Armour Residential REIT, Inc.
Form 10-Q
April 29, 2015

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 March 31, 2015
OR

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

For the transition period from to

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

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

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

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

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

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

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

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

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

The number of outstanding shares of the Registrant’s common stock as of April 28, 2015 was 352,379,624.

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

	March 31, 2015	December 31, 2014
Assets		
Cash	$473,826	$494,561
Cash collateral posted to counterparties	312,447	129,004
Agency Securities, available for sale, at fair value (including pledged securities of $14,626,615 and $14,370,847)	15,050,439	15,297,529
Receivable for unsettled sales (including pledged securities of $251,251 in 2014)	—	260,598
Derivatives, at fair value	451	60,518
Principal payments receivable	24	93
Accrued interest receivable	41,075	41,915
Prepaid and other assets	1,540	1,580
Total Assets	$15,879,802	$16,285,798
Liabilities and Stockholders' Equity		
Liabilities:		
Repurchase agreements	$13,904,770	$13,881,921
Cash collateral posted by counterparties	38,340	48,240
Payable for unsettled purchases	—	445,292
Derivatives, at fair value	272,282	137,393
Accrued interest payable	5,498	7,012
Accounts payable and other accrued expenses	800	16,649
Total Liabilities	$14,221,690	$14,536,507
Commitments and contingencies (Note 9)		
Stockholders' Equity:		
Preferred stock, $0.001 par value, 50,000 shares authorized;		
8.250% Series A Cumulative Preferred Stock; 2,181 issued and outstanding ($54,514 aggregate liquidation preference) at March 31, 2015 and December 31, 2014	2	2
7.875% Series B Cumulative Preferred Stock; 5,650 issued and outstanding ($141,250 aggregate liquidation preference) at March 31, 2015 and December 31, 2014	6	6
Common stock, $0.001 par value, 1,000,000 shares authorized, 352,375 and 353,159 shares issued and outstanding at March 31, 2015 and December 31, 2014	352	353
Additional paid-in capital	2,715,040	2,717,545
Accumulated deficit	(1,224,829)	(1,052,969)
Accumulated other comprehensive income	167,541	84,354
Total Stockholders' Equity	$1,658,112	$1,749,291
Total Liabilities and Stockholders' Equity	$15,879,802	$16,285,798

See notes to condensed consolidated financial statements.

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

	For the Quarter Ended March 31, 2015	March 31, 2014
Interest income, net of amortization of premium on Agency Securities	$99,550	$123,082
Interest expense	(14,192)	(14,747)
Net Interest Income	$85,358	$108,335
Other Income (Loss):		
Realized gain on sale of Agency Securities (reclassified from Other comprehensive income)	6,544	69,869
Subtotal	$6,544	$69,869
Realized gain (loss) on derivatives (1)	8,099	(11,739)
Unrealized loss on derivatives	(216,338)	(176,355)
Subtotal	$(208,239)	$(188,094)
Total Other Loss	$(201,695)	$(118,225)
Expenses:		
Management fee	6,877	6,965
Professional fees	793	1,274
Insurance	170	184
Compensation	613	712
Other	679	753
Total Expenses	$9,132	$9,888
Net Loss	$(125,469)	$(19,778)
Dividends declared on preferred stock	(3,905)	(3,905)
Net Loss related to common stockholders	$(129,374)	$(23,683)
Net loss related per share to common stockholders (Note 12):		
Basic	$(0.37)	$(0.07)
Diluted	$(0.37)	$(0.07)
Dividends declared per common share	$0.12	$0.15
Weighted average common shares outstanding:		
Basic	352,945	357,496
Diluted	352,945	357,496

(1) Interest expense related to our interest rate swap contracts is recorded as realized loss on derivatives on the condensed consolidated statements of operations. For additional information, see Note 8 to the condensed consolidated financial statements.

See notes to condensed consolidated financial statements.

ARMOUR Residential REIT, Inc. and Subsidiary
CONDENSED CONSOLIDATED STATEMENTS OF
COMPREHENSIVE INCOME (LOSS)
(in thousands)
(Unaudited)

	For the Quarter Ended	
	March 31, 2015	March 31, 2014
Net Loss	$(125,469)	$(19,778)
Other comprehensive income:		
Reclassification adjustment for realized gain on sale of available for sale Agency Securities	(6,544)	(69,869)
Net unrealized gain on available for sale Agency Securities	89,731	116,165
Other comprehensive income	$83,187	$46,296
Comprehensive Income (Loss)	$(42,282)	$26,518

See notes to condensed consolidated financial statements.

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

	Preferred Stock						Common Stock					
	8.250% Series A			7.875% Series B								
	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Shares	Par Amount	Additional Paid-in Capital	Total Additional Paid-in Capital	Accumulated Deficit	Accumulat Other Comprehe Income
Balance, January 1, 2015	2,181	$2	$53,172	5,650	$6	$136,547	353,159	$353	$2,527,826	$2,717,545	$(1,052,969)	$84,354
Series A Preferred dividends declared	—	—	—	—	—	—	—	—	—	—	(1,124)	—
Series B Preferred dividends declared	—	—	—	—	—	—	—	—	—	—	(2,781)	—
Common stock dividends declared	—	—	—	—	—	—	—	—	—	—	(42,486)	—
Issuance of common stock, net	—	—	—	—	—	—	13	—	43	43	—	—
Stock based compensation, net of withholding requirements	—	—	—	—	—	—	78	—	255	255	—	—
Common stock repurchased	—	—	—	—	—	—	(875)	(1)	(2,803)	(2,803)	—	—
Net loss	—	—	—	—	—	—	—	—	—	—	(125,469)	—
Other comprehensive income	—	—	—	—	—	—	—	—	—	—	—	83,187
Balance, March 31, 2015	2,181	$2	$53,172	5,650	$6	$136,547	352,375	$352	$2,525,321	$2,715,040	$(1,224,829)	$167,541

See notes to condensed consolidated financial statements.

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

	For the Quarter Ended March 31, 2015	March 31, 2014
Cash Flows From Operating Activities:		
Net loss	$(125,469)	$(19,778)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Net amortization of premium on Agency Securities	26,983	10,618
Realized gain on sale of Agency Securities	(6,544)	(69,869)
Stock based compensation	255	292
Changes in operating assets and liabilities:		
(Increase) decrease in accrued interest receivable	240	(3,150)
Decrease in prepaid and other assets	40	68
Decrease in derivatives, at fair value	194,956	178,791
Decrease in accrued interest payable	(1,514)	(588)
Decrease in accounts payable and other accrued expenses	(15,849)	(19,694)
Net cash provided by operating activities	$73,098	$76,690
Cash Flows From Investing Activities:		
Purchases of Agency Securities	(1,982,478)	(7,385,813)
Principal repayments of Agency Securities	481,387	307,214
Proceeds from sales of Agency Securities	1,626,904	5,279,609
Increase in cash collateral posted to/by counterparties	(193,343)	(136,949)
Net cash used in investing activities	$(67,530)	$(1,935,939)
Cash Flows From Financing Activities:		
Issuance of common stock, net of expenses	43	75
Proceeds from repurchase agreements	20,966,843	23,322,303
Principal repayments on repurchase agreements	(20,943,994)	(21,310,432)
Series A Preferred stock dividends paid	(1,124)	(1,124)
Series B Preferred stock dividends paid	(2,781)	(2,781)
Common stock dividends paid	(42,486)	(53,853)
Common stock repurchased	(2,804)	(2,585)
Net cash provided by (used in) financing activities	$(26,303)	$1,951,603
Net increase (decrease) in cash	(20,735)	92,354
Cash - beginning of period	494,561	496,478
Cash - end of period	$473,826	$588,832
Supplemental Disclosure:		
Cash paid during the period for interest	$93,160	$70,351
Non-Cash Investing and Financing Activities:		
Receivable for unsettled sales	$—	$296,378
Payable for unsettled purchases	$—	$382,833
Net unrealized gain on available for sale Agency Securities	$89,731	$116,165
Amounts receivable for issuance of common stock	$—	$6

See notes to condensed consolidated financial statements

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

Note 1 – Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (the “SEC”). Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter ended March 31, 2015 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2015. These unaudited financial statements should be read in conjunction with the audited financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2014.

The condensed consolidated financial statements include the accounts of ARMOUR Residential REIT, Inc. and its subsidiary. All intercompany accounts and transactions have been eliminated. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates affecting the accompanying condensed consolidated financial statements include the valuation of Agency Securities (as defined below) and derivative instruments.

Note 2 – Organization and Nature of Business Operations

References to “we,” “us,” “our,” “ARMOUR” or the “Company” are to ARMOUR Residential REIT, Inc. References to “ACM are to ARMOUR Capital Management LP, a Delaware limited partnership, formerly known as ARMOUR Residential Management LLC. On December 19, 2014, ARMOUR Residential Management LLC, our external manager under the Management Agreement, (as defined below) changed its name to ARMOUR Capital Management LP and converted from a Delaware limited liability company to a Delaware limited partnership and continued as the manager under the same Management Agreement.

We are an externally managed Maryland corporation organized in 2008, managed by ACM, an investment advisor registered with the SEC (see Note 9, “Commitments and Contingencies” and Note 14, “Related Party Transactions” for additional discussion). We invest in residential mortgage backed securities issued or guaranteed by a United States (“U.S.”) Government-sponsored entity (“GSE”), such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) or guaranteed by the Government National Mortgage Administration (Ginnie Mae) (collectively, "Agency Securities"). We also may invest in other securities backed by residential mortgages for which the payment of principal and interest is not guaranteed by a GSE or government agency (collectively, "Non-Agency Securities"). While we remain committed to investing in Agency Securities for so long as an adequate supply and pricing exists, we have the flexibility to invest in Non-Agency Securities and respond to changes in GSE policy as needed. At March 31, 2015 and December 31, 2014, Agency Securities accounted for 100% of our securities portfolio. It is expected that the percentage will continue to be 100% or close thereto. Our securities portfolio consists primarily of Agency Securities backed by fixed rate home loans. From time to time, a portion of our assets may be invested in Agency Securities backed by hybrid adjustable rate and adjustable rate home loans as well as unsecured notes and bonds issued by GSEs, U.S. Treasuries and money market instruments, subject to certain income tests we must satisfy for our qualification as a real estate investment trust (“REIT”).

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

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

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

Note 3 – Summary of Significant Accounting Policies

Cash

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

Cash Collateral Posted To/By Counterparties

Cash collateral posted to/by counterparties represents cash posted by us to counterparties or posted by counterparties to us as collateral for our interest rate swap contracts (including swaptions), Eurodollar Futures Contracts ("Futures Contracts") and repurchase agreements on our Agency Securities.
Agency Securities, Available For Sale

We generally intend to hold most of our Agency Securities for extended periods of time. We may, from time to time, sell any of our Agency Securities as part of the overall management of our securities portfolio. Management determines the appropriate classifications of the securities at the time they are acquired and evaluates the appropriateness of such classifications at each balance sheet date. At March 31, 2015 and December 31, 2014, all of our Agency Securities were classified as available for sale securities. Agency Securities classified as available for sale are reported at their estimated fair values with unrealized gains and losses excluded from earnings and reported as part of the condensed consolidated statements of comprehensive income (loss).

Receivables and Payables for Unsettled Sales and Purchases

We account for purchases and sales of securities on the trade date, including purchases and sales for forward settlement. Receivables and payables for unsettled trades represent the agreed trade price times the outstanding balance of the securities at the balance sheet date.

Accrued Interest Receivable and Payable

Accrued interest receivable includes interest accrued between payment dates on Agency Securities. Accrued interest payable includes interest payable on our repurchase agreements and may, at certain times, contain interest payable on U.S. Treasury Securities sold short.

Repurchase Agreements

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

In addition to the repurchase agreement financing discussed above, at certain times we have entered into reverse repurchase agreements with certain of our repurchase agreement counterparties. Under a typical reverse repurchase agreement, we purchase U.S. Treasury Securities from a borrower in exchange for cash and agree to sell the same securities in the future in exchange for a price that is higher than the original purchase price. The difference between the purchase price originally paid and the sale price represents interest received from the borrower. Reverse repurchase agreement receivables and repurchase agreement liabilities are presented net when they meet certain criteria, including being with the same counterparty, being governed by the same master repurchase agreement ("MRA"), settlement through the same brokerage or clearing account and maturing on the same day. We did not have any reverse repurchase agreements outstanding at March 31, 2015 and December 31, 2014.

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

Obligations to Return Securities Received as Collateral, at Fair Value

At certain times, we also sell to third parties the U.S. Treasury Securities received as collateral for reverse repurchase agreements and recognize the resulting obligation to return said U.S. Treasury Securities as a liability on our condensed consolidated balance sheets. Interest is recorded on the repurchase agreements, reverse repurchase agreements and U.S. Treasury Securities sold short on an accrual basis and presented as interest expense. Both parties to the transaction have the right to make daily margin calls based on changes in the fair value of the collateral received and/or pledged. We did not have any obligations to return securities received as collateral at March 31, 2015 and December 31, 2014.

Derivatives, at Fair Value

We recognize all derivatives as either assets or liabilities at fair value on our condensed consolidated balance sheets. All changes in the fair values of our derivatives are reflected in our condensed consolidated statements of operations. We designate derivatives as hedges for tax purposes and any unrealized derivative gains or losses would not affect our distributable net taxable income.

Preferred Stock

At March 31, 2015, we were authorized to issue up to 50,000 shares of preferred stock, par value $0.001 per share, with such designations, voting and other rights and preferences as may be determined from time to time by our Board of Directors (“Board”) or a committee thereof. We have designated 9,610 shares as 8.250% Series A Preferred Stock and 6,210 shares as 7.875% Series B Preferred Stock. At March 31, 2015, a total of 34,180 shares of our authorized preferred stock remain available for designation as future series.

Series A Cumulative Preferred Shares (“Series A Preferred Stock”)

At March 31, 2015 and December 31, 2014, we had 2,181 shares of Series A Preferred Stock issued and outstanding with a par value of $0.001 per share and a liquidation preference of $25.00 per share, or $54,514 in the aggregate. At March 31, 2015 and December 31, 2014, there were no accrued or unpaid dividends on the Series A Preferred Stock. The Series A Preferred Stock is entitled to a dividend at a rate of 8.250% per year based on the $25.00 per share liquidation preference before the common stock is entitled to receive any dividends. The Series A Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends exclusively at our option commencing on June 7, 2017 (subject to our right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve our qualification as a REIT). The Series A Preferred Stock is senior to our common stock and therefore in the event of liquidation, dissolution or winding up, the Series A Preferred Stock will receive a liquidation preference of $25.00 per share plus accumulated and unpaid dividends before distributions are paid to holders of our common stock, with no right or claim to any of our remaining assets thereafter. The Series A Preferred Stock generally does not have voting rights, except if we fail to pay dividends on the Series A Preferred Stock for eighteen months, whether or not consecutive. Under such circumstances, the Series A Preferred Stock will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set aside for payment. The Series A Preferred Stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and will remain outstanding indefinitely unless repurchased or redeemed by us or converted into our common stock in connection with a change of control by the holders of Series A Preferred Stock.

Series B Cumulative Preferred Shares (“Series B Preferred Stock”)

At March 31, 2015 and December 31, 2014, we had 5,650 shares of Series B Preferred Stock issued and outstanding with a par value of $0.001 per share and a liquidation preference of $25.00 per share, or $141,250 in the aggregate. At March 31, 2015 and December 31, 2014, there were no accrued or unpaid dividends on the Series B Preferred Stock. The Series B Preferred Stock is entitled to a dividend at a rate of 7.875% per year based on the $25.00 per share liquidation preference before the common stock is entitled to receive any dividends. The Series B Preferred Stock is redeemable at $25.00 per share plus accrued and unpaid dividends exclusively at our option commencing on February 12, 2018 (subject to our right under limited circumstances to redeem the Series A Preferred Stock earlier in order to preserve our qualification as a REIT). The Series B Preferred Stock is senior to our common stock and ranks on parity with the Series A Preferred Stock. In the event of liquidation, dissolution or winding up, the Series B Preferred Stock will receive a liquidation preference of $25.00 per share plus accumulated and unpaid dividends before distributions are paid to holders of our common stock, with no right or claim to any of our remaining assets thereafter. The Series B Preferred Stock generally does not have voting rights, except if we fail to pay dividends on the Series B Preferred Stock for eighteen months, whether or not consecutive. Under such circumstances, the Series B Preferred Stock will be entitled to vote to elect two additional directors to the Board, until all unpaid dividends have been paid or declared and set aside for payment. The Series B Preferred Stock has no stated maturity, is not subject to any sinking fund or mandatory redemption and will remain outstanding indefinitely unless repurchased or redeemed by us or converted into our common stock in connection with a change of control by the holders of Series B Preferred Stock.

Common Stock

Common Stock

At March 31, 2015, we were authorized to issue up to 1,000,000 shares of common stock, par value $0.001 per share, with such designations, voting and other rights and preferences as may be determined from time to time by our Board. We had 352,375 shares of common stock issued and outstanding at March 31, 2015 and 353,159 shares of common stock issued and outstanding at December 31, 2014.

Common Stock Repurchased

On March 5, 2014, our Board increased the authorization under our common stock repurchase program (the "Repurchase Program") to 50,000 shares of our common stock outstanding. Under the Repurchase Program, shares may be purchased in the open market, including block trades, through privately negotiated transactions, or pursuant to a trading plan separately adopted in the future. The timing, manner, price and amount of any repurchases will be at our discretion, subject to the requirements of the Securities Exchange Act of 1934, as amended, and related rules. We are not required to repurchase any shares under the Repurchase Program and it may be modified, suspended or terminated at any time for any reason. We do not intend to purchase shares from our Board or other affiliates. Under Maryland law, such repurchased shares are treated as authorized but unissued. For the quarter ended March 31, 2015, we repurchased 875 shares of our common stock under the Repurchase Program for an aggregate of $2,804. At March 31, 2015, there were 44,321 remaining shares authorized for repurchase under our Repurchase Program.

Revenue Recognition

Interest income is earned and recognized on Agency Securities based on their unpaid principal amounts and their contractual terms. Recognition of interest income commences on the settlement date of the purchase transaction and continues through the settlement date of the sale transaction. Premiums and discounts associated with the purchase of Multi-Family MBS, which are generally not subject to prepayment, are amortized or accreted into interest income over the contractual lives of the securities using a level yield method. Premiums and discounts associated with the purchase of other Agency Securities are amortized or accreted into interest income over the actual lives of the securities, reflecting actual prepayments as they occur.

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

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

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

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

Comprehensive Income (Loss)

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

Note 4 – Recent Accounting Pronouncements

In June 2014, the Financial Accounting Standards Board issued ASU 2014-11, Repurchase-to Maturity Transactions, Repurchase Financing, and Disclosures, Transfers and Servicing (Topic 860). We do not have repurchase-to-maturity transactions or repurchase financing arrangements of the type covered by ASU 2014-11, therefore this change will not affect our condensed consolidated balance sheets or statements of operations. The amendment also requires certain additional disclosures about repurchase agreements beginning with our second quarter 2015 financial statements.

Note 5 – Fair Value of Financial Instruments

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

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

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

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

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

Cash - Cash includes cash on deposit with financial institutions. The carrying amount of cash is deemed to be its fair value and is classified as Level 1. Cash balances posted by us to counterparties or posted by counterparties to us as collateral are classified as Level 2 because they are integrally related to the Company's repurchase financing and interest rate swap agreements, which are classified as Level 2.

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

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and classify it as a Level 3 security. At March 31, 2015 and December 31, 2014, all of our Agency Security fair values are classified as Level 2 based on the inputs used by our third party pricing services and dealer quotes.

Receivables and Payables for Unsettled Sales and Purchases - The carrying amount is generally deemed to be fair value because of the relatively short time to settlement. Such receivables and payables are classified as Level 2 because they are effectively secured by the related securities and could potentially be subject to counterparty credit considerations.

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

Obligations to Return Securities Received as Collateral - The fair value of the obligations to return securities received as collateral are based upon the prices of the related U.S. Treasury Securities obtained from a third party pricing service, which are indicative of market activity. Such obligations are classified as Level 1.

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

The following tables provide a summary of our assets and liabilities that are measured at fair value on a recurring basis at March 31, 2015 and December 31, 2014.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at March 31, 2015
Assets at Fair Value:				
Agency Securities, available for sale	$—	$15,050,439	$—	$15,050,439
Derivatives	$—	$451	$—	$451
Liabilities at Fair Value:				
Derivatives	$92	$272,190	$—	$272,282

There were no transfers of assets or liabilities between the levels of the fair value hierarchy during the quarter ended March 31, 2015.

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	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at December 31, 2014
Assets at Fair Value:				
Agency Securities, available for sale	$—	$15,297,529	$—	$15,297,529
Derivatives	$—	$60,518	$—	$60,518
Liabilities at Fair Value:				
Derivatives	$180	$137,213	$—	$137,393

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

The following tables provide a summary of the carrying values and fair values of our financial assets and liabilities not carried at fair value but for which fair value is required to be disclosed at March 31, 2015 and December 31, 2014.

March 31, 2015			Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Cash	$473,826	$473,826	$473,826	$—	$—
Cash collateral posted to counterparties	$312,447	$312,447	$—	$312,447	$—
Principal payments receivable	$24	$24	$—	$24	$—
Accrued interest receivable	$41,075	$41,075	$—	$41,075	$—
Financial Liabilities:					
Repurchase agreements	$13,904,770	$13,904,770	$—	$13,904,770	$—
Cash collateral posted by counterparties	$38,340	$38,340	$—	$38,340	$—
Accrued interest payable- repurchase agreements	$5,498	$5,498	$—	$5,498	$—

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December 31, 2014			Fair Value Measurements using:		
	Carrying Value	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Assets:					
Cash	$494,561	$494,561	$494,561	$—	$—
Cash collateral posted to counterparties	$129,004	$129,004	$—	$129,004	$—
Receivable for unsettled sales	$260,598	$260,598	$—	$260,598	$—
Principal payments receivable	$93	$93	$—	$93	$—
Accrued interest receivable	$41,915	$41,915	$—	$41,915	$—
Financial Liabilities:					
Repurchase agreements	$13,881,921	$13,881,921	$—	$13,881,921	$—
Cash collateral posted by counterparties	$48,240	$48,240	$—	$48,240	$—
Payable for unsettled purchases	$445,292	$445,292	$—	$445,292	$—
Accrued interest payable- repurchase agreements	$7,012	$7,012	$—	$7,012	$—

Note 6 – Agency Securities, Available for Sale

All of our Agency Securities are classified as available for sale and, as such, are reported at their estimated fair value and changes in fair value reported as part of the statements of comprehensive income (loss). At March 31, 2015 and December 31, 2014, investments in Agency Securities accounted for 100% of our securities portfolio.

We evaluated our Agency Securities with unrealized losses at March 31, 2015, March 31, 2014 and December 31, 2014, to determine whether there was an other than temporary impairment. All of our Agency Securities are issued and guaranteed by GSEs or Ginnie Mae. The GSEs have a long term credit rating of AA+. At March 31, 2015, March 31, 2014 and December 31, 2014, we also considered whether we intended to sell Agency Securities and whether it was more likely than not that we could meet our liquidity requirements and contractual obligations without selling Agency Securities. There was no other than temporary impairment recognized for the quarters ended March 31, 2015 and March 31, 2014 and for the year ended December 31, 2014.

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At March 31, 2015, we had the following Agency Securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities at March 31, 2015 are also presented below. Our Agency Securities had a weighted average coupon of 3.47% at March 31, 2015.

March 31, 2015	Amortized Cost	Gross Unrealized Loss		Gross Unrealized Gain	Fair Value	Percent of Total	
Fannie Mae							
ARMs & Hybrids	$53,272	$(109	)	$717	$53,880	0.36	%
Multi-Family MBS	1,997,937	(2,382	)	47,988	2,043,543	13.58	
10 Year Fixed	13,407	(4	)	379	13,782	0.09	
15 Year Fixed	5,744,790	(56	)	91,324	5,836,058	38.78	
20 Year Fixed	3,272,830	(9,498	)	19,313	3,282,645	21.81	
25 Year Fixed	20,734	—		34	20,768	0.14	
30 Year Fixed	1,649,744	—		15,450	1,665,194	11.06	
Total Fannie Mae	$12,752,714	$(12,049	)	$175,205	$12,915,870	85.82	%
Freddie Mac							
ARMs & Hybrids	13,939	(32	)	244	14,151	0.09	%
10 Year Fixed	2,500	(3	)	40	2,537	0.02	
15 Year Fixed	227,805	—		3,274	231,079	1.54	
20 Year Fixed	1,813,241	(8,762	)	9,372	1,813,851	12.05	
Total Freddie Mac	$2,057,485	$(8,797	)	$12,930	$2,061,618	13.70	%
Ginnie Mae							
ARMs & Hybrids	72,368	(325	)	550	72,593	0.48	%
15 Year Fixed	331	—		27	358	0.00	
Total Ginnie Mae	$72,699	$(325	)	$577	$72,951	0.48	%
Total Agency Securities	$14,882,898	$(21,171	)	$188,712	$15,050,439	100.00	%

There were no unsettled purchases at March 31, 2015.

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At December 31, 2014, we had the following securities in an unrealized gain or loss position as presented below. The components of the carrying value of our Agency Securities at December 31, 2014 are also presented below. Our Agency Securities had a weighted average coupon of 3.47% at December 31, 2014.

December 31, 2014	Amortized Cost	Gross Unrealized Loss	Gross Unrealized Gain	Fair Value	Percent of Total
Fannie Mae					
ARMs&Hybrids	$40,410	$(119)	$729	$41,020	0.27 %
Multi-Family MBS	1,239,227	—	22,676	1,261,903	8.25
10 Year Fixed	5,336	(3)	201	5,534	0.04
15 Year Fixed	7,394,694	(539)	54,041	7,448,196	48.69
20 Year Fixed	3,050,676	(13,867)	16,756	3,053,565	19.96
25 Year Fixed	21,194	(55)	—	21,139	0.14
30 Year Fixed	1,249,696	(227)	5,765	1,255,234	8.21
Total Fannie Mae	$13,001,233	$(14,810)	$100,168	$13,086,591	85.56 %