CAPSTEAD MORTGAGE CORP
Form 10-Q
October 30, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: September 30, 2018

OR

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

Commission File Number: 001-08896

CAPSTEAD MORTGAGE CORPORATION

(Exact name of Registrant as specified in its Charter)

Maryland	75-2027937
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
8401 North Central Expressway, Suite 800, Dallas, TX	75225-4404
(Address of principal executive offices)	(Zip Code)

(214) 874-2323

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). YES NO

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

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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock ($0.01 par value) 90,927,815 as of October 30, 2018

CAPSTEAD MORTGAGE CORPORATION

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2018

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ITEM 1. FINANCIAL STATEMENTS

PART I. — FINANCIAL INFORMATION

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except pledged and per share amounts)

	September 30, 2018 (unaudited)	December 31, 2017
Assets		
Residential mortgage investments ($12.25 and $12.98 billion pledged at September 30, 2018 and December 31, 2017, respectively)	$ 12,681,791	$ 13,454,098
Cash collateral receivable from interest rate swap counterparties	26,293	42,506
Cash and cash equivalents	31,725	103,907
Receivables and other assets	152,216	132,938
	$ 12,892,025	$ 13,733,449
Liabilities		
Secured borrowings	$ 11,619,966	$ 12,331,060
Interest rate swap agreements at fair value	13,012	23,772
Unsecured borrowings	98,266	98,191
Common stock dividend payable	10,365	18,487
Accounts payable and accrued expenses	29,323	23,063
	11,770,932	12,494,573
Stockholders' equity		
Preferred stock - $0.10 par value; 100,000 shares authorized:		
7.50% Cumulative Redeemable Preferred Stock, Series E, 10,329 shares issued and outstanding ($258,226 aggregate liquidation preference) at September 30, 2018 and December 31, 2017	250,946	250,946
Common stock - $0.01 par value; 250,000 shares authorized: 91,068 and 95,698 shares issued and outstanding at September 30, 2018 and December 31, 2017, respectively	911	957
Paid-in capital	1,220,415	1,271,425
Accumulated deficit	(346,570)	(346,570)
Accumulated other comprehensive (loss) income	(4,609)	62,118
	1,121,093	1,238,876
	$ 12,892,025	$ 13,733,449

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	Quarter Ended September 30		Nine Months Ended September 30	
	2018	2017	2018	2017
Interest income:				
Residential mortgage investments	$67,649	$57,073	$201,989	$168,017
Other	350	366	1,063	757
	67,999	57,439	203,052	168,774
Interest expense:				
Secured borrowings	(54,393)	(36,655)	(147,655)	(98,745)
Unsecured borrowings	(1,910)	(1,910)	(5,701)	(5,701)
	(56,303)	(38,565)	(153,356)	(104,446)
	11,696	18,874	49,696	64,328
Other revenue (expense):				
Compensation-related expense	(1,913)	(1,073)	(5,521)	(4,021)
Other general and administrative expense	(1,184)	(1,097)	(3,320)	(3,435)
Miscellaneous other revenue	81	48	233	130
	(3,016)	(2,122)	(8,608)	(7,326)
Net income	$8,680	$16,752	$41,088	$57,002
Net income available to common stockholders:				
Net income	$8,680	$16,752	$41,088	$57,002
Less preferred stock dividends	(4,842)	(4,718)	(14,526)	(12,600)
	$3,838	$12,034	$26,562	$44,402
Net income per common share:				
Basic and diluted	$0.04	$0.13	$0.29	$0.46
Weighted average common shares outstanding:				
Basic	91,206	95,792	92,202	95,768
Diluted	91,346	95,923	92,317	95,905
Cash dividends declared per share:				
Common	$0.11	$0.19	$0.41	$0.61
Series E preferred	0.47	0.47	1.41	1.41

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands, unaudited)

	Quarter Ended September 30		Nine Months Ended September 30	
	2018	2017	2018	2017
Net income	$8,680	$16,752	$41,088	$57,002
Other comprehensive (loss) income				
Amounts related to available-for-sale securities:				
Change in net unrealized losses	(26,771)	(7,072)	(87,336)	(14,496)
Amounts related to cash flow hedges:				
Change in net unrealized gains	7,580	1,827	46,385	3,541
Reclassification adjustment for amounts included in net income	(11,162)	(3,213)	(25,776)	(2,207)
	(30,353)	(8,458)	(66,727)	(13,162)
Comprehensive (loss) income	$(21,673)	$8,294	$(25,639)	$43,840

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands, unaudited)

	Nine Months Ended September 30	
	2018	2017
Operating activities:		
Net income	$41,088	$57,002
Noncash items:		
Amortization of investment premiums	88,293	98,996
Amortization of equity-based awards	1,477	1,671
Other depreciation and amortization	79	89
Change in recorded measureable hedge ineffectiveness on interest rate swap agreements designated as cash flow hedges	–	36
Net change in receivables, other assets, accounts payable and accrued expenses	6,461	1,877
Net cash provided by operating activities	137,398	159,671
Investing activities:		
Purchases of residential mortgage investments	(2,158,970)	(3,380,199)
Interest receivable acquired with the purchase of residential mortgage investments	(4,167)	(5,410)
Principal collections on residential mortgage investments, including changes in mortgage securities principal remittance receivable	2,739,267	2,972,002
Net cash provided by (used in) investing activities	576,130	(413,607)
Financing activities:		
Proceeds from repurchase arrangements and similar borrowings	137,810,441	126,991,975
Principal payments on repurchase arrangements and similar borrowings	(138,521,532)	(126,669,933)
Increase (decrease) in cash collateral receivable from interest rate swap counterparties	16,213	(17,590)
Net proceeds from interest rate swap settlements	10,906	8,842
Proceeds from issuance of preferred shares	–	52,051
Common stock repurchases	(41,313)	–
Other capital stock transactions	(72)	(261)

Dividends paid	(60,353)	(74,426)
Net cash (used in) provided by financing activities	(785,710)	290,658
Net change in cash and cash equivalents	(72,182)	36,722
Cash and cash equivalents at beginning of period	103,907	56,732
Cash and cash equivalents at end of period	$31,725	$93,454

See accompanying notes to consolidated financial statements.

CAPSTEAD MORTGAGE CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2018

(unaudited)

NOTE 1 — BUSINESS

Capstead Mortgage Corporation operates as a self-managed real estate investment trust for federal income tax purposes (a “REIT”) and is based in Dallas, Texas. Unless the context otherwise indicates, Capstead Mortgage Corporation, together with its subsidiaries, is referred to as “Capstead” or the “Company.” Capstead earns income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of adjustable-rate mortgage (“ARM”) securities issued and guaranteed by government-sponsored enterprises, either Fannie Mae, Freddie Mac, or by an agency of the federal government, Ginnie Mae. Residential mortgage pass-through securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae are referred to as “Agency Securities” and are considered to have limited, if any, credit risk.

NOTE 2 — BASIS OF PRESENTATION

Interim Financial Reporting

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted 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. 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 and nine months ended September 30, 2018 are not necessarily indicative of the results that may be expected for the calendar year ending December 31, 2018. For further information refer to the audited consolidated financial statements and footnotes thereto included in the Company’s annual report on Form 10-K for the year ended December 31, 2017.

Recent Accounting Pronouncements

In November 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2016-18, Statement of Cash Flows: Restricted Cash (“ASU 2016-18”) which clarifies how entities should present restricted cash and restricted cash equivalents in the statement of cash flows. ASU 2016-18 is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company adopted ASU 2016-18 on January 1, 2018, which had no effect on the Company’s results of operations, financial condition or cash flows.

In May 2017, the FASB issued Accounting Standards Update No. 2017-09, Compensation-Stock Compensation: Scope of Modification Accounting (“ASU 2017-09”) which allows companies to make certain changes to stock awards without accounting for them as modifications. It does not change the accounting for modifications. ASU 2017-09 is effective for fiscal years beginning after December 15, 2017 and interim periods within those fiscal years. The Company adopted ASU 2017-09 on January 1, 2018, which had no effect on the Company’s results of operations, financial condition or cash flows.

NOTE 3 — NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income, after deducting dividends paid or accrued on preferred stock and allocating earnings to equity awards deemed to be participating securities pursuant to the two-class method, by the average number of shares of common stock outstanding, calculated excluding unvested stock awards. Participating securities include unvested equity awards that contain non-forfeitable rights to dividends prior to vesting.

Diluted net income per common share is computed by dividing the numerator used to compute basic net income per common share by the denominator used to compute basic net income per common share, further adjusted for the dilutive effect, if any, of equity awards and shares of preferred stock when and if convertible into shares of common stock. Shares of the Company's 7.50% Series E Cumulative Redeemable Preferred Stock are contingently convertible into shares of common stock only upon the occurrence of a change in control and therefore are not considered dilutive securities absent such an occurrence. Any unvested equity awards that are deemed participating securities are included in the calculation of diluted net income per common share, if dilutive, under either the two-class method or the treasury stock method, depending upon which method produces the more dilutive result. Components of the computation of basic and diluted net income per common share were as follows for the indicated periods (dollars in thousands, except per share amounts):

	Quarter Ended September 30		Nine Months Ended September 30	
	2018	2017	2018	2017
Basic net income per common share				
Numerator for basic net income per common share:				
Net income	$8,680	$16,752	$41,088	$57,002
Preferred stock dividends	(4,842)	(4,718)	(14,526)	(12,600)
Earnings participation of unvested equity awards	(24)	(36)	(84)	(116)
	$3,814	$11,998	$26,478	$44,286
Denominator for basic net income per common share:				
Average number of shares of common stock outstanding	91,659	96,094	92,649	96,073
Average unvested stock awards outstanding	(453)	(302)	(447)	(305)
	91,206	95,792	92,202	95,768
	$0.04	$0.13	$0.29	$0.46
Diluted net income per common share				
Numerator for diluted net income per common share:				
Numerator for basic net income per common share	$3,814	$11,998	$26,478	$44,286
Denominator for diluted net income per common share:				
Denominator for basic net income per common share	91,206	95,792	92,202	95,768
Net effect of dilutive equity awards	140	131	115	137
	91,346	95,923	92,317	95,905
	$0.04	$0.13	$0.29	$0.46

NOTE 4 — RESIDENTIAL mortgage investments

Residential mortgage investments classified by collateral type and interest rate characteristics as of the indicated dates were as follows (dollars in thousands):

	Unpaid Principal Balance	Investment Premiums	Amortized Cost Basis	Carrying Amount [a]	Net WAC [b]	Average Yield [c]
September 30, 2018						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$138	$–	$138	$138	6.50 %	5.65 %
ARMs	9,305,702	277,403	9,583,105	9,561,713	3.29	2.01
Ginnie Mae ARMs	3,058,570	79,388	3,137,958	3,117,258	3.17	2.30
	12,364,410	356,791	12,721,201	12,679,109	3.26	2.08
Residential mortgage loans:						
Fixed-rate	576	1	577	577	6.79	4.99
ARMs	1,045	6	1,051	1,051	4.04	3.18
	1,621	7	1,628	1,628	5.01	3.81
Collateral for structured financings	1,037	17	1,054	1,054	8.02	9.42
	$12,367,068	$356,815	$12,723,883	$12,681,791	3.26	2.08
December 31, 2017						
Agency Securities:						
Fannie Mae/Freddie Mac:						
Fixed-rate	$265	$1	$266	$266	6.51 %	6.22 %
ARMs	10,216,099	313,547	10,529,646	10,578,364	2.97	1.93
Ginnie Mae ARMs	2,791,340	84,297	2,875,637	2,872,163	2.78	1.83
	13,007,704	397,845	13,405,549	13,450,793	2.93	1.91
Residential mortgage loans:						
Fixed-rate	645	1	646	646	6.74	5.32
ARMs	1,211	7	1,218	1,218	4.04	3.19
	1,856	8	1,864	1,864	4.98	3.91
Collateral for structured financings	1,418	23	1,441	1,441	7.94	7.67
	$13,010,978	$397,876	$13,408,854	$13,454,098	2.93	1.91

(a) Includes unrealized gains and losses for residential mortgage investments classified as available-for-sale.
(b) Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments net of servicing and other fees as of the indicated balance sheet date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments.

(c) Average yield is presented for the quarter then ended and is based on the cash component of interest income expressed as a percentage calculated on an annualized basis on average amortized cost basis (the "cash yield") less the effects of amortizing investment premiums. Investment premium amortization is determined using the interest method and incorporates actual and anticipated future mortgage prepayments.

Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by Fannie Mae and Freddie Mac, which are federally chartered corporations, or Ginnie Mae, which is an agency of the federal government. Residential mortgage loans held by Capstead were originated prior to 1995 when the Company operated a mortgage conduit and the related credit risk is borne by the Company. Collateral for structured financings consists of private residential mortgage securities that are backed by loans obtained through this mortgage conduit and are pledged to secure repayment of related structured financings. Credit risk for these securities is borne by the related bondholders. The maturity of Residential mortgage investments is directly affected by prepayments of principal on the underlying mortgage loans. Consequently, actual maturities will be significantly shorter than the portfolio's weighted average contractual maturity of 288 months.

Fixed-rate investments consist of residential mortgage loans and Agency Securities backed by residential mortgage loans with fixed rates of interest. ARMs are adjustable-rate Agency Securities backed by residential mortgage loans that have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. After the initial fixed-rate period, if applicable, mortgage loans underlying ARM securities typically either (i) adjust annually based on specified margins over the one-year London interbank offered rate ("LIBOR") or the one-year Constant Maturity U.S. Treasury Note Rate ("CMT"), (ii) adjust semiannually based on specified margins over six-month LIBOR, or (iii) adjust monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index, usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans.

Capstead classifies its ARM investments based on average number of months until coupon reset ("months to roll"). Months to roll is an indicator of asset duration which is a measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk. Current-reset ARM investments have months to roll of less than 18 months while longer-to-reset ARM investments have months to roll of 18 months or greater. As of September 30, 2018, the average months to roll for the Company's $6.55 billion (amortized cost basis) in current-reset ARM investments was 6.2 months while the average months to roll for the Company's $6.18 billion (amortized cost basis) in longer-to-reset ARM investments was 42.1 months.

NOTE 5 — SECURED borrowings

Capstead pledges its Residential mortgage investments as collateral for secured borrowings primarily in the form of repurchase arrangements with commercial banks and other financial institutions (collectively referred to as "counterparties" or "lending counterparties"). Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of each repurchase arrangement and receives the related principal and interest payments.

The terms and conditions of secured borrowings are negotiated on a transaction-by-transaction basis when each such borrowing is initiated or renewed. The amount borrowed is generally equal to the fair value of the securities pledged, as determined by the lending counterparty, less an agreed-upon discount, referred to as a "haircut." Interest rates are generally fixed based on prevailing rates corresponding to the terms of the borrowings. Interest may be paid monthly or at the termination of a borrowing at which time the
Company may enter into a new borrowing at prevailing haircuts and rates with the same lending counterparty or repay that counterparty and negotiate financing with a different lending counterparty. None of the Company's lending counterparties are obligated to renew or otherwise enter into new borrowings at the conclusion of existing borrowings. In response to declines in fair value of pledged securities due to changes in market conditions or the publishing of monthly security pay-down factors, lending counterparties typically require the Company to post additional securities as collateral, pay down borrowings or fund cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements. These actions are referred to as margin calls. Conversely, in response to increases in fair value of pledged securities, the Company routinely margin calls its lending counterparties in order to have previously pledged collateral returned.

Secured borrowings (and related pledged collateral, including accrued interest receivable), classified by collateral type and remaining maturities, and related weighted average borrowing rates as of the indicated dates were as follows (dollars in thousands):

Collateral Type	Collateral Carrying Amount	Accrued Interest Receivable	Borrowings Outstanding	Average Borrowing Rates	
September 30, 2018					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	$11,973,233	$ 33,105	$11,352,886	2.28	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	280,255	775	266,026	2.34	
Similar borrowings:					
Collateral for structured financings	1,054	–	1,054	8.02	
	$12,254,542	$ 33,880	$11,619,966	2.29	
Quarter-end borrowing rates adjusted for effects of related derivative financial instruments (Derivatives) held as cash flow hedges				1.93	
December 31, 2017					
Borrowings under repurchase arrangements with maturities of 30 days or less:					
Agency Securities	$12,943,193	$ 30,646	$12,296,546	1.60	%
Borrowings under repurchase arrangements with maturities greater than 30 days:					
Agency Securities (31 to 90 days)	35,568	75	33,073	1.53	
Similar borrowings:					
Collateral for structured financings	1,441	–	1,441	7.94	
	$12,980,202	$ 30,721	$12,331,060	1.60	
Year-end borrowing rates adjusted for effects of related Derivatives held as cash flow hedges				1.46	

Average secured borrowings outstanding during the indicated periods differed from respective ending balances primarily due to changes in portfolio levels and differences in the timing of portfolio acquisitions relative to portfolio runoff as illustrated below (dollars in thousands):

	Quarter Ended					
	September 30, 2018			December 31, 2017		
	Average Borrowings	Average Rate		Average Borrowings	Average Rate	
Average borrowings and rates adjusted for the effects of related Derivatives held as cash flow hedges for the indicated periods	$11,957,518	1.82	%	$12,408,550	1.29	%

NOTE 6 — USE OF DERIVATIVES, OFFSETTING DISCLOSURES AND CHANGES IN OTHER COMPREHENSIVE INCOME BY COMPONENT

Capstead attempts to mitigate exposure to higher interest rates by entering into one- and three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements for terms of two and three years. These Derivatives are designated as cash flow hedges of the variability of the underlying benchmark interest rate of current and forecasted 30- to 90-day secured borrowings. This hedge relationship establishes a relatively stable fixed rate on related borrowings because the variable-rate payments received on the swap agreements offset a significant portion of the interest accruing on the designated borrowings, leaving the fixed-rate swap payments as the Company’s effective borrowing rate, subject to certain adjustments. These adjustments include differences between variable-rate payments received on the swap agreements and related unhedged borrowing rates as well as the effects of any measured hedge ineffectiveness. Additionally, changes in fair value of these Derivatives tend to partially offset opposing changes in fair value of the Company’s residential mortgage investments that can occur in response to changes in market interest rates.

During the nine months ended September 30, 2018, Capstead entered into swap agreements with notional amounts of $1.2 billion requiring fixed-rate interest payments averaging 2.62%. The Company did not enter into any new swap agreements during the quarter ended September 30, 2018. During the quarter and nine months ended September 30, 2018, $400 million and $2.7 billion notional amount of swaps requiring fixed-rate interest payments averaging 0.88% and 0.78% matured, respectively. At September 30, 2018, the Company’s portfolio financing-related swap positions had the following characteristics (dollars in thousands):

Period of Contract Expiration	Notional Amount	Average Fixed-Rate Payment Requirement
Fourth quarter 2018	$800,000	1.15 %
First quarter 2019	950,000	1.58
Second quarter 2019	1,650,000	1.33
Third quarter 2019	550,000	1.40
Fourth quarter 2019	700,000	1.72
First quarter 2020	600,000	2.07
Second quarter 2020	600,000	2.68
Third quarter 2020	200,000	1.64
Fourth quarter 2020	200,000	2.04
First quarter 2021	100,000	2.67
Second quarter 2021	200,000	2.87
	$6,550,000	

The Company has three-month LIBOR-indexed, pay-fixed, receive-variable, interest rate swap agreements with notional amounts totaling $100 million and average fixed rates of 4.09% with 20-year payment terms coinciding with the floating-rate terms of the Company’s Unsecured borrowings. These Derivatives are designated as cash flow hedges of the variability of the underlying contractual rate associated with the floating-rate terms of these long-term borrowings which began on various dates between October 2015 and September 2016.

Interest rate swap agreements are measured at fair value on a recurring basis primarily using Level Two Inputs in accordance with ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820). In determining fair value estimates for these Derivatives, Capstead utilizes the standard methodology of netting the discounted future fixed cash payments and the discounted future variable cash receipts which are based on expected future interest rates derived from observable market interest rate curves. The

Company also incorporates both its own nonperformance risk and its counterparties' nonperformance risk in determining fair value. In considering the effect of nonperformance risk, the Company considered the impact of netting and credit enhancements, such as collateral postings and guarantees, and has concluded that counterparty risk is not significant to the overall valuation.

The fair value of exchange-traded swap agreements held as cash flow hedges of Secured borrowings is calculated including accrued interest and net of variation margin amounts received or paid through the exchange, resulting in separately presenting on the balance sheet a significantly reduced fair value amount representing the unsettled fair value of these Derivatives. Non-exchange traded swap agreements held as cash flow hedges of Unsecured borrowings are reported at fair value calculated excluding accrued interest. At September 30, 2018, Cash collateral receivable from interest rate swap counterparties includes initial margin for all swap agreements and variation margin for non-exchange traded swap agreements. Accrued interest for non-exchange traded swap agreements is included in Accounts payable and accrued expenses.

The following tables include fair value and other related disclosures regarding all Derivatives held as of and for the indicated periods (in thousands):

	Balance Sheet Location	September 30 2018	December 31 2017
Balance sheet-related			
Swap agreements in a loss position (a liability) related to unsecured borrowings	(a)	$ (13,012)	$ (23,772)
Related net interest payable	(b)	(916)	(484)
		$ (13,928)	$ (24,256)

(a) The fair value of Derivatives with unrealized gains are aggregated and recorded as an asset on the face of the Balance Sheets separately from the fair value of Derivatives with unrealized losses that are recorded as a liability. The amount of unrealized gains, net of unrealized losses, scheduled to be recognized in the Statements of Income over the next twelve months primarily in the form of current market rates in excess of fixed-rate swap payments totaled $37.0 million at September 30, 2018.

(b) Included in "Accounts payable and accrued expenses" on the face of the Balance Sheets.

	Location of Gain or (Loss) Recognized in Net Income	Quarter Ended September 30 2018	Quarter Ended September 30 2017	Nine Months Ended September 30 2018	Nine Months Ended September 30 2017
Income statement-related					
Components of Secured borrowings-related effects on interest expense:					
Amount of gain (loss) reclassified from		$11,585	$3,912	$27,277	$4,412

Accumulated other comprehensive income					
Amount of loss recognized in income		–	1,141	—	(360)
	(a)	11,585	5,053	27,277	4,052
Component of Unsecured borrowings-related effects on interest expense:					
Amount of loss reclassified from Accumulated other comprehensive income	(b)	(423)	(699)	(1,501)	(2,205)
Decrease (increase) in interest expense and increase (decrease) in Net income as a result of the use of Derivatives		$11,162	$4,354	$25,776	$1,847
Other comprehensive income-related					
Amount of gain recognized in Other comprehensive income		$7,580	$1,827	$46,385	$3,541

(a) Included in “Interest expense: Secured borrowings” on the face of the Statements of Income.
(b) Included in “Interest expense: Unsecured borrowings” on the face of the Statements of Income.

Capstead’s swap agreements and borrowings under repurchase arrangements are subject to master netting arrangements in the event of default on, or termination of, any one contract. See NOTE 5 for more information on the Company’s use of secured borrowings. The following tables provide disclosures concerning offsetting of financial liabilities and Derivatives as of the indicated dates (in thousands):

Offsetting of Derivative Assets

	Gross Amounts of Recognized Assets [(a)]	Gross Amounts Offset in the Balance Sheet [(a)]	Net Amounts of Assets Presented in the Balance Sheet	Gross Amounts Not Offset in the Balance Sheet [(b)] Financial Instruments	Cash Collateral Received	Net Amount
September 30, 2018						
Counterparty 4	$40,220	$ (40,220)	$ –	$ –	$ –	$ –
December 31, 2017						
Counterparty 4	$30,676	$ (30,676)	$ –	$ –	$ –	$ –

(a) Included in gross amounts of recognized assets at September 30, 2018 is the fair value of exchange-traded swap agreements, calculated including accrued interest. Included in gross amounts offset in the balance sheet are variation margin amounts associated with these swaps at September 30, 2018.
(b) Amounts presented are limited to recognized liabilities and cash collateral received associated with the indicated counterparty sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.

Offsetting of Financial Liabilities and Derivative Liabilities

	Gross Amounts of Recognized Liabilities [(a)]	Gross Amounts Offset in the Balance Sheet [(a)]	Net Amounts of Liabilities Presented in the Balance Sheet [(b)]	Gross Amounts Not Offset in the Balance Sheet [(c)] Financial Instruments	Cash Collateral Pledged	Net Amount
September 30, 2018						
Derivatives by counterparty:						
Counterparty 1	$13,927	$ –	$13,927	$–	$(13,927)	$ –
Counterparty 4	2,820	(2,820)	–	–	–	–
	16,747	(2,820)	13,927	–	(13,927)	–

Borrowings under repurchase arrangements (d)	11,631,352	–	11,631,352	(11,631,352)	–	–
	$11,648,099	$ (2,820)	$11,645,279	$(11,631,352)	$(13,927)	$ –
December 31, 2017						
Derivatives by counterparty:						
Counterparty 1	$24,256	$ –	$24,256	$–	$(24,256)	$ –
Counterparty 4	3,701	(3,701)	–	–	–	–
	27,957	(3,701)	24,256	–	(24,256)	–
Borrowings under repurchase arrangements (d)	12,337,299	–	12,337,299	(12,337,299)	–	–
	$12,365,256	$ (3,701)	$12,361,555	$(12,337,299)	$(24,256)	$ –

(a) Included in gross amounts of recognized liabilities at September 30, 2018 is the fair value of non-exchange traded swap agreements (Counterparty 1) and exchange-traded swap agreements (Counterparty 4), calculated including accrued interest. Included in gross amounts offset in the balance sheet are variation margin amounts associated with exchange-traded swap agreements at September 30, 2018.
(b) Amounts presented are limited to recognized liabilities and cash collateral received associated with the indicated counterparty sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.
(c) Amounts presented are limited to recognized assets and collateral pledged associated with the indicated counterparty sufficient to reduce the related Net Amount to zero in accordance with ASU No. 2011-11, as amended by ASU No. 2013-01.
(d) Amounts include accrued interest payable of $12.4 million and $7.7 million on borrowings under repurchase arrangements as of September 30, 2018 and December 31, 2017, respectively.

Changes in Accumulated other comprehensive income by component for the quarter and nine months ended September 30, 2018 were as follows (in thousands):

	Unrealized Gains and Losses on Cash Flow Hedges	Unrealized Gains and Losses on Available-for-Sale Securities	Total
Balance at June 30, 2018	$ 41,065	$ (15,321)	$25,744
Activity for the quarter ended September 30, 2018:			
Other comprehensive income (loss) before reclassifications	7,580	(26,771)	(19,191)
Amounts reclassified from accumulated other comprehensive income	(11,162)	–	(11,162)
Other comprehensive loss	(3,582)	(26,771)	(30,353)
Balance at September 30, 2018	$ 37,483	$ (42,092)	$(4,609)
Balance at December 31, 2017	$ 16,874	$ 45,244	$62,118
Activity for the nine months ended September 30, 2018:			
Other comprehensive income (loss) before reclassifications	46,385	(87,336)	(40,951)
Amounts reclassified from accumulated other comprehensive income	(25,776)	–	(25,776)
Other comprehensive income (loss)	20,609	(87,336)	(66,727)
Balance at September 30, 2018	$ 37,483	$ (42,092)	$(4,609)

NOTE 7 — unsecured BORROWINGS

Unsecured borrowings consist of 30-year junior subordinated notes issued in 2005 and 2006 and maturing in 2035 and 2036, for a total face amount of $100 million. Note balances net of deferred issuance costs, and related weighted average interest rates as of the indicated dates (calculated including issuance cost amortization and adjusted for effects of related Derivatives held as cash flow hedges) were as follows (dollars in thousands):

	September 30, 2018		December 31, 2017	
	Borrowings Outstanding	Average Rate	Borrowings Outstanding	Average Rate
Junior subordinated notes maturing in:				
October 2035 ($35,000 face amount)	$34,344	7.89 %	$34,315	7.90 %
December 2035 ($40,000 face amount)	39,349	7.65	39,320	7.66
September 2036 ($25,000 face amount)	24,573	7.69	24,556	7.70
	$98,266	7.74	$98,191	7.75

NOTE 8 — Capital transactions

On November 1, 2017, Capstead's Board of Directors authorized the reinstatement of its previously unused $100 million common stock repurchase program. During the quarter and nine months ended September 30, 2018 the Company repurchased 1.4 million and 4.9 million shares of common stock in the open market for approximately $11.8 million and $41.3 million, respectively (an average repurchase price, including program costs, of $8.25 and $8.50 per share). An additional 140,000 share repurchases settled subsequent to quarter-end for $1.0 million (an average repurchase price, including program costs, of $7.18), leaving a remaining repurchase program authorization of $54.3 million. Repurchases made pursuant to the program are made in the open market in accordance with and as permitted by securities laws and other legal requirements. The timing, manner, price and amount of any future repurchases will be determined by the Company in its discretion and will be subject to economic and market conditions, stock price, applicable legal requirements and other factors including alternative capital investment opportunities. In addition, the Company may enter into Rule 10b5-1 plans under which repurchases can be made. The authorization does not obligate the Company to acquire any particular amount of common stock and repurchases under the program and the program itself may be suspended or discontinued at the Company's discretion without prior notice.

NOTE 9 — FAIR VALUE

The fair value of Capstead's financial assets and liabilities are influenced by changes in, and market expectations for changes in, interest rates and market liquidity conditions, as well as other factors beyond the control of management. With the exception of the fair value of lending counterparty investments, all fair values were determined using Level 2 Inputs in accordance with ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820). Lending counterparty investments are nonmarketable securities classified as assets for which Level 3 Inputs are used to determine fair value. These assets are considered strategic investments that are carried at cost and periodically valued and evaluated for impairment. No impairment charges have been recorded relative to these investments and the Company's cost basis is deemed to approximate fair value.

Residential mortgage investments, nearly all of which are mortgage securities classified as available-for-sale, are measured at fair value on a recurring basis. In determining fair value estimates the Company considers recent trading activity for similar investments and pricing levels indicated by lenders in connection with designating collateral for secured borrowings, provided such pricing levels are considered indicative of actual market clearing transactions. In determining fair value estimates for Secured borrowings with initial terms of greater than 120 days, the Company considers pricing levels indicated by lenders for entering into new transactions using similar pledged collateral with terms equal to the remaining terms of these borrowings. The Company currently bases fair value for Unsecured borrowings on discounted cash flows using Company estimates for market yields. Excluded from these disclosures are financial instruments for which cost basis is deemed to approximate fair value due primarily to the short duration of these instruments, which are valued using primarily Level 1 measurements, including Cash and cash equivalents, Cash collateral receivable from, or payable to, interest rate swap counterparties, receivables, payables and secured borrowings with initial terms of 120 days or less. See NOTE 6 for information relative to the valuation of interest rate swap agreements.

Fair value-related disclosures for financial instruments other than debt securities were as follows as of the indicated dates (in thousands):

	September 30, 2018		December 31, 2017	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Residential mortgage loans	$1,628	$1,600	$1,864	$1,900
Lending counterparty investments	5,002	5,002	5,002	5,002
Financial liabilities:				
Secured borrowings with initial terms of greater than 120 days	–	–	33,073	33,100
Unsecured borrowings	98,266	85,500	98,191	74,100
Unsecured borrowings-related interest rate swap agreements	13,012	13,012	23,772	23,772

Fair value-related disclosures for debt securities were as follows as of the indicated dates (in thousands):

	Amortized	Gross Unrealized		
	Cost Basis	Gains	Losses	Fair Value
September 30, 2018				
Agency Securities classified as available-for-sale:				
Fannie Mae/Freddie Mac	$9,583,105	$66,619	$88,011	$9,561,713
Ginnie Mae	3,137,958	7,235	27,935	3,117,258
Residential mortgage securities classified as held-to-maturity	1,192	4	–	1,196
December 31, 2017				
Agency Securities classified as available-for-sale:				
Fannie Mae/Freddie Mac	10,529,646	85,740	37,022	10,578,364
Ginnie Mae	2,875,637	8,958	12,432	2,872,163
Residential mortgage securities classified as held-to-maturity	1,706	17	–	1,723

	September 30, 2018		December 31, 2017	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities in an unrealized loss position:				
One year or greater	$3,056,513	$61,923	$2,552,668	$26,701
Less than one year	4,466,222	54,023	4,665,883	22,752
	$7,522,735	$115,946	$7,218,551	$49,453

Capstead's investment strategy involves managing a leveraged portfolio of relatively short-duration ARM Agency Securities and management expects these securities will be held until payoff absent a major shift in strategy or a severe contraction in the Company's ability to obtain financing to support its portfolio. Declines in fair value caused by increases in interest rates are typically modest for investments in short-duration ARM Agency Securities compared to investments in longer-duration ARM or fixed-rate assets. These declines are generally recoverable in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then-current interest rate environment.

From a credit risk perspective, federal government support for Fannie Mae and Freddie Mac helps ensure that fluctuations in value due to credit risk associated with these securities will be limited. Given that (a) any existing unrealized losses on mortgage securities held by the Company are not attributable to credit risk and declines in fair value of ARM securities due to changes in interest rates are generally recoverable in a relatively short period of time, (b) the Company typically holds its investments to maturity, and (c) it is more likely than not that the Company will not be required to sell any of its investments given the resiliency of the financing market for Agency Securities, none of these investments were considered other-than-temporarily impaired at September 30, 2018.

NOTE 10 — COMPENSATION PROGRAMS

Capstead's annual and long-term incentive compensation programs for key executives are largely nondiscretionary, formulaic and target-based, utilizing multiple pre-established performance goals (referred to as "metrics") and defined threshold, target and maximum award amounts determined by reference to established percentages of base salaries. Metrics used include (a) relative and absolute economic return (change in book value per common share plus common stock dividends divided by beginning book value per common share), (b) relative operating cost efficiency (operating expenses divided by Unsecured borrowings and Stockholders' equity), (c) relative total stockholder return (change in stock price plus reinvested dividends, and (d) attainment of individual goals and objectives. Each performance metric is assigned a weighting and performance relative to each metric is calculated separately. No awards can be earned for performance below defined threshold return levels and awards are capped for performance above defined maximum return levels. Awards are made pursuant to the Company's Amended and Restated 2014 Flexible Incentive Plan that was approved by stockholders in May 2014. At September 30, 2018, this plan had 3,312,051 shares of common stock remaining available for future issuances.

Short-term Incentive Compensation Programs

Under the provisions of Capstead's annual incentive compensation program, participating executives have overall target award opportunities ranging from 75% to 125% of base salary. Included in Accounts payable and accrued expenses at September 30, 2018 are annual incentive compensation accruals for participating executives, together with discretionary accruals for all other employees, totaling $1.1 million. Recognized in Compensation-related expense are $332,000 and $1.1 million related to annual incentive compensation for all employees for the quarter and nine months ended September 30, 2018, respectively.

The Company administers an additional performance-based short-term incentive compensation program for key executives that provides for quarterly cash payments equal to per share dividends declared on Capstead's common stock multiplied by a notional amount of non-vesting shares of common stock ("Dividend Equivalent Rights" or "DERs"). DERs only represent the right to receive the same cash distributions that the Company's common stockholders are entitled to receive during the term of the grants, subject to certain conditions, including continuous service. Included in Accounts payable and accrued expenses are third quarter 2018 DERs distribution amounts totaling $66,000 that were paid in October 2018. Recognized in Compensation-related expense are $66,000 and $246,000 related to the DERs program for the quarter and nine months ended September 30, 2018, respectively.

Long-term Equity-based Awards – Performance-based RSUs

Capstead's performance-based long-term incentive compensation program for key executives provides for the grant of performance-based RSUs that are convertible into shares of common stock following three-year performance periods, contingent upon whether, and to what extent, performance metrics are met or exceeded. The actual number of shares of common stock the units can convert into for each of the metrics, if any, can range from one-half of a share per unit if that metric's threshold level of performance is met, to two shares per unit if the related maximum level of performance is met or exceeded, adjusted for the weighting assigned to the metric. Dividends accrue from the date of grant and will be paid in cash to the extent the units convert into shares of common stock following completion of related performance periods.

Pursuant to this program, in January 2018 and 2017, as well as February 2016, respectively, the Company granted 183,137, 148,894 and 269,354 RSUs with three-year performance periods ending December 31, 2020, 2019 and 2018. Initial grant date fair values developed for compensation cost purposes of $8.71, $10.52 and $8.03 were assigned to the units of each grant, respectively. Amounts actually expensed are largely predicated on estimated performance metric attainment. Recognized in Compensation-related expense are $211,000 and $228,000 related to this program during the quarter and nine months ended September 30, 2018, respectively.

RSU activity for the nine months ended September 30, 2018 is summarized below:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested RSU awards outstanding at December 31, 2017	435,976	$ 9.10
January 2018 grants	183,137	8.71
Forfeiture of remaining 2015 grants	(117,255)	8.83
Unvested RSU awards outstanding at September 30, 2018	501,858	9.02

Long-term Equity-based Awards – Stock Awards

In January 2018 and 2017, as well as February 2016, respectively, the Company granted service-based stock awards for 126,451, 74,446 and 67,337 shares of common stock with grant date fair values of $8.60, $10.41 and $9.32 per share to executives awarded RSUs. Outstanding awards under this program and related deferred dividends are scheduled to vest in January 2021, January 2020 and February 2019, respectively, assuming service conditions are met. In January of 2018, 2017 and 2016, respectively, the Company granted service-based stock awards for 57,283, 49,416 and 61,272 shares of common stock with grant date fair values of $8.60, $10.41 and $7.87 per share to employees not awarded RSUs. These awards vest in January of 2021, 2020 and 2019, respectively, assuming service conditions are met.

As a component of the Company's director compensation program, directors are granted service-based stock awards annually upon election or re-election to the board of directors that vest approximately one year from issuance. In July 2017 director common stock awards for a total of 41,797 shares with a grant date fair value of $10.05 per share were granted that vested in July 2018. In July 2018 director common stock awards for a total of 57,113 shares with a grant date fair value of $8.58 per share were granted that will vest in July 2019.

Performance-based and service-based stock award activity for the nine months ended September 30, 2018 is summarized below:

	Number of Shares	Weighted Average Grant Date Fair Value
Unvested stock awards outstanding at December 31, 2017	296,940	$ 9.90
Grants	240,847	8.60
Vestings	(76,696)	11.15
Unvested stock awards outstanding at September 30, 2018	461,091	9.01

During the quarter and nine months ended September 30, 2018, the Company recognized in Compensation-related expense $307,000 and $922,000, respectively, related to amortization of the grant date fair value of employee stock awards. In addition, the Company recognized in Other general and administrative expense $117,000 and $327,000 related to amortization of the grant date fair value of director stock awards during the quarter and nine months ended September 30, 2018, respectively.

Unrecognized compensation expense for unvested stock awards for employees and directors totaled $2.2 million as of September 30, 2018, to be expensed over a weighted average period of 1.3 years.

Service-based stock awards issued to non-executive employees and to directors receive dividends on a current basis without risk of forfeiture if the related awards do not vest. Stock awards issued to executives defer the payment of dividends accruing between the grant dates and the end of related service periods. If these awards do not vest, the related accrued dividends will be forfeited.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL

CONDITION AND RESULTS OF OPERATIONS

FINANCIAL CONDITION

Overview

Capstead operates as a self-managed REIT earning income from investing in a leveraged portfolio of residential mortgage pass-through securities consisting almost exclusively of short-duration ARM Agency Securities, which reset to more current interest rates within a relatively short period of time and are considered to have limited, if any, credit risk. See NOTE 1 to the consolidated financial statements (included under Item 1 of this report) for defined terms used in this discussion and analysis. By investing in short-duration ARM Agency Securities, the Company is positioned to benefit from future recoveries in financing spreads that typically contract during periods of rising interest rates and to experience smaller fluctuations in portfolio values compared to leveraged portfolios containing a significant amount of longer-duration ARM or fixed-rate mortgage securities. Duration is a common measure of market price sensitivity to interest rate movements. A shorter duration generally indicates less interest rate risk.

Capstead finances its residential mortgage investments by leveraging its long-term investment capital with secured borrowings consisting primarily of borrowings under repurchase arrangements with commercial banks and other financial institutions. Long-term investment capital totaled $1.22 billion at September 30, 2018, consisting of $870 million of common and $251 million of preferred stockholders' equity, together with $98 million of unsecured borrowings maturing in 2035 and 2036 (recorded amounts). Long-term investment capital decreased $118 million during the first nine months of 2018 as a result of common stock repurchases totaling $41 million, declines in portfolio valuations that outstripped increases in swap gains ($67 million net decline) and dividend distributions in excess of earnings ($11 million).

Book value per common share (total stockholders' equity, less liquidation preferences for outstanding shares of preferred stock, divided by outstanding shares of common stock) declined 7.5% ($0.77) to $9.48 per share during the first nine months of 2018, as declines in portfolio valuations and dividend distributions in excess of earnings were only partially offset by swap gains and common stock repurchases.

Capstead's residential mortgage investments portfolio decreased $772 million during the first nine months of 2018 to $12.68 billion at September 30, 2018 as the portfolio declined in value and a portion of capital made available from portfolio runoff was used to fund stock repurchases. Secured borrowings decreased $711 million to $11.62 billion. Portfolio leverage (secured borrowings divided by long-term investment capital) increased to 9.53 to one at September 30, 2018 from 9.22 to one at December 31, 2017. Management believes current portfolio leverage levels represent an appropriate use of leverage under current market conditions for a portfolio consisting of seasoned, short-duration ARM Agency Securities.

Capstead reported net income of $9 million and $41 million or $0.04 and $0.29 per diluted common share for the quarter and nine months ended September 30, 2018, compared to $17 million and $57 million or $0.13 and $0.46 per diluted common share for the same periods in 2017, respectively. Capstead’s earnings in the 2018 periods benefited from higher cash yields and lower investment premium while being negatively impacted by higher borrowing costs. Investment premium amortization was lower due to portfolio basis trending lower in recent periods coupled with lower mortgage prepayment rates. Higher borrowing costs were driven by Federal Reserve actions to increase the Federal Funds rate by 25 basis points in December 2017, March 2018, June 2018 and, to a lesser extent, September 2018. The Company declared a third quarter 2018 common dividend of $0.11 per share that was paid on October 19, 2018 to holders of record on September 30, 2018.

Common Stock Repurchase Program

The Company repurchased 4.9 million shares of common stock in the open market during the nine months ended September 30, 2018 at an average repurchase price, including program costs, of $8.50 per share, or approximately 82.9% of the Company's December 31, 2017 book value per common share. These repurchases, which primarily occurred during the first and third quarters of 2018, generated $0.09 per common share in book value accretion. An additional 140,000 share repurchases settled subsequent to quarter-end for $1 million at an average repurchase price, including program costs, of $7.18. Approximately $54 million remains under the repurchase program.

Repurchases made pursuant to the program are made in the open market in accordance with and as permitted by securities laws and other legal requirements. The timing, manner, price and amount of any repurchases will be determined by the Company in its discretion and will be subject to economic and market conditions, stock price, applicable legal requirements and other factors including alternative capital investment opportunities. In addition, the Company may enter into Rule 10b5-1 plans under which repurchases can be made. The authorization does not obligate the Company to acquire any particular amount of common stock and repurchases under the program and the program itself may be suspended or discontinued at the Company's discretion without prior notice.

Book Value per Common Share

All but $3 million of Capstead's residential mortgage investments portfolio and all of its interest rate swap agreements are recorded at fair value on the Company's balance sheet and are therefore included in the calculation of book value per common share. See NOTE 9 to the consolidated financial statements (included under Item 1 of this report) for additional disclosures regarding fair values of financial instruments held or issued by the Company.

Fair value is impacted by market conditions, including changes in interest rates, and the availability of financing at reasonable rates and leverage levels, among other factors. The Company's investment strategy attempts to mitigate these risks by focusing on investments in Agency Securities, which are considered to have little, if any, credit risk and are collateralized by ARM loans with interest rates that reset periodically to more current levels, generally within five years. Because of these characteristics, the fair value of the Company's portfolio is considerably less vulnerable to significant pricing declines caused by credit concerns or rising interest rates compared to leveraged portfolios containing a significant amount of non-agency securities or longer-duration ARM and/or fixed-rate Agency Securities.

The following table illustrates the progression of Capstead's book value per common share as well as changes in book value expressed as percentages of beginning book value for the quarter and nine months ended September 30, 2018:

	Quarter Ended September 30, 2018		Nine Months Ended September 30, 2018	
Book value per common share, beginning of period	$9.85		$10.25	
Change in net unrealized gains on mortgage securities classified as available-for-sale	(0.29)		(0.96)	
Change in net unrealized gains and losses on interest rate swap agreements designated as cash flow hedges of:				
Secured borrowings	(0.07)		0.11	
Unsecured borrowings	0.03		0.12	
	(0.33)	(3.4)%	(0.73)	(7.1)%
Capital transactions:				
Accretion from common stock repurchases	0.03		0.09	
Dividend distributions in excess of earnings	(0.07)		(0.12)	
Stock compensation-related activity	–		(0.01)	
	(0.04)	(0.4)%	(0.04)	(0.4)%
Book value per common share, end of period	$9.48		$9.48	
Decrease in book value per common share during the indicated periods	$(0.37)	(3.8)%	$(0.77)	(7.5)%

Residential Mortgage Investments

The following table illustrates the progression of Capstead's portfolio of residential mortgage investments for the quarter and nine months ended September 30, 2018 (dollars in thousands):

	Quarter Ended September 30, 2018	Nine Months Ended September 30, 2018
Residential mortgage investments, beginning of period	$ 13,017,107	$ 13,454,098
Portfolio acquisitions (principal amount)	728,340	2,111,736
Investment premiums on acquisitions*	15,051	47,234
Portfolio runoff (principal amount)	(1,019,582)	(2,755,648)
Investment premium amortization*	(32,354)	(88,293)
Decrease in net unrealized gains on securities classified as available-for-sale	(26,771)	(87,336)
Residential mortgage investments, end of period	$ 12,681,791	$ 12,681,791

Decrease in residential mortgage investments during the indicated periods	$ (335,316)	$ (772,307)

* Residential mortgage investments typically are acquired at a premium to the securities' unpaid principal balances. Investment premiums are recognized in earnings as portfolio yield adjustments using the interest method over the estimated lives of the related investments. As such, the level of mortgage prepayments impacts how quickly investment premiums are amortized.

Capstead's investment strategy focuses on managing a portfolio of residential mortgage investments consisting almost exclusively of ARM Agency Securities. Agency Securities are considered to have limited, if any, credit risk because the timely payment of principal and interest is guaranteed by Fannie Mae and Freddie Mac, which are federally chartered corporations, or Ginnie Mae, which is an agency of the federal government. Federal government support for Fannie Mae and Freddie Mac has largely alleviated market concerns regarding the ability of Fannie Mae and Freddie Mac to fulfill their guarantee obligations.

By focusing on investing in short-duration ARM Agency Securities, changes in fair value caused by changes in interest rates are typically relatively modest compared to changes in fair value of longer-duration ARM or fixed-rate assets. Declines in fair value caused by increases in interest rates are generally recoverable in a relatively short period of time as coupon interest rates on the underlying mortgage loans reset to rates more reflective of the then-current interest rate environment. This investment strategy positions the Company to benefit from potential recoveries in financing spreads that typically contract during periods of rising interest rates.

ARM securities are backed by mortgage loans that generally have coupon interest rates that adjust at least annually to more current interest rates or begin doing so after an initial fixed-rate period. These coupon adjustments are usually subject to periodic and lifetime limits, or caps, on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. After the initial fixed-rate period, if applicable, the coupon interest rates of mortgage loans underlying the Company's ARM securities typically adjust either (a) annually based on specified margins over the one-year London interbank offered rate ("LIBOR") or the one-year Constant Maturity U.S. Treasury Note Rate ("CMT"), (b) semiannually based on specified margins over six-month LIBOR, or (c) monthly based on specified margins over indices such as one-month LIBOR, the Eleventh District Federal Reserve Bank Cost of Funds Index, or over a rolling twelve month average of the one-year CMT index.

Capstead classifies its ARM securities based on the average length of time until the loans underlying each security reset to more current rates ("months-to-roll") (less than 18 months for "current-reset" ARM securities, and 18 months or greater for "longer-to-reset" ARM securities). The Company's ARM holdings featured the following characteristics at September 30, 2018 (dollars in thousands):

ARM Type	Amortized Cost Basis [a]	Net WAC [b]	Fully Indexed WAC [b]	Average Net Margins [b]	Average Periodic Caps [b]	Average Lifetime Caps [b]	Months To Roll
Current-reset ARMs:							
Fannie Mae Agency Securities	$ 3,674,581	3.68 %	4.45 %	1.68 %	2.77 %	9.23 %	6.1
Freddie Mac Agency Securities	1,565,499	3.63	4.64	1.78	2.24	9.04	7.2
Ginnie Mae Agency Securities	1,305,026	3.12	4.10	1.51	1.06	8.28	5.6
Residential mortgage loans	1,051	4.04	4.70	2.11	1.72	11.17	5.3
(51% of total)	6,546,157	3.56	4.42	1.67	2.30	9.00	6.2
Longer-to-reset ARMs:							
Fannie Mae Agency Securities	2,910,692	2.85	4.51	1.59	3.07	7.86	40.0
Freddie Mac Agency Securities	1,432,333	2.79	4.56	1.64	2.72	7.87	37.7
Ginnie Mae Agency Securities	1,832,932	3.20	4.09	1.50	1.00	8.20	48.9
(49% of total)	6,175,957	2.94	4.40	1.58	2.15	7.98	42.1
	$ 12,722,114	3.26	4.41	1.62	2.24	8.59	23.7
Gross WAC (rate paid by borrowers) [c]		3.85					

(a) Amortized cost basis represents the Company's investment (unpaid principal balance plus unamortized investment premiums) before unrealized gains and losses. At September 30, 2018, the ratio of amortized cost basis to unpaid principal balance for the Company's ARM holdings was 102.89. This table excludes $2 million in fixed-rate agency-guaranteed mortgage pass-through securities, residential mortgage loans and private residential mortgage pass-through securities held as collateral for structured financings.

(b) Net WAC, or weighted average coupon, is the weighted average interest rate of the mortgage loans underlying the indicated investments, net of servicing and other fees as of the indicated date. Net WAC is expressed as a percentage calculated on an annualized basis on the unpaid principal balances of the mortgage loans underlying these investments. As such, it is similar to the cash yield on the portfolio which is calculated using amortized cost basis. Fully indexed WAC represents the weighted average coupon upon one or more resets using interest rate indexes and net margins as of the indicated date. Average net margins represent the weighted average levels over the underlying indexes that the portfolio can adjust to upon reset, usually subject to initial, periodic and/or lifetime caps on the amount of such adjustments during any single interest rate adjustment period and over the contractual term of the underlying loans. ARM securities with initial fixed-rate periods of five years or longer typically have either 200 or 500 basis point initial caps with 200 basis point periodic caps. Additionally, certain ARM securities held by the Company are subject only to lifetime caps or are not subject to a cap. For presentation purposes, average periodic caps in the table above reflect initial caps until after an ARM security has reached its initial reset date and lifetime caps, less the current net WAC, for ARM securities subject only to lifetime caps. At quarter-end, 74% of current-reset ARMs were subject to periodic caps averaging 1.76%; 19% were subject to initial caps averaging 2.90%; and 7% were subject to lifetime caps averaging 6.65%. All longer-to-reset ARM securities at September 30, 2018 were subject to initial caps.

(c) Gross WAC is the weighted average interest rate of the mortgage loans underlying the indicated investments, including servicing and other fees paid by borrowers, as of the indicated balance sheet date.

After consideration of any applicable initial fixed-rate periods, at September 30, 2018 approximately 91%, 4% and 3% of the Company’s ARM securities were backed by mortgage loans that reset annually, semi-annually and monthly, respectively, while approximately 2% reset every five years. Approximately 81% of the Company’s current-reset ARM securities have reached an initial coupon reset date, while none of its longer-to-reset ARM securities have reached an initial coupon reset date. Additionally, at September 30, 2018 approximately 5% of the Company’s ARM securities were backed by interest-only loans, with remaining interest-only payment periods averaging 24 months. All percentages are based on averages of the characteristics of mortgage loans underlying each security and calculated using unpaid principal balances as of the indicated date.

Secured Borrowings

Capstead finances its residential mortgage investments by leveraging its long-term investment capital with secured borrowings consisting primarily of borrowings under repurchase arrangements with commercial banks and other financial institutions. Repurchase arrangements entered into by the Company involve the sale and a simultaneous agreement to repurchase the transferred assets at a future date and are accounted for as financings. The Company maintains the beneficial interest in the specific securities pledged during the term of each repurchase arrangement and receives the related principal and interest payments.

The terms and conditions of secured borrowings are negotiated on a transaction-by-transaction basis when each such borrowing is initiated or renewed. None of the Company’s counterparties are obligated to renew or otherwise enter into new borrowings at the conclusion of existing borrowings. Collateral requirements in excess of amounts borrowed (referred to as “haircuts”) averaged 4.6 percent of the fair value of pledged residential mortgage pass-through securities at September 30, 2018. After considering haircuts and related interest receivable on the collateral, as well as interest payable on these borrowings, the Company had $656 million of capital at risk with its lending counterparties at September 30, 2018. The Company did not have capital at risk with any single counterparty exceeding 6% of total stockholders’ equity at September 30, 2018.

Secured borrowing rates are generally fixed based on prevailing rates corresponding to the terms of the borrowings. Interest may be paid monthly or at the termination of a borrowing at which time the Company may enter into a new borrowing at prevailing haircuts and rates with the same counterparty or repay that counterparty and negotiate financing with a different counterparty. When the fair value of pledged securities declines due to changes in market conditions or the publishing of monthly security pay-down factors, lenders typically require the Company to post additional securities as collateral, pay down borrowings or fund cash margin accounts with the counterparties in order to re-establish the agreed-upon collateral requirements, referred to as margin calls. Conversely, if collateral fair values increase, lenders are required to release collateral back to the Company pursuant to Company-issued margin calls.

As of September 30, 2018, the Company's secured borrowings totaled $11.62 billion with 23 counterparties at average rates of 2.29%, before the effects of currently-paying interest rate swap agreements held as cash flow hedges and 1.93% including the effects of these derivatives. The Company typically uses two- and three-year term interest rate swap agreements with variable rate receipts primarily based on three-month LIBOR to help mitigate exposure to rising short-term interest rates. At quarter-end the Company held $6.55 billion notional amount of portfolio financing-related interest rate swap agreements with contract expirations occurring at various dates through the second quarter of 2021 and a weighted average expiration of 11 months.

After consideration of all portfolio financing-related swap positions entered into as of quarter-end, the Company's residential mortgage investments and secured borrowings had estimated durations at September 30, 2018 of 12¼ and 6½ months, respectively, for a net duration gap of approximately 5¾ months – see "Interest Rate Risk" for further information about the Company's sensitivity to changes in market interest rates. The Company intends to continue to manage interest rate risk associated with holding and financing its residential mortgage investments by utilizing suitable derivative financial instruments such as interest rate swap agreements as well as longer-maturity secured borrowings, if available at attractive rates and terms.

Utilization of Long-term Investment Capital and Potential Liquidity

Capstead's investment strategy involves managing an appropriately leveraged portfolio of ARM Agency Securities that management believes can produce attractive risk-adjusted returns over the long term, while reducing, but not eliminating, sensitivity to changes in interest rates. The potential liquidity inherent in the Company's unencumbered residential mortgage investments is as important as the actual level of cash and cash equivalents carried on the balance sheet because secured borrowings generally can be increased or decreased on a daily basis to meet cash flow requirements and otherwise manage capital resources efficiently. Potential liquidity is affected by, among other factors:

- current portfolio leverage levels,
- changes in market value of assets pledged and interest rate swap agreements held for hedging purposes as determined by lending and swap counterparties,
- mortgage prepayment levels,
- collateral requirements of lending and swap counterparties, and
- general conditions in the commercial banking and mortgage finance industries.

Capstead's utilization of its long-term investment capital and its estimated potential liquidity were as follows as of September 30, 2018 in comparison with December 31, 2017 (in thousands):

	Investments [(a)]	Secured Borrowings	Capital Employed	Potential Liquidity [(b)]	Portfolio Leverage
Residential mortgage investments	$12,681,791	$11,619,966	$1,061,825	$ 481,770	
Cash collateral receivable from swap counterparties, net [(c)]			13,281	–	
Other assets, net of other liabilities			144,253	31,725	
Balances as of September 30, 2018:	$12,681,791	$11,619,966	$1,219,359	$ 513,495	9.53:1
Balances as of December 31, 2017	$13,454,098	$12,331,060	$1,337,067	$ 613,791	9.22:1

(a) Investments are stated at balance sheet carrying amounts, which generally reflect estimated fair value as of the indicated dates.

(b) Potential liquidity is based on maximum amounts of borrowings available under existing uncommitted financing arrangements considering management's estimate of the fair value of residential mortgage investments held as of the indicated dates adjusted for other sources of liquidity such as cash and cash equivalents.

(c) Cash collateral receivable from swap counterparties is presented net of cash collateral payable to swap counterparties, if applicable, and the fair value of interest rate swap positions as of the indicated date.

In order to efficiently manage its liquidity and capital resources, Capstead attempts to maintain sufficient liquidity reserves to fund borrowing and interest rate swap margin calls under stressed market conditions, including margin calls resulting from monthly principal payments (remitted to the Company 20 to 45 days after any given month-end), as well as reasonably possible declines in the market value of pledged assets and swap positions. Should market conditions deteriorate, management may reduce portfolio leverage and increase liquidity by raising new equity capital, selling mortgage securities and/or curtailing the replacement of portfolio runoff. Additionally, the Company routinely does business with a large number of lending counterparties, which bolsters financial flexibility to address challenging market conditions and limits exposure to any individual counterparty.

Future levels of portfolio leverage will be dependent on many factors, including the size and composition of the Company's investment portfolio (see "Liquidity and Capital Resources"). Portfolio leverage increased from year-end primarily due to the decline in the market value of assets pledged. Potential liquidity declined during this period primarily as a result of the increase in leverage along with a decline in long-term investment capital. Management believes current portfolio leverage levels represent an appropriate use of leverage under current market conditions for a portfolio consisting of seasoned, short-duration ARM Agency Securities.

Supplemental Analysis of Quarterly Financing Spreads

Quarterly financing spreads and mortgage prepayment rates were as follows for the indicated periods:

	2018 Q3	Q2	Q1	2017 Q4	Q3	Q2	Q1	2016 Q4
Total financing spreads: [a]								
Yields on all interest-earning assets	2.08 %	2.00 %	2.07 %	1.90 %	1.68 %	1.65%	1.67%	1.49%
Borrowing rates on all interest-paying liabilities	1.87	1.67	1.52	1.34	1.22	1.13	0.99	0.94
Total financing spreads	0.21	0.33	0.55	0.56	0.46	0.52	0.68	0.55
Financing spreads on residential mortgage investments, a non-GAAP financial measure:								
Cash yields on residential mortgage investments [b]	3.07	2.93	2.85	2.79	2.72	2.66	2.60	2.55
Investment premium amortization [b]	(0.99)	(0.93)	(0.77)	(0.88)	(1.03			