this Quarterly Report on Form 10-Q for further details regarding our borrowings under repurchase agreements and weighted average interest rates as of June 30, 2010 and December 31, 2009.

Amounts available to be borrowed under these arrangements are dependent upon lender collateral requirements and the lender's determination of the fair value of the securities pledged as collateral, which fluctuates with changes in interest rates, credit quality and liquidity conditions within the investment banking, mortgage finance and real estate industries. Under the repurchase agreements, we may be required to pledge additional assets to the repurchase agreement counterparties (i.e., lenders) in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (a margin call), which may take the form of additional securities or cash. Similarly, if the estimated fair value of investment securities increases due to changes in the market interest rates, lenders may release collateral back to us. Specifically, margin calls would result from a decline in the value of the agency securities securing our repurchase agreements and prepayments on the mortgages securing such agency securities. As of June 30, 2010, we have met all margin requirements. We had unrestricted cash and cash equivalents of \$150.1 million and unpledged agency securities of \$295.7 million available to meet margin calls on our repurchase agreements and derivative instruments as of June 30, 2010.

Although we believe that we will have adequate sources of liquidity available to us through repurchase agreement financing to execute our business strategy, there can be no assurances that repurchase agreement financing will be available to us upon the maturity of our current repurchase agreements to allow us to renew or replace our repurchase agreement financing on favorable terms or at all. If our repurchase agreement lenders default on their obligations to resell the underlying agency securities back to us at the end of the term, we could incur a loss equal to the difference between the value of the agency securities and the cash we originally received.

We maintain an interest rate risk management strategy under which we use derivative financial instruments to manage the adverse impact of interest rates changes on the value of our investment portfolio as well as our cash flows. In particular we attempt to mitigate the risk of the cost of our short-term variable rate liabilities increasing at a faster rate than the earnings of our long-term assets during a period of rising interest rates. The principal derivative instruments that we use are interest rate swaps, interest rate swaptions, TBA agency securities, options and futures.

We use interest rate swap agreements to effectively lock in fixed rates on a portion of our short-term borrowings because longer-term committed borrowings are not available at attractive terms. We have entered into interest rate swap agreements to attempt to mitigate the risk of the cost of our short-term variable rate liabilities rising during a period of rising interest rates, thereby compressing the net spreads that we earn on our long-term fixed-rate assets. As of June 30, 2010, our interest rate swap agreements had notional amounts totaling \$3.0 billion and were designated as cash flow hedges for accounting purposes of a like amount of our short-term borrowings. Refer to Note 6 to our consolidated financial statements in this Quarterly Report on Form 10-Q for further details regarding our outstanding interest rate swaps as of June 30, 2010 and December 31, 2009 and the related activity for the three and six months ended June 30, 2010 and 2009.



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We may be limited on the types of hedging strategies we can deploy as a REIT under the Code; therefore, we may implement part of our hedging strategy through American Capital Agency TRS, LLC, our domestic taxable REIT subsidiary, which will be subject to federal, state and, if applicable, local income tax. As of June 30, 2010, we had not transacted any hedging transactions through American Capital Agency TRS, LLC.

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

As of June 30, 2010, we did not maintain any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, or special purpose or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, as of June 30, 2010, we had not guaranteed any obligations of unconsolidated entities or entered into any commitment or intent to provide funding to any such entities.

## **FORWARD-LOOKING STATEMENTS**

This document contains forward-looking statements (within the meaning of the Private Securities Litigation Reform Act of 1995) that inherently involve risks and uncertainties. Our actual results and liquidity can differ materially from those anticipated in these forward-looking statements because of changes in the level and composition of our investments and other factors. These factors may include, but are not limited to, changes in general economic conditions, the availability of suitable investments from both an investment return and regulatory perspective, the availability of new investment capital, fluctuations in interest rates and levels of mortgage prepayments, deterioration in credit quality and ratings, the effectiveness of risk management strategies, the impact of leverage, liquidity of secondary markets and credit markets, increases in costs and other general competitive factors.

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

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

Market risk is the exposure to loss resulting from changes in interest rates, foreign currency exchange rates, commodity prices and equity prices. The primary market risks that we are exposed to are interest rate risk, prepayment risk, liquidity risk, extension risk and inflation risk.

#### ***Interest Rate Risk***

Interest rate risk is highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond our control.

Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with our interest-bearing liabilities, by affecting the spread between our

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interest-earning assets and interest bearing liabilities. Changes in the level of interest rates can also affect the rate of prepayments of our securities and the value of the agency securities that constitute our investment portfolio, which affects our ability to realize gains from the sale of these assets and impacts our ability and the amount that we can borrow against these securities.

We may utilize a variety of financial instruments, including interest rate swaps, swaptions, caps, collars, floors, purchases and sales of TBA agency securities and specified agency securities on a forward basis, or put and call options on securities or securities underlying futures contracts, in order to limit the effects of changes in interest rates on our operations. When we use these types of derivatives to hedge the risk of interest-earning assets or interest-bearing liabilities, we may be subject to certain risks, including the risk that losses on a hedge position will reduce the funds available for payments to holders of our common stock and that the losses may exceed the amount we invested in the instruments.

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Our profitability and the value of our investment portfolio (including derivatives used for hedging purposes) may be adversely affected during any period as a result of changing interest rates including resulting changes in forward yield curves. The following table quantifies the estimated changes in net interest income and investment portfolio value should interest rates go up or down by 50 and 100 basis points, assuming the yield curves of the rate shocks will be parallel to each other and the current yield curve. These estimates were compiled using a combination of third-party services, market data and internal models. All changes in income and value are measured as percentage changes from the projected net interest income and investment portfolio value at the base interest rate scenario. The base interest rate scenario assumes interest rates as of June 30, 2010. Given the low level of interest rates, we also apply a floor of 0% for all anticipated interest rates included in our assumptions, such that any hypothetical interest rate decrease would have a limited positive impact on our funding costs beyond a certain level. However, because estimated prepayment speeds are unaffected by this floor, it is expected that an increase in our prepayment speeds as a result of a hypothetical interest rate decrease would result in an acceleration of our premium amortization and could result in reinvestment of such prepaid principal into lower yielding assets.

Actual results could differ materially from estimates, especially in the current market environment. The accuracy of the projected agency securities prices relies on assumptions that define specific agency securities spreads and varying prepayment assumptions at projected interest rate levels. To the extent that these estimates or other assumptions do not hold true, which is likely in a period of high price volatility, actual results will likely differ materially from projections and could be larger or smaller than the estimates in the table below. Moreover, if different models were employed in the analysis, materially different projections could result. In addition, while the tables below reflect the estimated impact of interest rate increases and decreases on a static portfolio we may from time to time sell any of our agency securities as a part of our overall management of our investment portfolio.

| <b>Change in Interest Rate</b> | <b>Percentage Change<br/>in Projected Net<br/>Interest Income</b> | <b>Percentage Change<br/>in Projected<br/>Portfolio Value, with<br/>Effect of Derivatives</b> |
|--------------------------------|---|---|
| +100 Basis Points              | -4.7%   | -1.1%   |
| +50 Basis Points               | -1.0%   | -0.4%   |
| -50 Basis Points               | -8.5%   | 0.3%  |
| -100 Basis Points              | -23.8%  | 0.2%  |

**Prepayment Risk**

Premiums and discounts associated with the purchase of agency securities are amortized or accreted into interest income over the projected lives of the securities, including contractual payments and estimated prepayments using the interest method. Furthermore, U.S. Government agency or U.S. Government entity buyouts of loans in imminent risk of default, loans that have been modified, or loans that have defaulted will generally be reflected as prepayments on agency securities and also increase the uncertainty around these estimates. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate published prepayment data for similar agency securities, market consensus and current market conditions. If the actual prepayment experienced differs from our estimate of prepayments, we will be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

**Spread Risk**

Our available-for-sale securities are reflected at their estimated fair value with unrealized gains and losses excluded from earnings and reported in OCI pursuant to ASC 320. As of June 30, 2010, the fair value of these securities was \$7.1 billion. When the spread between the yield on our agency securities and U.S. Treasuries or swap rates widens, this could cause the value of our agency securities to decline, creating what we refer to as spread risk. The spread risk associated with our agency securities and the resulting fluctuations in fair value of these securities can occur independent of interest rates and may relate to other factors impacting the mortgage and fixed income markets such as liquidity or changes in

required rates of return on different assets.

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### ***Liquidity Risk***

The primary liquidity risk for us arises from financing long-term assets with shorter-term borrowings in the form of repurchase agreements. Our assets which are pledged to secure repurchase agreements are high-quality agency securities and cash. As of June 30, 2010, we had unrestricted cash and cash equivalents of \$150.1 million and unpledged agency securities of \$295.7 million available to meet margin calls on our repurchase agreements, derivative instruments and for other corporate purposes. However, should the value of our agency securities pledged as collateral suddenly decrease, margin calls relating to our repurchase agreements could increase, causing an adverse change in our liquidity position. As such, we cannot assure that we will always be able to renew (or roll) our repurchase agreements.

### ***Extension Risk***

The projected weighted-average life of our investments is based on our assumptions regarding the rate at which the borrowers will prepay the underlying mortgage loans. In general, when we acquire an agency security collateralized by FRMs or hybrid ARMs, we may, but are not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes our borrowing costs for a period close to the anticipated average life of the fixed-rate portion of the related assets. This strategy is designed to protect us from rising interest rates because the borrowing costs are fixed for the duration of the fixed-rate portion of the related agency security.

However, if prepayment rates decrease in a rising interest rate environment, the life of the fixed-rate portion of the related assets could extend beyond the term of the swap agreement or other hedging instrument. This could have a negative impact on our results from operations, as borrowing costs would no longer be fixed after the end of the hedging instrument while the income earned on the agency securities collateralized by FRMs or hybrid ARMs would remain fixed. This situation may also cause the market value of our agency security collateralized by FRMs or hybrid ARMs to decline, with little or no offsetting gain from the related hedging transactions. In extreme situations, we may be forced to sell assets to maintain adequate liquidity, which could cause us to incur losses.

### ***Inflation Risk***

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance more so than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Further, our consolidated financial statements are prepared in accordance with GAAP and our distributions are determined by our Board of Directors based primarily by our net income as calculated for income tax purposes. In each case, our activities and balance sheet are measured with reference to historical cost and/or fair market value without considering inflation.

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

### **Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to

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allow timely decisions regarding required disclosure based on the definition of disclosure controls and procedures as promulgated under the SEC Act of 1934, as amended. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

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We, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2010. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective.

### **Changes in Internal Controls over Financial Reporting**

There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during the quarter ended June 30, 2010 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***

From time to time, we may be involved in various claims and legal actions arising in the ordinary course of business. As of June 30, 2010, we have no legal proceedings.

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

There have been no material changes to the risk factors previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009, except as described below.

You should carefully consider the risks described below and all other information contained in this interim report on Form 10-Q, including our interim consolidated financial statements and the related notes thereto before making a decision to purchase our securities. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us, or not presently deemed material by us, may also impair our operations and performance.

If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. If that happens, the trading price of our securities could decline, and you may lose all or part of your investment.

### **Risks Related to Our Investing, Active Portfolio Management and Financing Strategy**

*The 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, may adversely affect our business.*

Due to increased market concerns about Fannie Mae and Freddie Mac's ability to withstand future credit losses associated with securities held in their investment portfolios, and on which they provide guarantees, without the direct support of the federal government, on July 30, 2008, the government passed the Housing and Economic Recovery Act of 2008 (the "HERA"). On September 6, 2008, the FHFA placed Fannie Mae and Freddie Mac into conservatorship and, together with the U.S. Treasury, established a program designed to boost investor confidence in Fannie Mae's and Freddie Mac's debt and mortgage-backed securities. As the conservator of Fannie Mae and Freddie Mac, the FHFA controls and directs the operations of Fannie Mae and Freddie Mac and may (i) take over the assets of and operate Fannie Mae and Freddie Mac with all the powers of the stockholders, the directors and the officers of Fannie Mae and Freddie Mac and conduct all business of Fannie Mae and Freddie Mac; (ii) collect all obligations and money due to Fannie Mae and Freddie Mac; (iii) perform all functions of Fannie Mae and Freddie Mac which are consistent with the conservator's appointment; (iv) preserve and conserve the assets and property of Fannie Mae and Freddie Mac; and (v) contract for assistance in fulfilling any function, activity, action or duty of the conservator. A primary focus of the HERA was to increase the availability of mortgage financing by allowing Fannie Mae and Freddie Mac to continue to grow



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their guarantee business without limit, while limiting net purchases of agency securities to a modest amount through the end of 2009. Fannie Mae and Freddie Mac began gradually reducing the size of their agency security portfolios in 2010.

In addition to FHFA becoming the conservator of Fannie Mae and Freddie Mac, the U.S. Department of Treasury, or the U.S. Treasury, took three additional actions: (i) the U.S. Treasury and FHFA entered into preferred stock purchase agreements between the U.S. Treasury and Fannie Mae and Freddie Mac pursuant to which the U.S. Treasury required that each of Fannie Mae and Freddie Mac maintain a positive net worth; (ii) the U.S. Treasury established a secured lending credit facility which provided Fannie Mae, Freddie Mac and the Federal Home Loan Banks access to a liquidity backstop; and (iii) the U.S. Treasury initiated a temporary program to purchase agency securities issued by Fannie Mae and Freddie Mac.

Initially, Fannie Mae and Freddie Mac each issued \$1.0 billion of senior preferred stock to the U.S. Treasury and warrants to purchase 79.9% of the fully-diluted common stock outstanding of each government sponsored enterprise, or GSE, at a nominal exercise price. Pursuant to these stock purchase agreements, each of Fannie Mae's and Freddie Mac's mortgage and agency security portfolios may not exceed \$900 billion as of December 31, 2009. In December 2009, these stock purchase agreements were amended to allow Freddie Mac and Fannie Mae additional flexibility to reduce the size of their portfolios over time, such that each portfolio will be required to decline by 10% of the maximum portfolio size permitted as of December 31, 2009 each year until such portfolio reaches \$250 billion. Given the highly fluid and evolving nature of these events, it is unclear how our business will be impacted.

Although the U.S. Treasury has committed capital to Fannie Mae and Freddie Mac, there can be no assurance that these actions will be adequate for their needs. If these actions are inadequate, Fannie Mae and Freddie Mac could continue to suffer losses and could fail to honor their guarantees and other obligations. The future roles of Fannie Mae and Freddie Mac could be significantly reduced and the nature of their guarantees could be considerably limited relative to historical measurements. Any changes to the nature of the guarantees provided by Fannie Mae and Freddie Mac could redefine what constitutes an agency security and could have broad adverse market implications.

On November 25, 2008, the Federal Reserve announced that it would initiate a program to purchase \$100 billion in direct obligations of Fannie Mae, Freddie Mac and the Federal Home Loan Banks and \$500 billion in agency securities backed by Fannie Mae, Freddie Mac and Ginnie Mae. In March 2009, the size of the direct obligation purchase program was expanded to \$200 billion and the agency securities purchase program was expanded to a total of \$1.25 trillion. Purchases of direct obligations began in December 2008 and purchases of agency securities began in January 2009. Both purchase programs were concluded in the first quarter of 2010. One of the effects of these programs has been to increase competition for available direct obligations and agency securities, with the result being an increase in pricing of such securities. The conclusion of the Federal Reserve's purchase activities may result in decreased demand for these securities, which may reduce the market price of such securities. The Federal Reserve may hold the direct obligations and agency mortgage securities to maturity or may sell them on the open market. Sales by the Federal Reserve of the direct obligations or agency mortgage securities that it currently holds may reduce the market price of such securities. Reductions in the market price of agency mortgage securities may negatively impact our book value.

In December 2009, the U.S. Treasury extended the duration and increased the size of its credit support commitment to Fannie Mae and Freddie Mac under the HERA. However, the U.S. Treasury could stop providing credit support to Fannie Mae and Freddie Mac in the future. The problems faced by Fannie Mae and Freddie Mac resulting in their being placed into conservatorship have stirred debate among some federal policy makers regarding the continued role of the federal government in providing liquidity for mortgage loans. Following expiration of the current authorization, each of Fannie Mae and Freddie Mac could be dissolved and the federal government could stop providing liquidity support of any kind to the mortgage market. If Fannie Mae or Freddie Mac were eliminated, or their structures were to change radically, we would not be able to acquire agency securities from these companies, which would eliminate the major component of our business model.

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In April 2010, Freddie Mac and Fannie Mae announced tighter underwriting guidelines for ARMs and hybrid interest-only ARMs in particular. Specifically, Freddie Mac announced that it would no longer purchase interest-only mortgages and Fannie Mae changed its eligibility criteria for purchasing and securitizing ARMs to protect consumers from potentially dramatic payment increases. Although our portfolio includes fixed-rate agency securities, we also purchase adjustable-rate agency securities and tighter underwriting standards could reduce the supply of ARMs, resulting in a reduction in the attractiveness of the asset class.

Our income could be negatively affected in a number of ways depending on the manner in which related events unfold. For example, the current credit support provided by the U.S. Treasury to Fannie Mae and Freddie Mac, and any additional credit support it may provide in the future, could have the effect of lowering the interest rate we expect to receive from agency securities that we seek to acquire, thereby tightening the spread between the interest we earn on our portfolio of targeted assets and our cost of financing that portfolio. A reduction in the supply of agency securities could also negatively affect the pricing of agency securities we seek to acquire by reducing the spread between the interest we earn on our portfolio of targeted assets and our cost of financing that portfolio.

As indicated above, recent legislation has changed the relationship between Fannie Mae and Freddie Mac and the federal government and requires Fannie Mae and Freddie Mac to reduce the amount of mortgage loans they own or for which they provide guarantees on agency securities. Future legislation could further change the relationship between Fannie Mae and Freddie Mac and the federal government, and could also nationalize or eliminate such entities entirely. Any law affecting these GSEs may create market uncertainty and have the effect of reducing the actual or perceived credit quality of securities issued or guaranteed by Fannie Mae or Freddie Mac. As a result, such laws could increase the risk of loss on investments in Fannie Mae and/or Freddie Mac agency security. It also is possible that such laws could adversely impact the market for such securities and spreads at which they trade. All of the foregoing could materially adversely affect our business, operations and financial condition.

*There can be no assurance that the actions of the U.S. Treasury, the Federal Reserve and other governmental and regulatory bodies for the purpose of stabilizing the financial markets, or market response to those actions, will achieve the intended effect, our business may not benefit from these actions and further government or market developments could adversely impact us. Further, when the U.S. Government withdraws its support under these programs, the market may lose liquidity, adversely impacting us.*

In response to the financial issues affecting the banking system and financial markets and going concern threats to investment banks and other financial institutions, the U.S. Government implemented a number of initiatives intended to bolster the banking system, the financial and housing markets and the economy as a whole. These initiatives include: (i) the Emergency Economic Stabilization Act of 2008, or the EESA, which established the Troubled Asset Relief Program, (ii) the voluntary Capital Purchase Program which was implemented under authority provided in the EESA and gives the U.S. Treasury the authority to purchase up to \$250 billion of senior preferred shares in qualifying U.S. controlled banks, saving associations, and certain bank and savings and loan holding companies engaged only in financial activities, (iii) a program to purchase \$200 billion in direction obligations issued by Fannie Mae, Freddie Mac and the Federal Home Loan Banks and \$1.25 trillion in agency securities backed by Fannie Mae, Freddie Mac and Ginnie Mae, which was concluded during the first quarter of 2010, (iv) a program to purchase up to \$300 billion of U.S. Treasury securities, (v) the creation of the PPIP for private investors to purchase mortgage-related assets from financial institutions and (vi) the TALF which is intended to increase securitization activity for various consumer and commercial loans and other financial assets, including student loans, automobile loans and leases, credit card receivables, SBA small business loans and commercial mortgage-backed securities. There can be no assurance these programs and proposals will have a beneficial impact on the financial and housing markets or the banking system. To the extent the market does not respond favorably to these programs and proposals or the initiatives do not function as intended, our business may not receive the anticipated positive impact therefrom.

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*Changes in prepayment rates may adversely affect our profitability.*

The agency securities in our investment portfolio are backed by pools of mortgage loans. We receive payments, generally, from the payments that are made on these underlying mortgage loans. When borrowers prepay their mortgage loans at rates that are faster or slower than expected, this results in prepayments that are faster or slower than expected on the related agency securities. These faster or slower than expected payments may adversely affect our profitability.

We may purchase agency securities that have a higher interest rate than the then prevailing market interest rate. In exchange for this higher interest rate, we may pay a premium to par value to acquire the security. In accordance with GAAP, we amortize this premium over the expected term of the agency security based on our prepayment assumptions. If the agency security is prepaid in whole or in part at a faster than expected rate, however, we must expense all or a part of the remaining unamortized portion of the premium that was paid at the time of the purchase, which will adversely affect our profitability.

We also may purchase agency securities that have a lower interest rate than the then prevailing market interest rate. In exchange for this lower interest rate, we may pay a discount to par value to acquire the security. We accrete this discount over the expected term of the agency security based on our prepayment assumptions. If the agency security is prepaid at a slower than expected rate, however, we must accrete the remaining portion of the discount at a slower than expected rate. This will extend the expected life of the portfolio and result in a lower than expected yield on securities purchased at a discount to par.

Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. Prepayments can also occur when borrowers sell the property and use the sale proceeds to prepay the mortgage as part of a physical relocation or when borrowers default on their mortgages and the mortgages are prepaid from the proceeds of a foreclosure sale of the property. Fannie Mae and Freddie Mac will generally, among other conditions, purchase mortgages that are 120 days or more delinquent from MBS trusts when the cost of guarantee payments to security holders, including advances of interest at the security coupon rate, exceeds the cost of holding the nonperforming loans in their portfolios. Consequently, prepayment rates also may be affected by conditions in the housing and financial markets, which may result in increased delinquencies on mortgage loans, the GSEs' cost of capital, general economic conditions and the relative interest rates on FRM and ARM loans, which could lead to an acceleration of the payment of the related principal. Additionally, changes in the GSEs' decisions as to when to repurchase delinquent loans can materially impact prepayment rates.

In addition, the introduction of government programs, such as the U.S. Treasury's HASP program, are expected to increase the availability of mortgage credit to a large number of homeowners in the U.S., which we expect will impact the prepayment rates for the entire mortgage securities market, but primarily for Fannie Mae and Freddie Mac agency securities. While increased prepayment rates negatively impact our interest income for agency securities purchased at a premium, we believe we have sourced agency securities with collateral attributes that improve the prepayment profile of our investment portfolio. However, these are new programs and there could be additional programs or changes to existing programs made in the future, such that there is substantial uncertainty around the magnitude of prepayment speed increases and our asset selection process may not provide the desired benefits. While we will seek to manage prepayment risk, in selecting investments we must balance prepayment risk against other risks, the potential returns of each investment and the cost of hedging our risks. No strategy can completely insulate us from prepayment or other such risks, and we may deliberately retain exposure to prepayment or other risks.

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### **Risks Related to Conflicts of Interest in Our Relationship with Our Manager and American Capital**

*Our Manager's management fee is based on the amount of our Equity and is payable regardless of our performance.*

Our Manager is entitled to receive a management fee from us that is based on the amount of our Equity (as defined in our management agreement), regardless of the performance of our investment portfolio. For example, we would pay our Manager a management fee for a specific period even if we experienced a net loss during the same period. The amount of the management fee is equal to one-twelfth of 1.25% of our Equity and therefore is only increased by raising new Equity, which could result in a conflict of interest between our manager and our shareholders with respect to the timing and terms of our equity offerings. Our Manager's entitlement to substantial nonperformance-based compensation may reduce its incentive to devote sufficient time and effort to seeking investments that provide attractive risk-adjusted returns for our investment portfolio. This in turn could harm our ability to make distributions to our stockholders and the market price of our common stock.

### **Risks Related to Our Common Stock**

*Changes in laws or regulations governing our operations or our failure to comply with those laws or regulations may adversely affect our business.*

We are subject to regulation by laws at the local, state and federal level, including securities and tax laws and financial accounting and reporting standards. These laws and regulations, as well as their interpretation, may be changed from time to time. Accordingly, any change in these laws or regulations or the failure to comply with these laws or regulations could have a material adverse impact on our business. Certain of these laws and regulations pertain specifically to REITs.

*The market price of our common stock may fluctuate significantly.*

The market price and marketability of shares of our securities may from time to time be significantly affected by numerous factors, including many over which we have no control and that may not be directly related to us. These factors include the following:

price and volume fluctuations in the stock market from time to time, which are often unrelated to the operating performance of particular companies;

significant volatility in the market price and trading volume of securities of REITs or other companies in our sector, which is not necessarily related to the operating performance of these companies;

changes in regulatory policies, tax guidelines and financial accounting and reporting standards, particularly with respect to REITs;

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changes in our dividend policy and earnings or variations in operating results;

any shortfall in revenue or net income or any increase in losses from levels expected by securities analysts;

decreases in our net asset value per share;

general economic trends and other external factors; and

loss of major repurchase agreement providers.

Fluctuations in the trading price of our common stock may adversely affect the liquidity of the trading market for our common stock and, in the event that we seek to raise capital through future equity financings, our ability to raise such equity capital.

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

None.

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

None.

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

**Item 5.     *Other Information***

None.

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**Item 6. Exhibits**

- (a) **Exhibits:**
- \*3.1 American Capital Agency Corp. Amended and Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 3.1 of Form 10-Q for the quarter ended June 30, 2008 (File No. 001-34057), filed August 14, 2008.
  - \*3.2 American Capital Agency Corp. Amended and Restated Bylaws, incorporated herein by reference to Exhibit 3.2 of Form 10-Q for the quarter ended June 30, 2008 (File No. 001-34057), filed August 14, 2008.
  - \*4.1 Instruments defining the rights of holders of securities: See Article IV of our Amended and Restated Certificate of Incorporation, incorporated herein by reference to Exhibit 4.1 of Form 10-Q for the quarter ended June 30, 2008 (File No. 001-34057), filed August 14, 2008.
  - \*4.2 Instruments defining the rights of holders of securities: See Article VI of our Amended and Restated Bylaws, incorporated herein by reference to Exhibit 4.2 of Form 10-Q for the quarter ended June 30, 2008 (File No. 001-34057), filed August 14, 2008.
  - \*10.1 Underwriting Agreement, dated May 14, 2010, by and among American Capital Agency Corp., American Capital Agency Management, LLC, Citigroup Global Markets Inc. , Credit Suisse Securities (USA) LLC, Deutsche Bank Securities Inc., and UBS Securities LLC, incorporated herein by reference to Exhibit 1.1 of Form 8-K (File No. 001-34057), filed May 19, 2010.
  - 31.1 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
  - 31.2 Certification pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
  - 32 Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Previously filed in whole or in part.

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**SIGNATURES**

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

AMERICAN CAPITAL AGENCY CORP.

Date: August 6, 2010

By: */s/* MALON WILKUS  
**Malon Wilkus**

**Chairman of the Board of Directors,**

**President and Chief Executive Officer**



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**INDEX TO EXHIBITS**

| <b>Exhibit No.</b> | <b>Description</b>  |
|--------------------|---|
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