



ANNALY CAPITAL MANAGEMENT, INC.

2006 Annual Report



ANNALY CAPITAL MANAGEMENT, INC. 2006 Annual Report

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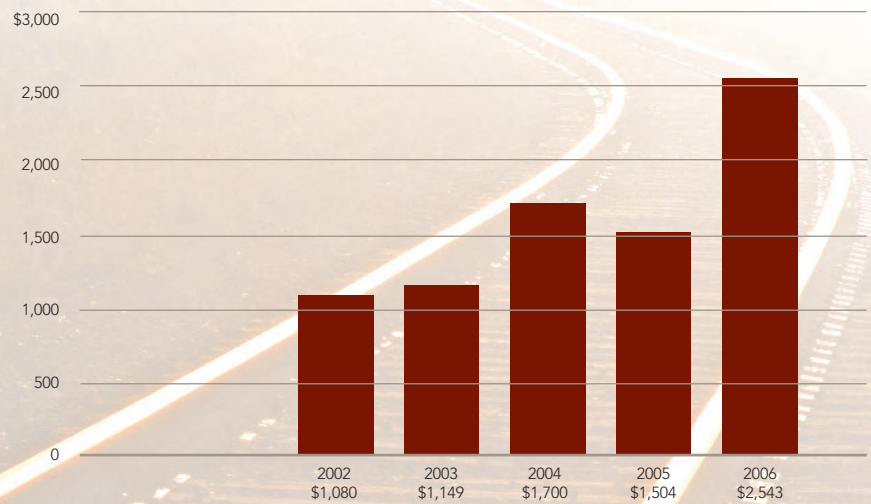


PRODESSE NON NOCERE

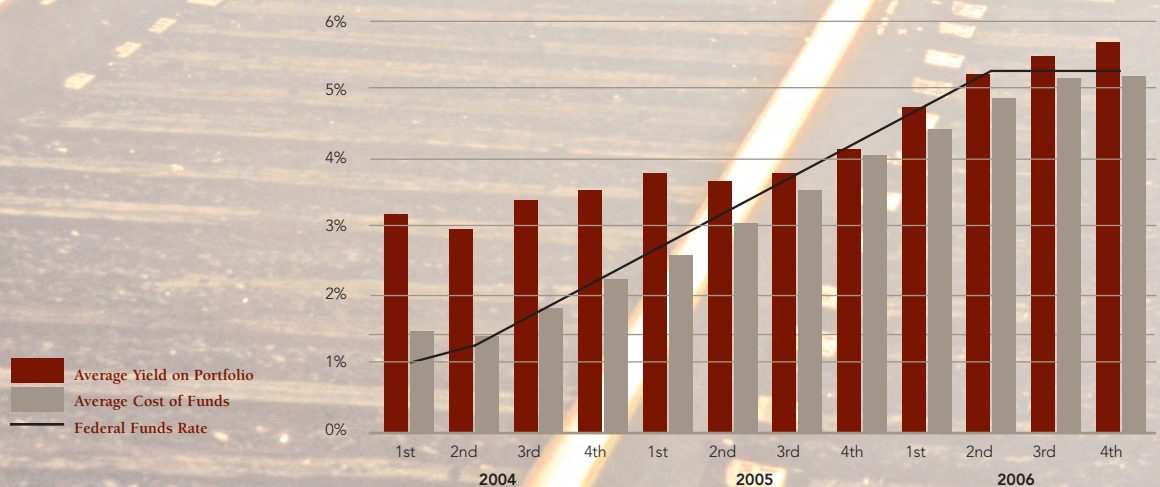
Our family crest and its motto “Prodesse Non Nocere” are trademarks of the Company. The description figuratively means ‘Proceed without fear.’ That symbolizes the confidence we try to instill in our investors. It is reinforced by years of reliable, highly competitive investment performance.

2006 was a year of transition as the Federal Reserve paused in August after an unprecedented two-year period of seventeen consecutive interest rate hikes. As a result, the pressure on short-term borrowing costs and asset values began to ease. Seeing attractive investment opportunities for new capital, we executed two secondary common stock offerings and one preferred stock offering during the year, raising approximately \$1 billion in new stockholders' equity. With the combination of new capital and improving market conditions, we were able to increase Annaly's dividend each quarter throughout the year. We declared dividends to common shareholders of \$0.57 per share in 2006. FIDAC, which was acquired in June 2004, increased net assets under management by almost 12% and generated \$19 million in fee income. In addition, in August, we changed our name to Annaly Capital Management, Inc. in order to better reflect our business and the global reach of FIDAC.

STOCKHOLDERS' EQUITY (dollars in millions)



INTEREST RATE SPREAD



Corporate Profile

Annaly Capital Management, Inc. manages assets on behalf of institutional and individual investors worldwide through Annaly and through the funds managed by its wholly-owned registered investment advisor, FIDAC. The Company's principal business objective is to generate net income for distribution to investors from the spread between the interest income on its Mortgage-Backed Securities and the cost of borrowing to finance their acquisition and from dividends the Company receives from FIDAC, which earns investment advisory fees. We have elected to be taxed as a real estate investment trust (or REIT) under the Internal Revenue Code and therefore are required to pay out at least 90% of our earnings to our shareholders in order to avoid taxation at the corpo-

rate level. We commenced operations on February 18, 1997.

All of the Mortgage-Backed Securities we own are issued by an agency of the United States government and carry an actual or implied AAA rating. Mortgage-backed securities are ownership interests in mortgage loans made by financial institutions (savings and loans, commercial banks and mortgage bankers). When an institution has made enough loans it will "pool" or package them together and sell them to mortgage investors like Annaly. The institution will collect the principal and interest payments made by the homeowners and forward them to the mortgage investor. We structure our portfolio using the Annaly MBS Barbell StrategySM. This strategy utilizes a combination of adjustable-, floating-, and

fixed-rate Mortgage-Backed Securities so that it can perform through a wide range of interest rate environments.

We employ leverage to enhance our returns. To date, our debt has consisted entirely of borrowings collateralized by a pledge of our Mortgage-Backed Securities. On our balance sheet, these borrowings appear as Repurchase Agreements. Our leverage, measured as a ratio of debt-to-equity, typically is managed in a band of 8:1 to 12:1.

FIDAC is a registered investment advisor which manages, assists in managing or supervises investment funds for a wide array of clients around the world on a discretionary basis. FIDAC is a fee-based asset management business with a global distribution reach.



Michael A. J. Farrell
Chairman, President &
Chief Executive Officer



Wellington J. Denahan-Norris
Vice Chairman,
Chief Investment Officer
& Chief Operating Officer



Kathryn F. Fagan
Chief Financial Officer
& Treasurer



R. Nicholas Singh
Executive Vice President,
General Counsel, Secretary &
Chief Compliance Officer

PART PLAN SHOWING SCREW REVERSING GEAR.

The Annaly Team

Annaly's team is experienced in Wall Street trading, management and operations, with a specialization in investing in mortgage-backed securities on a leveraged basis. Senior management founded FIDAC in July 1994 and Annaly in November 1996. From our IPO in October 1997 through the end of 2006, Annaly has raised almost

\$2.5 billion in subsequent equity offerings, making us one of the largest mortgage REITs by market capitalization.

Annaly has consistently generated competitive returns for its shareholders. Our success and future growth prospects are based on the proven ability of our strong and seasoned management team to successfully take advantage of market

opportunities and deliver compelling returns in a wide range of interest rate environments.

We are self-advised and self-managed. Management incentives are tied to book value. Our low general and administrative expense ratio keeps our operating costs low and adds to shareholder return.

Matthew Lambiase
Executive Vice President
Structured Products

Eric Szabo, CFA, PRM
Senior Vice President
Investment Strategist

Dennis E. Malloy
Senior Vice President
Marketing & Sales

Ronald D. Kazel
Managing Director

Kristopher Konrad
Executive Vice President
Co-Head of Portfolio Management

Jeremy Diamond
Managing Director

James P. Fortescue
Executive Vice President
Head of Liabilities

Rose-Marie Lyght
Executive Vice President
Co-Head of Portfolio Management



Letter From the Chairman

Dear Fellow Shareholders,

In the waning years of his life, my Dad, an immigrant union construction worker, took a job as an evening custodian in a local kindergarten in New Jersey to keep himself busy. Nothing had been easy in Dad's life—hard times in post-World War I Dublin, the Roaring Twenties, the Depression, service as a British army tank driver in Africa and Europe during World War II, marriage to his Irish sweetheart at the end of the war and immigrating to America in 1947 to raise his family—but this tough man found himself becoming quite attached to the children who inhabited the classrooms he cleaned each night. They started leaving little notes for him pasted on the blackboards or desks, just saying “hello” or “thanks”. He started coming in

2005. As 2006 began to unfold, the stocks of the homebuilders began to fade as reality hit home that the supply-demand curve had been overwhelmed by supply. That supply and its capacity were fed by excessive liquidity sloshing through the debt and equity markets. This led to a dilution of underwriting standards the likes of which had never been seen in consumer and corporate debt. There was no proverbial ‘punch bowl’ at this party. The Federal Reserve had been taking away that ‘juice’ for two years in the longest and most prolific tightening in history on a percentage basis, 425% from the bottom. Usually the Fed accomplishes what it wants in six months to a year with a smaller percentage move. Regulators restrained credit underwriting at their constituents,

As a manager of high quality assets, we were content to be the ‘designated driver’ at this party. We have patiently stuck to our discipline, grew our strengths, did not change or drift from our business model, drew the line on behalf of investors’ capital and protected those who wanted protection in this storm of virtually unchecked credit creation. As we’ve always said, there are always bear markets and bull markets being created in each part of the business cycle, and we experienced ours at the front end of the mortgage yield curve in 2004 and 2005. In 2006, as market sentiment began to shift to our vision, we began to grow the company again. We virtually doubled the market capitalization in 120 days between April and August while stabilizing book value and increasing our

“We have patiently stuck to our discipline, grew our strengths, did not change or drift from our business model, drew the line on behalf of investors’ capital and protected those who wanted protection in this storm of virtually unchecked credit creation.”

earlier every day, not to clock in for extra pay, but to meet the children he cleaned up after. They were, as he noted in his own way, ‘the future’, and he, who had seen so much in life, was re-energized by the little lives around him. Strange how a little dust and paper waste can lead to such revitalization.

As 2006 came to a close for the capital markets, there was an eerie calm as volatility ebbed to 10-year lows. As we noted in our earnings releases, annual letters and in the media, the housing boom actually ended in the summer of

the banks, as best they could. The private sector, however, aided by broker-dealer banking conduits, just piled on wherever they could. Mortgage bankers, builders, hedge funds, credit sensitive originators, under the relentless pressure to compete, created more and more complex and risky mortgage paper and structures. In the search for yield, investment managers, pension funds, offshore investors, foundations and the like poured capital into the bucket of complacent risk analysis until it overflowed.

dividend every quarter. We were able to do this because the acquisition of FIDAC and the portfolio management steps we have taken since 2003 put us in a position to access capital at a time when others could not.

Like the ‘happy custodian’ of over twenty years ago, we are now prepared to begin to sweep up the dust and paper being created today. We have protected our core businesses, stabilized them, seeded new structures and established the infrastructure and track records to exploit the opportunities that will emerge in the

aftermath of the storm in housing and credit. We can more clearly see the future of our asset management business, and we believe that the disciplines and belief systems we operate under give us a tremendous head start in helping to repair that which is broken in the markets to the benefit of our shareholders and investors.

Just like my Dad saw the future in those kids, we at Annaly see the fruits of our labor leading to the future of our businesses. The energy I feel every day starts and ends with the major assets of our firm, our employees. Sometimes in life you get a chance to work with people who are passionate about what they do, yet have the character to face adversity and success with the same demeanor. That describes the team at Annaly, and we are as energized today by the opportunities that lay before us in new products and our core strategy as we were when we started. We have largely been together for over a decade, as we celebrate the tenth anniversary of our NYSE listing on October 8th, 2007.

As represented on the cover of this year's annual report, this train is rolling, and the crew is hard at work at their stations.

Prodesse Non Nocere



Michael A. J. Farrell
March 17, 2007



MICHAEL A. J. FARRELL

FIDAC

FIXED INCOME DISCOUNT ADVISORY COMPANY

FIDAC generated almost \$19 million in fee income in 2006 and over \$56 million in fee income since its acquisition by Annaly in 2004. This fee income adds to the spread income earned by Annaly to benefit shareholders.

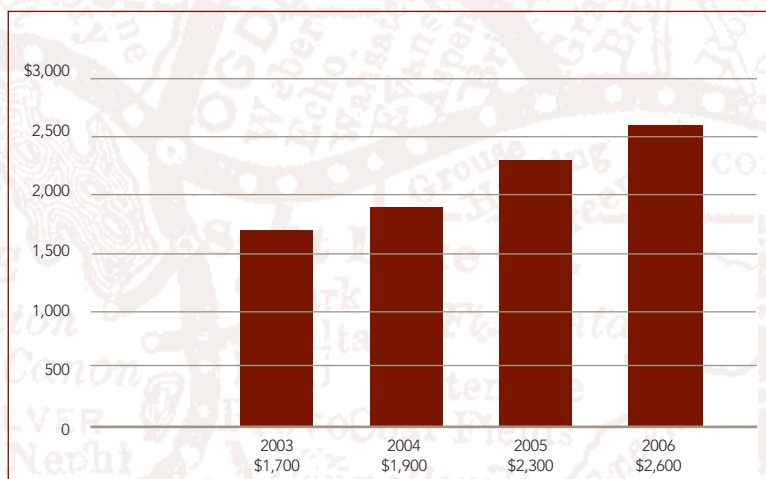
At December 31, 2006, FIDAC managed, advised or sub-advised approximately \$2.6 billion in net assets or \$15.1

billion in gross assets through numerous offshore and on-shore public and private investment funds distributed globally as well as separate accounts for high net worth individuals, municipal funds and school endowments. In 2006, FIDAC launched its first CDO product, Harp High Grade CDO I Ltd. Harp is a \$1 billion multi-tranche collateralized debt

obligation that invests in a high-grade portfolio of primarily residential mortgage-backed securities.

Formed in 1994, FIDAC is an asset management firm and one of the leading fixed income management companies in the United States. FIDAC's team of investment professionals has built a successful long-term track record through

NET ASSETS UNDER MANAGEMENT (dollars in millions)



some of the most challenging fixed income markets in memory.

The team managing Annaly fills the same roles at FIDAC. The general strategy of the investment products managed by FIDAC is to provide net interest income for distribution to investors from the spread between the interest income earned from portfolios of residential mortgage-backed securities and the cost of repurchase agreements entered into to finance their acquisition, while seeking to limit exposure to interest rate risk and credit risk. Since the majority of the assets in FIDAC-managed portfolios are created and guaranteed by a U.S. Agency and further secured by the relevant

mortgaged property of the homeowners, FIDAC believes that there is minimal credit risk in its portfolios.

FIDAC's strategy is differentiated from those of most other fixed income and mortgage investment managers by the liquidity of the assets it purchases, its ability to leverage these assets, the transparency of the business model and the management compensation structure. Acquiring the most basic and liquid mortgage-backed securities is intended to give investors the desired element of clear and accurate valuation.

The management fees payable to FIDAC are not linked to investment performance, but rather they are linked to assets

under management. FIDAC believes that this remuneration philosophy increases the returns to investors and encourages a focus on long-term goals. Distribution partners in the U.S. and around the world market the investment vehicles managed by FIDAC. This distribution system and the track record of FIDAC serve as a platform for growth into new investment products and strategies. The long-term growth of FIDAC will enable Annaly shareholders to benefit from a growing stream of dividend income we receive from FIDAC.

SELECTED FINANCIAL DATA

(dollars in thousands, except for per share data)	FOR THE YEAR ENDED				
	December 31, 2006	December 31, 2005	December 31, 2004	December 31, 2003	December 31, 2002
Statement of Operations Data:					
Interest income	\$1,221,882	\$705,046	\$532,328	\$337,433	\$404,165
Interest expense	1,055,013	568,560	270,116	182,004	191,758
Net interest income	166,869	136,486	262,212	155,429	212,407
Other (loss) income:					
Investment advisory and service fees	22,351	35,625	12,512	—	—
(Loss) gain on sale of investment securities	(3,862)	(53,238)	5,215	40,907	21,063
Gain on termination of interest rate swaps	10,674	—	—	—	—
Income from trading securities	3,994	—	—	—	—
Loss on other-than-temporarily impaired securities	(52,348)	(83,098)	—	—	—
Total other (loss) income	(19,191)	(100,711)	17,727	40,907	21,063
Expenses:					
Distribution fees	3,444	8,000	2,860	—	—
General and administrative expenses	40,063	26,278	24,029	16,233	13,963
Total expenses	43,507	34,278	26,889	16,233	13,963
Impairment of intangible for customer relationships	2,493	—	—	—	—
Income before income taxes	101,678	1,497	253,050	180,103	219,507
Income taxes	7,538	10,744	4,458	—	—
Income (loss) before minority interest	94,140	(9,247)	248,592	180,103	219,507
Minority interest	324	—	—	—	—
Net income (loss)	93,816	(9,247)	248,592	180,103	219,507
Dividends on preferred stock	19,557	14,593	7,745	—	—
Net income available (loss related) to common shareholders	\$74,259	(\$23,840)	\$240,847	\$180,103	\$219,507
Basic net income (loss) per average common share	\$0.44	(\$0.19)	\$2.04	\$1.95	\$2.68
Diluted net income (loss) per average common share	\$0.44	(\$0.19)	\$2.03	\$1.94	\$2.67
Dividends declared per common share	\$0.57	\$1.04	\$1.98	\$1.95	\$2.67
Dividends declared per preferred Series A share	\$1.97	\$1.97	\$1.45	—	—
Dividends declared per preferred Series B share	\$1.08	—	—	—	—
	December 31, 2006	December 31, 2005	December 31, 2004	December 31, 2003	December 31, 2002
Balance Sheet Data:					
Mortgage-Backed Securities, at fair value	\$30,167,509	\$15,929,864	\$19,038,386	\$11,956,512	\$11,551,857
Agency debentures, at fair value	49,500	—	390,509	978,167	—
Total assets	30,715,980	16,063,422	19,560,299	12,990,286	11,659,084
Repurchase agreements	27,514,020	13,576,301	16,707,879	11,012,903	10,163,174
Total liabilities	28,056,149	14,559,399	17,859,829	11,841,066	10,579,018
Stockholders' equity	2,543,041	1,504,023	1,700,470	1,149,220	1,080,066
Number of common shares outstanding	205,345,591	123,684,931	121,263,000	96,074,096	84,569,206
	December 31, 2006	December 31, 2005	December 31, 2004	December 31, 2003	December 31, 2002
Other Data:					
Average total assets	\$23,130,057	\$18,724,075	\$17,293,174	\$12,975,039	\$10,486,423
Average investment securities	23,029,195	18,543,749	16,399,184	12,007,333	9,575,365
Average borrowings	21,399,130	17,408,828	15,483,118	11,549,368	9,128,933
Average equity	2,006,206	1,614,743	1,550,076	1,122,633	978,107
Yield on average interest-earning assets	5.31%	3.80%	3.25%	2.81%	4.22%
Cost of funds on average interest-bearing liabilities	4.93%	3.27%	1.74%	1.58%	2.10%
Interest rate spread	0.38%	0.53%	1.51%	1.23%	2.12%
Financial Ratios:					
Net interest margin (net interest income/average total assets)	0.72%	0.73%	1.52%	1.20%	2.03%
G&A expense as a percentage of average total assets	0.17%	0.14%	0.14%	0.13%	0.13%
G&A expense as a percentage of average equity	2.00%	1.63%	1.55%	1.45%	1.43%
Return on average total assets	0.41%	(0.05%)	1.44%	1.39%	2.09%
Return on average equity	4.68%	(0.57%)	16.04%	16.04%	22.44%

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This annual report and our public documents to which we refer contain or incorporate by reference certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements which are based on various assumptions (some of which are beyond our control) may be identified by reference to a future period or periods or by the use of forward-looking terminology, such as "may," "will," "believe," "expect," "anticipate," "continue," or similar terms or variations on those terms or the negative of those terms. Actual results could differ materially from those set forth in forward-looking statements due to a variety of factors, including, but not limited to, changes in interest rates, changes in yield curve, changes in prepayment rates, the availability of mortgage-backed securities for purchase, the availability of financing and, if available, the terms of any financing, changes in the market value of our assets, changes in business conditions and the general economy, and risks associated with the investment advisory business of FIDAC, including the removal by FIDAC's clients of assets FIDAC manages, FIDAC's regulatory requirements, and competition in the investment advisory business, changes in government regulations affecting our business, and our ability to maintain our qualification as a REIT for federal income tax purposes. For a discussion of the risks and uncertainties which could cause actual results to differ from those contained in the forward-looking statements, see "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 and all subsequent Quarterly Reports on Form 10-Q. We do not undertake, and specifically disclaim any obligation, to publicly release the result of any revisions which may be made to any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements.

OVERVIEW

We are a self-managed real estate investment trust ("REIT") that owns and manages a portfolio of mortgage-backed securities and agency debentures. Our principal business objective is to generate net income for distribution to our stockholders from the spread between the interest income on our investment securities and the costs of borrowing to finance our acquisition of investment securities.

We are primarily engaged in the business of investing, on a leveraged basis, in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans (collectively, "Mortgage-Backed Securities"). We also invest in Federal Home Loan Bank ("FHLB"), Federal Home Loan Mortgage Corporation ("FHLMC"), and Federal National Mortgage Association ("FNMA") debentures. The Mortgage-Backed Securities and agency debentures are collectively referred to herein as "Investment Securities."

Under our capital investment policy, at least 75% of our total assets must be comprised of high-quality mortgage-backed securities and short-term investments. High quality securities means securities that (1) are rated

within one of the two highest rating categories by at least one of the nationally recognized rating agencies, (2) are unrated but are guaranteed by the United States government or an agency of the United States government, or (3) are unrated but we determine them to be of comparable quality to rated high-quality mortgage-backed securities.

The remainder of our assets, comprising not more than 25% of our total assets, may consist of other qualified REIT real estate assets which are unrated or rated less than high quality, but which are at least "investment grade" (rated "BBB" or better by Standard & Poor's Corporation ("S&P") or the equivalent by another nationally recognized rating agency) or, if not rated, we determine them to be of comparable credit quality to an investment which is rated "BBB" or better. In addition, we may directly or indirectly invest part of this remaining 25% of our assets in other types of securities, including without limitation, unrated debt, equity or derivative securities, to the extent consistent with our REIT qualification requirements. The derivative securities in which we invest may include securities representing the right to receive interest only or a disproportionately large amount of interest, as well as inverse floaters, which may have imbedded leverage as part of their structural characteristics.

We may acquire mortgage-backed securities backed by single-family residential mortgage loans as well as securities backed by loans on multi-family, commercial or other real estate related properties. To date, all of the mortgage-backed securities that we have acquired have been backed by single-family residential mortgage loans.

We have elected to be taxed as a REIT for federal income tax purposes. Pursuant to the current federal tax regulations, one of the requirements of maintaining our status as a REIT is that we must distribute at least 90% of our REIT taxable income (determined without regard to the deduction for dividends paid and by excluding any net capital gain) to our stockholders, subject to certain adjustments.

The results of our operations are affected by various factors, many of which are beyond our control. Our results of operations primarily depend on, among other things, the level of our net interest income, the market value of our assets and the supply of and demand for such assets. Our net interest income, which reflects the amortization of purchase premiums and accretion of discounts, varies primarily as a result of changes in interest rates, borrowing costs and prepayment speeds, the behavior of which involves various risks and uncertainties. Prepayment speeds, as reflected by the Constant Prepayment Rate, or CPR, and interest rates vary according to the type of investment, conditions in financial markets, competition and other factors, none of which can be predicted with any certainty. In general, as prepayment speeds on our Mortgage-Backed Securities portfolio increase, related purchase premium amortization increases, thereby reducing the net yield on such assets. The CPR on our Mortgage Backed Securities portfolio averaged 17% and 27% for the years ended December 31, 2006 and 2005, respectively. Since changes in interest rates may significantly affect our activities, our operating results depend, in large part, upon our ability to effectively manage interest rate risks and prepayment risks while maintaining our status as a REIT.

The table below provides quarterly information regarding our average balances, interest income, interest expense, yield on assets, cost of funds, net interest income and net interest rate spread for the quarterly periods presented.

(ratios for the quarters have been annualized, dollars in thousands)	Average Investment Securities Held (1)	Total Interest Income	Yield on Average Interest Earning Assets	Average Balance of Repurchase Agreements	Interest Expense	Average Cost of Funds	Net Interest Income	Net Interest Rate Spread
Quarter Ended December 31, 2006	\$28,888,956	\$407,092	5.64%	\$27,118,402	\$349,302	5.15%	\$57,790	0.49%
Quarter Ended September 30, 2006	\$24,976,876	\$339,737	5.44%	\$23,120,247	\$295,726	5.12%	\$44,011	0.32%
Quarter Ended June 30, 2006	\$21,660,089	\$280,171	5.17%	\$20,060,978	\$242,473	4.83%	\$37,698	0.34%
Quarter Ended March 31, 2006	\$16,590,859	\$194,882	4.70%	\$15,296,893	\$167,512	4.38%	\$27,370	0.32%

(1) Does not reflect unrealized gains/(losses).

The following table presents the CPR experienced on our Mortgage-Backed Securities portfolio, on an annualized basis, for the quarterly periods presented.

Quarter Ended	CPR
December 31, 2006	15%
September 30, 2006	16%
June 30, 2006	19%
March 31, 2006	18%
December 31, 2005	28%
September 30, 2005	28%
June 30, 2005	27%
March 31, 2005	25%

We believe that the CPR in future periods will depend, in part, on changes in and the level of market interest rates across the yield curve, with higher CPRs expected during periods of declining interest rates and lower CPRs expected during periods of rising interest rates.

We continue to explore alternative business strategies, alternative investments and other strategic initiatives to complement our core business strategy of investing, on a leveraged basis, in high quality Investment Securities. No assurance, however, can be provided that any such strategic initiative will or will not be implemented in the future.

For the purposes of computing ratios relating to equity measures, throughout this report, equity includes Series B Cumulative Convertible Preferred Stock, which has been treated under GAAP as temporary equity.

CRITICAL ACCOUNTING POLICIES

Management's discussion and analysis of financial condition and results of operations is based on the amounts reported in our financial statements. These financial statements are prepared in conformity with accounting principles generally accepted in the United States of America. In preparing the financial statements, management is required to make various judgments, estimates and assumptions that affect the reported amounts. Changes in these estimates and assumptions could have a material effect on our financial statements. The following is a summary of our policies most affected by management's judgments, estimates and assumptions.

Market Valuation of Investment Securities: All assets classified as available-for-sale are reported at fair value, based on market prices. Although we generally intend to hold most of our Investment Securities until maturity, we may, from time to time, sell any of our Investment Securities as part of our overall management of our portfolio. Accordingly, we are required to classify all of our Investment Securities as available-for-sale. Our policy is to obtain market values from independent sources. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. The determination of whether a security is other-than-temporarily impaired involves judgements and assumptions based on subjective and objective factors. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Investments with unrealized losses are not considered other-than-temporarily impaired if the Company has the ability and intent to hold the investments for a period of time, to maturity if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments. Unrealized losses on Investment Securities that are considered other than temporary, as measured by the amount of decline in fair value attributable to factors other than temporary, are recognized in income and the cost basis of the Investment Securities is adjusted. Other-than-temporary impaired losses on securities totaled \$52.3 million for the year ended December 31, 2006 and \$83.1 million for the year ended December 31, 2005. There were no such adjustments for the year ended December 31, 2004.

Interest Income: Interest income is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment

Securities are amortized or accreted into interest income over the projected lives of the securities using the interest method. Our policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, street consensus prepayment speeds, and current market conditions. If our estimate of prepayments is incorrect, we may be required to make an adjustment to the amortization or accretion of premiums and discounts that would have an impact on future income.

Repurchase Agreements: We finance the acquisition of our Investment Securities through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

Income Taxes: We have elected to be taxed as a Real Estate Investment Trust (or REIT) and intend to comply with the provisions of the Internal Revenue Code of 1986, as amended (or the Code), with respect thereto. Accordingly, the Company will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. The Company and FIDAC have made a joint election to treat FIDAC as a taxable REIT subsidiary. As such, FIDAC is taxable as a domestic C corporation and subject to federal and state and local income taxes based upon its taxable income.

Impairment of Intangibles: The Company's acquisition of FIDAC was accounted for using the purchase method. The cost of FIDAC was allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of cost over the fair value of the net assets acquired was recognized as goodwill. Intangible assets are periodically reviewed for potential impairment. This evaluation requires significant judgment. During 2006, we recognized impairment charges totaling \$2.5 million on intangible assets relating to customer relationships.

RESULTS OF OPERATIONS

NET INCOME SUMMARY

For the year ended December 31, 2006, our net income was \$93.8 million or \$0.44 basic income per average share related to common shareholders, as compared to \$9.2 million net loss or \$0.19 basic loss per average share for the year ended December 31, 2005. For the year ended December 31, 2004, our net income was \$248.6 million or \$2.04 basic income per average share related to common shareholders. Net income per average share increased by \$0.63 per average share available to common shareholders and total net income increased \$103.0 million for the year ended December 31, 2006, when compared to the year ended December 31, 2005. We attribute the increase in total net income for the year ended December 31, 2006 compared to the year ended December 31, 2005 to the increase in net interest income, reduction in losses on sales of securities and losses on other-than-temporarily impaired securities, and gains on termination of interest rate swaps. Net interest income increased by \$30.4 million for the year ended December 31, 2006, as compared to the year ended December 31, 2005, due to the increase in interest earning assets from the deployment of additional capital we raised in 2006. For the year ended December 31, 2006, net loss on sale of Mortgage-Backed Securities was \$3.9 million, as compared to a net loss of \$53.2 million in 2005. The loss on other-than-temporarily impaired securities totaled \$52.3 million for the year ended December 31, 2006, as compared to \$83.1 million for the year ended December 31, 2005. During the year ended December 31, 2006, the Company realized a gain on the termination of interest rate swaps of \$10.7 million. There was no gain on termination of swaps for the year ended December 31, 2005. We attribute the decrease in total net income for the year ended December 31, 2005 compared to the year ended December 31, 2004 to the decline in interest rate spread, losses on sales of securities, and losses on other-than-temporarily impaired securities. The interest rate spread decreased from 1.51% for the year ended December 31, 2004 to 0.53% for the year ended December 31, 2005. The total amortization for the year ended December 31, 2005 was \$154.3 million and for the year ended December 31, 2004 was \$179.6 million. For the year ended December 31, 2005, net loss on sale of Mortgage-Backed Securities was \$53.2 million, as compared to a net gain of \$5.2 million in 2004.

The table below presents the net income (loss) summary for the years ended December 31, 2006, 2005, and 2004.

NET INCOME (LOSS) SUMMARY

(dollars in thousands, except for per share data)	FOR THE YEAR ENDED		
	December 31, 2006	December 31, 2005	December 31, 2004
Interest income	\$1,221,882	\$705,046	\$532,328
Interest expense	1,055,013	568,560	270,116
Net interest income	166,869	136,486	262,212
Other (loss) income:			
Investment advisory and service fees	22,351	35,625	12,512
(Loss) gain on sale of investment securities	(3,862)	(53,238)	5,215
Gain on termination of interest rate swaps	10,674	—	—
Income from trading securities	3,994	—	—
Loss on other-than-temporarily impaired securities	(52,348)	(83,098)	—
Total other (loss) income	(19,191)	(100,711)	17,727
Expenses:			
Distribution fees	3,444	8,000	2,860
General and administrative expenses	40,063	26,278	24,029
Total expenses	43,507	34,278	26,889
Impairment of intangible for customer relationships	2,493	—	—
Income before income taxes	101,678	1,497	253,050
Income taxes	7,538	10,744	4,458
Income (loss) before minority interest	94,140	(9,247)	248,592
Minority interest	324	—	—
Net Income (loss)	93,816	(9,247)	248,592
Dividends on preferred stock	19,557	14,593	7,745
Net income available (loss related) to common shareholders	\$74,259	(\$23,840)	\$240,847
Weighted average number of basic common shares outstanding	167,666,631	122,475,032	118,223,330
Weighted average number of diluted common shares outstanding	167,746,387	122,475,032	118,459,145
Basic net income (loss) per average common share	\$0.44	(\$0.19)	\$2.04
Diluted net income (loss) per average common share	\$0.44	(\$0.19)	\$2.03
Average total assets	\$23,130,057	\$18,724,075	\$17,293,174
Average equity	2,006,206	1,614,743	1,550,076
Return on average total assets	0.41%	(0.05%)	1.44%
Return on average equity	4.68%	(0.57%)	16.04%

INTEREST INCOME AND AVERAGE EARNING ASSET YIELD

We had average earning assets of \$23.0 billion for the year ended December 31, 2006. We had average earning assets of \$18.5 billion for the year ended December 31, 2005. We had average earning assets of \$16.4 billion for the year ended December 31, 2004. Our primary source of income is interest income. Our interest income was \$1.2 billion for the year ended December 31, 2006, \$705.0 million for the year ended December 31, 2005, and \$532.3 million for the year ended December 31, 2004. The yield on average investment securities was 5.31%, 3.80%, and 3.25% for the respective periods.

INTEREST EXPENSE AND THE COST OF FUNDS

Our largest expense is the cost of borrowed funds. We had average borrowed funds of \$21.4 billion and total interest expense of \$1.1 billion for the year ended December 31, 2006. We had average borrowed funds of \$17.4 billion and total interest expense of \$568.6 million for the year ended December 31, 2005. We had average borrowed funds of \$15.5 billion and total interest expense of \$270.1 million for the year ended December 31, 2004. Our average cost of funds was 4.93% for the year ended December 31, 2006 and 3.27% for the year ended December 31, 2005 and 1.74% for the year December 31, 2004. The cost of funds rate

increased by 166 basis points and the average borrowed funds increased by \$4.0 billion for the year ended December 31, 2006 when compared to the year ended December 31, 2005. Interest expense for the year 2006 increased by \$486.5 million over the prior year due to the substantial increase in the average repurchase balance and the increase in the cost of funds rate. The cost of funds rate increased by 153 basis points and the average borrowed funds increased by \$1.9 billion for the year ended December 31, 2005, when compared to the year ended December 31, 2004. Interest expense for the year ended December 31, 2005 increased by \$298.5 million over the previous year due to the increase in the average repurchase balance and substantial increase in the cost of funds rate. Since a substantial portion of our repurchase agreements are short term, changes in market rates are directly reflected in our interest expense. Our average cost of funds was 0.10% below average one-month LIBOR and 0.28% below average six-month LIBOR for the year ended December 31, 2006. Our average cost of funds was 0.06% below average one-month LIBOR and 0.45% below average six-month LIBOR for the year ended December 31, 2005. Our average cost of funds was 0.24% above average one-month LIBOR and 0.06% below average six-month LIBOR for the year ended December 31, 2004. Since the Federal Reserve continued to raise the federal funds rate after December 31, 2005, we experienced an increase in our funding costs.

The table below shows our average borrowed funds and average cost of funds as compared to average one-month and average six-month LIBOR for the years ended December 31, 2006, 2005, 2004, 2003, and 2002 and the four quarters in 2006.

AVERAGE COST OF FUNDS

(Ratios for the four quarters in 2006 have been annualized, dollars in thousands)	Average Borrowed Funds	Interest Expense	Average Cost of Funds	Average One-Month LIBOR	Average Six-Month LIBOR	Average One-Month LIBOR Relative to Average Six-Month LIBOR	Average Cost of Funds Relative to Average One-Month LIBOR	Average Cost of Funds Relative to Average Six-Month LIBOR
For the Year Ended December 31, 2006	\$21,399,130	\$1,055,013	4.93%	5.03%	5.21%	(0.18%)	(0.10%)	(0.28%)
For the Year Ended December 31, 2005	\$17,408,828	\$568,560	3.27%	3.33%	3.72%	(0.39%)	(0.06%)	(0.45%)
For the Year Ended December 31, 2004	\$15,483,118	\$270,116	1.74%	1.50%	1.80%	(0.30%)	0.24%	(0.06%)
For the Year Ended December 31, 2003	\$11,549,368	\$182,004	1.58%	1.21%	1.23%	(0.02%)	0.37%	0.35%
For the Year Ended December 31, 2002	\$9,128,933	\$191,758	2.10%	1.77%	1.88%	(0.11%)	0.33%	0.22%
For the Quarter Ended December 31, 2006	\$27,118,402	\$349,302	5.15%	5.27%	5.31%	(0.04%)	(0.12%)	(0.16%)
For the Quarter Ended September 30, 2006	\$23,120,247	\$295,726	5.12%	5.29%	5.43%	(0.14%)	(0.17%)	(0.31%)
For the Quarter Ended June 30, 2006	\$20,060,978	\$242,473	4.83%	5.03%	5.27%	(0.24%)	(0.20%)	(0.44%)
For the Quarter Ended March 31, 2006	\$15,296,893	\$167,512	4.38%	4.55%	4.84%	(0.29%)	(0.17%)	(0.46%)

NET INTEREST INCOME

Our net interest income which equals interest income less interest expense, totaled \$166.9 million for the year ended December 31, 2006, \$136.5 million for the year ended December 31, 2005 and \$262.2 million for the year ended December 31, 2004. Our net interest income increased for the year ended December 31, 2006, as compared to the year ended December 31, 2005, because of the increased average asset base in 2006. In 2006 average assets increased because of the deployment of additional capital. Our net interest spread, which equals the yield on our average assets for the period less the average cost of funds for the period,

was 0.38% for the year ended December 31, 2006 as compared to 0.53% for the year ended December 31, 2005 and 1.51% for the year ended December 31, 2004. This 15 basis point decrease was the result in the increased funding cost of 166 basis points, offset by the increase in yield of 151 basis points. Our net interest income increased for the year ended December 31, 2006 as compared to the year ended December 31, 2005 by \$30.4 million because of the increased average asset base for 2006. The net interest income for the year ended December 31, 2005 decreased by \$125.7 million, when compared to the year ended December 31, 2004. This reduction was the result of the interest rate spread decreasing by 98 basis points.

The table below shows our interest income by earning asset type, average earning assets by type, total interest income, interest expense, average repurchase agreements, average cost of funds, and net interest income for the years ended December 31, 2006, 2005, 2004, 2003 and 2002 and the four quarters in 2006.

NET INTEREST INCOME

(Ratios for the four quarters in 2006 have been annualized, dollars in thousands)	Average Investment Securities Held	Total Interest Income	Yield Average Interest Earning Assets	Average Balance of Repurchase Agreements	Interest Expense	Average Cost of Funds	Net Interest Income	Net Interest Rate Spread
For the Year Ended December 31, 2006	\$23,029,195	\$1,221,882	5.31%	\$21,399,130	\$1,055,013	4.93%	\$166,869	0.38%
For the Year Ended December 31, 2005	\$18,543,749	\$705,046	3.80%	\$17,408,827	\$568,560	3.27%	\$136,486	0.53%
For the Year Ended December 31, 2004	\$16,399,184	\$532,328	3.25%	\$15,483,118	\$270,116	1.74%	\$262,212	1.51%
For the Year Ended December 31, 2003	\$12,007,333	\$337,433	2.81%	\$11,549,368	\$182,004	1.58%	\$155,429	1.23%
For the Year Ended December 31, 2002	\$9,575,365	\$404,165	4.22%	\$9,128,933	\$191,758	2.10%	\$212,407	2.12%
For the Quarter Ended December 31, 2006	\$28,888,956	\$407,092	5.64%	\$27,118,402	\$349,302	5.15%	\$57,790	0.49%
For the Quarter Ended September 30, 2006	\$24,976,876	\$339,737	5.44%	\$23,120,247	\$295,726	5.12%	\$44,011	0.32%
For the Quarter Ended June 30, 2006	\$21,660,089	\$280,171	5.17%	\$20,060,978	\$242,473	4.83%	\$37,698	0.34%
For the Quarter Ended March 31, 2006	\$16,590,859	\$194,882	4.70%	\$15,296,893	\$167,512	4.38%	\$27,370	0.32%

INVESTMENT ADVISORY AND SERVICE FEES

FIDAC is a registered investment advisor which specializes in managing fixed income securities. FIDAC expanded its line of business in 2006 to include the management of equity securities, initially for us and an affiliated person and collateralized debt obligations. FIDAC generally receives annual net investment advisory fees of approximately 10 to 20 basis points of the gross assets it manages, assists in managing or supervises. At December 31, 2006, FIDAC had under management approximately \$2.6 billion in net assets and \$15.1 billion in gross assets, compared to \$2.3 billion in net assets and \$18.7 billion in gross assets at December 31, 2005. Net investment advisory and service fees for the years ended December 31, 2006, 2005, and 2004 totaled \$18.9 million, \$27.6 million, and \$9.7 million, respectively, net of fees paid to third parties pursuant to distribution service agreements for facilitating and promoting distribution of shares or units to FIDAC's clients. Gross assets under management will vary from time to time because of changes in the amount of

net assets FIDAC manages as well as changes in the amount of leverage used by the various funds and accounts FIDAC manages. Although net assets under management increased by approximately \$300 million from December 31, 2005 to December 31, 2006, gross assets under management declined during the same time period, as leverage declined on the assets under management.

GAINS AND LOSSES ON SALES OF INVESTMENT SECURITIES AND INTEREST RATE SWAPS

For the year ended December 31, 2006, we sold investment securities with an aggregate historical amortized cost of \$3.2 billion for an aggregate loss of \$3.9 million. In addition, the Company had a \$10.7 million gain on the termination of interest rate swaps with a notional value of \$1.2 billion. For the year ended December 31, 2005, we sold investment securities with an aggregate historical amortized cost of \$3.4 billion for an aggregate loss of \$53.2 million. For the year ended December 31, 2004,

we sold mortgage-backed securities with an aggregate historical amortized cost of \$591.7 million for an aggregate gain of \$5.2 million. The loss on sale of assets for the year ended December 31, 2005 was due to portfolio rebalancing that was initiated in the fourth quarter of 2005. We determined that certain assets purchased in a much lower interest rate environment of 2003 and 2004 were unlikely to receive their amortized cost basis, and commenced selling these assets. The rebalancing was done with the objective of improving future financial performance. A positive difference between the sale price and the historical amortized cost of our Mortgage-Backed Securities is a realized gain and increases income accordingly. We do not expect to sell assets on a frequent basis, but may from time to time sell existing assets to move into new assets, which our management believes might have higher risk-adjusted returns, or to manage our balance sheet as part of our asset/liability management strategy.

INCOME FROM TRADING SECURITIES

Income from trading securities totaled \$4.0 million for the year ended December 31, 2006. FIDAC expanded its line of business in 2006 to include the management of equity securities, initially for us and an affiliated person. During the year ended December 31, 2005 and 2004, we did not earn income from trading securities.

IMPAIRMENT OF INTANGIBLE FOR CUSTOMER RELATIONSHIPS

During the year ended December 31, 2006, intangibles were evaluated for possible impairment. It was determined that an impairment charge of \$1.4 million was necessary based on the decline in expected future cash flows on one customer relationship. We also terminated an investment advisory agreement during the year ended December 31, 2006. The expected cash flows from the contract were valued as a component of the intangible for customer relationships on June 4, 2004, the date of the

acquisition of FIDAC. The value of \$1.1 million was deemed to be impaired. The total impairment of intangible assets relating to customer relationships is \$2.5 million for the year ended December 31, 2006. There were no impairment charges during the years ended December 31, 2005 and 2004.

LOSS ON OTHER-THAN-TEMPORARILY IMPAIRED SECURITIES

At each quarter end, the Company reviewed each of its securities to determine if an other-than-temporary impairment charge would be necessary. It was determined that for certain securities that were in an unrealized loss position, the Company did not intend to hold them for a period of time, to maturity if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments. For the years ended December 31, 2006 and 2005, the loss on other-than-temporarily impaired securities totaled \$52.3 million and \$83.1 million, respectively.

GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative (or G&A) expenses were \$40.1 million for the year ended December 31, 2006, \$26.3 million for the year ended December 31, 2005, \$24.0 million for the year ended December 31, 2004. G&A expenses as a percentage of average total assets was 0.17%, 0.14%, and 0.14% for the years ended December 31, 2006, 2005, and 2004, respectively. The increase in G&A expenses of \$13.8 million for the year December 31, 2006, was primarily the result of increased salaries, directors and officers insurance and additional costs related to FIDAC. Staff increased from 30 at the end of 2004 to 31 at the end of 2005 and 34 at the end of 2006. Salaries and bonuses for the years ended December 31, 2006, 2005, and 2004 were \$28.7 million, \$18.8 million and \$17.2 million, respectively.

The table below shows our total G&A expenses as compared to average total assets and average equity for the years ended December 31, 2006, 2005, 2004, 2003 and 2002 and the four quarters in 2006.

G&A EXPENSES AND OPERATING EXPENSE RATIOS

(Ratios for the four quarters in 2006 have been annualized, dollars in thousands)	Total G&A Expenses	Total G&A Expenses/ Average Assets	Total G&A Expenses/ Average Equity
For the Year Ended December 31, 2006	\$40,063	0.17%	2.00%
For the Year Ended December 31, 2005	\$26,278	0.14%	1.63%
For the Year Ended December 31, 2004	\$24,029	0.14%	1.55%
For the Year Ended December 31, 2003	\$16,233	0.13%	1.45%
For the Year Ended December 31, 2002	\$13,963	0.13%	1.43%
For the Quarter Ended December 31, 2006	\$12,219	0.16%	1.86%
For the Quarter Ended September 30, 2006	\$11,542	0.18%	2.08%
For the Quarter Ended June 30, 2006	\$8,985	0.18%	2.19%
For the Quarter Ended March 31, 2006	\$7,177	0.18%	1.95%

NET INCOME AND RETURN ON AVERAGE EQUITY

Our net income was \$93.8 million for the year ended December 31, 2006, our net loss was \$9.2 million for the year ended December 31, 2005, and our net income was \$248.6 million for the year ended December 31, 2004. Our return on average equity was 4.68% for the year ended December 31, 2006, (0.57%) for the year ended December 31, 2005, and 16.04% for the year ended December 31, 2004. Even with the increase in G&A expenses and the reduction of net investment advisory and service fees, net income for the year increased by \$103.0 million. We

attribute the increase in total net income for the year ended December 31, 2006 over the year ended December 31, 2005 to the increase in net interest income, the reduction in losses realized on sale of assets and the loss on other-than-temporarily impaired securities, and the gains realized on the termination of interest rate swaps. We attribute the decrease in total net income for the year ended December 31, 2005 over the year ended December 31, 2004 to the decrease in interest rate spread, the loss realized on sale of assets during the repositioning and the loss on other-than-temporarily impaired securities.

The table below shows our net interest income, net investment advisory and service fees, gain on sale of investment securities and termination of interest rate swaps, G&A expenses, loss on other-than-temporarily impaired securities, income from equity investment, income taxes, impairment of intangible and minority interest, each as a percentage of average equity, and the return on average equity for the years ended December 31, 2006, 2005, 2004, 2003, and 2002 and for the four quarters in 2006.

COMPONENTS OF RETURN ON AVERAGE EQUITY

(Ratios for the four quarters in 2006 have been annualized)	Net Interest Income/Average Equity	Net Investment Advisory and Service Fees/Average Equity	Gain/Loss on Sale of Mortgage-Backed Securities and Interest Rate Swaps/Average Equity	Loss on other-than-temporarily Impaired Securities/Average Equity	Income From Equity Investment/Average Equity	G & A Expenses/Average Equity	Income Taxes/Average Equity	Impairment of Intangible Relationships/Average Equity	Minority Interest/Average Equity	Return on Average Equity
For the Year Ended December 31, 2006	8.32%	0.94%	0.34%	(2.61%)	0.20%	(2.00%)	(0.38%)	(0.12%)	(0.01%)	4.68%
For the Year Ended December 31, 2005	8.45%	1.71%	(3.30%)	(5.15%)	—	1.63%	0.67%	—	—	(0.57%)
For the Year Ended December 31, 2004	16.92%	0.62%	0.34%	—	—	1.55%	0.29%	—	—	16.04%
For the Year Ended December 31, 2003	13.85%	—	3.64%	—	—	1.45%	—	—	—	16.04%
For the Year Ended December 31, 2002	21.72%	—	2.15%	—	—	1.43%	—	—	—	22.44%
For the Quarter Ended December 31, 2006	8.81%	0.67%	1.08%	(0.84%)	0.52%	(1.86%)	(0.20%)	—	(0.05%)	8.13%
For the Quarter Ended September 30, 2006	7.93%	0.76%	1.44%	—	0.08%	(2.08%)	(0.41%)	—	—	7.72%
For the Quarter Ended June 30, 2006	9.20%	1.08%	(0.30%)	(4.91%)	—	(2.19%)	(0.33%)	(0.46%)	—	2.09%
For the Quarter Ended March 31, 2006	7.45%	1.59%	(1.91%)	(7.28%)	—	(1.95%)	(0.57%)	(0.31%)	—	(2.98%)

FINANCIAL CONDITION

INVESTMENT SECURITIES, AVAILABLE FOR SALE

All of our Mortgage-Backed Securities at December 31, 2006, 2005, and 2004 were adjustable-rate or fixed-rate mortgage-backed securities backed by single-family mortgage loans. All of the mortgage assets underlying these mortgage-backed securities were secured with a first lien position on the underlying single-family properties. All of our mortgage-backed securities were FHLMC, FNMA or GNMA mortgage pass-through certificates or CMOs, which carry implied "AAA" ratings. We mark-to-market all of our earning assets to fair value.

All of our agency debentures are callable and carry "AAA" ratings. We mark-to-market all of our agency debentures to fair value.

We accrete discount balances as an increase in interest income over the life of discount investment securities and we amortize premium balances as a decrease in interest income over the life of premium investment securities. At December 31, 2006, 2005, and 2004 we had on our balance sheet a total of \$78.4 million, \$21.5 million and \$1.1 million, respectively, of unamortized discount (which is the difference between the remaining principal value and current historical amortized cost of our investment securities acquired at a price below principal value) and a

total of \$219.1 million, \$242.1 million and \$427.0 million, respectively, of unamortized premium (which is the difference between the remaining principal value and the current historical amortized cost of our investment securities acquired at a price above principal value).

We received mortgage principal repayments of \$5.1 billion for the year ended December 31, 2006, \$7.1 billion for the year ended December 31, 2005, and \$6.5 billion for the year ended December 31, 2004. The overall prepayment speed for the year ended December 31, 2006, 2005 and 2004 was 17%, 27%, and 29% respectively. During the year ended December 31, 2006, the CPR declined to 17%, from 27%, due to a decline in refinancing activity. During the year ended December 31, 2004, the annual prepayment speed was 29%. Given our current portfolio composition, if mortgage principal prepayment rates were to increase over the life of our mortgage-backed securities, all other factors being equal, our net interest income would decrease during the life of these mortgage-backed securities as we would be required to amortize our net premium balance into income over a shorter time period. Similarly, if mortgage principal prepayment rates were to decrease over the life of our mortgage-backed securities, all other factors being equal, our net interest income would increase during the life of these mortgage-backed securities as we would amortize our net premium balance over a longer time period.

The table below summarizes our Investment Securities at December 31, 2006, 2005, 2004, 2003, and 2002 and September 30, 2006, June 30, 2006, and March 31, 2006.

INVESTMENT SECURITIES

(dollars in thousands)	Principal Amount	Net Premium	Amortized Cost	Amortized Cost/ Principal Amount	Fair Value	Fair Value/ Principal Amount	Weighted Average Yield
At December 31, 2006	\$30,134,791	\$140,709	\$30,275,500	100.47%	\$30,217,009	100.27%	5.63%
At December 31, 2005	\$15,915,801	\$220,637	\$16,136,438	101.39%	\$15,929,864	100.09%	4.68%
At December 31, 2004	\$19,123,902	\$425,792	\$19,549,694	102.23%	\$19,428,895	101.59%	3.43%
At December 31, 2003	\$12,682,130	\$299,810	\$12,981,940	102.36%	\$12,934,679	101.99%	2.96%
At December 31, 2002	\$11,202,384	\$273,963	\$11,476,347	102.45%	\$11,551,857	103.12%	3.25%
At September 30, 2006	\$28,297,950	\$139,717	\$28,437,667	100.49%	\$28,348,027	100.18%	5.58%
At June 30, 2006	\$23,822,683	\$141,671	\$23,964,354	100.59%	\$23,474,006	98.54%	5.42%
At March 31, 2006	\$16,288,848	\$173,428	\$16,462,276	101.06%	\$16,176,348	99.31%	5.03%

The tables below set forth certain characteristics of our investment securities. The index level for adjustable-rate Investment Securities is the weighted average rate of the various short-term interest rate indices, which determine the coupon rate.

ADJUSTABLE-RATE INVESTMENT SECURITY CHARACTERISTICS

(dollars in thousands)	Principal Amount	Weighted Average Coupon Rate	Weighted Average Term to Next Adjustment	Weighted Average Lifetime Cap	Weighted Average Asset Yield	Principal Amount at Period End as % of Total Investment Securities
At December 31, 2006	\$8,493,242	5.72%	19 months	9.76%	5.57%	28.18%
At December 31, 2005	\$9,699,133	4.76%	22 months	10.26%	4.74%	60.94%
At December 31, 2004	\$13,544,872	4.23%	24 months	10.12%	3.24%	70.83%
At December 31, 2003	\$9,294,934	3.85%	23 months	9.86%	2.47%	73.29%
At December 31, 2002	\$7,007,062	4.10%	11 months	10.37%	2.33%	62.55%
At September 30, 2006	\$8,291,239	5.57%	17 months	9.64%	5.47%	29.30%
At June 30, 2006	\$7,964,221	5.36%	16 months	9.75%	5.26%	33.43%
At March 31, 2006	\$7,785,082	4.99%	20 months	10.27%	5.07%	47.79%

FIXED-RATE INVESTMENT SECURITY CHARACTERISTICS

(dollars in thousands)	Principal Amount	Weighted Average Coupon Rate	Weighted Average Asset Yield	Principal Amount at Period End as % of Total Investment Securities
At December 31, 2006	\$21,641,549	5.83%	5.65%	71.82%
At December 31, 2005	\$6,216,668	5.37%	4.60%	39.06%
At December 31, 2004	\$5,579,030	5.24%	3.89%	29.17%
At December 31, 2003	\$3,387,196	5.77%	4.29%	26.71%
At December 31, 2002	\$4,195,322	6.76%	4.78%	37.45%
At September 30, 2006	\$20,006,711	5.82%	5.62%	70.70%
At June 30, 2006	\$15,858,461	5.73%	5.50%	66.57%
At March 31, 2006	\$8,503,766	5.43%	4.99%	52.21%

At December 31, 2006 and 2005, we held investment securities with coupons linked to various indices. The following tables detail the portfolio characteristics by index.

ADJUSTABLE-RATE INVESTMENT SECURITIES BY INDEX—December 31, 2006

	One-Month Libor	Six-Month Libor	Twelve-Month Libor	Six-Month Auction Average	Twelve-Month Moving Average	11th District Cost of Funds	National Financial Average Mortgage Rate	Six-Month CD Rate	One-Year Treasury Index	Two-Year Treasury Index	Three-Year Treasury Index	Five-Year Treasury Index	Monthly Federal Cost of Funds
Weighted Average Term to Next Adjustment	1 mo.	35 mo.	36 mo.	2 mo.	1 mo.	1 mo.	5 mo.	3 mo.	13 mo.	9 mo.	17 mo.	31 mo.	1 mo.
Weighted Average Annual Period Cap	6.70%	1.88%	2.00%	1.00%	0.16%	0.00%	2.00%	1.75%	1.00%	2.00%	2.03%	1.97%	0.00%
Weighted Average Lifetime Cap at December 31, 2006	7.32%	10.39%	10.70%	12.95%	10.53%	12.07%	10.90%	9.75%	10.81%	11.91%	13.17%	12.56%	13.41%
Investment Principal Value as Percentage of Investment Securities at December 31, 2006	8.29%	2.71%	9.89%	0.00%	0.07%	0.41%	0.00%	0.06%	6.34%	0.00%	0.10%	0.03%	0.28%

ADJUSTABLE-RATE INVESTMENT SECURITIES BY INDEX—December 31, 2005

	One-Month Libor	Six-Month Libor	Twelve-Month Libor	Six-Month Auction Average	Twelve-Month Moving Average	11th District Cost of Funds	National Financial Average Mortgage Rate	Six-Month CD Rate	One-Year Treasury Index	Two-Year Treasury Index	Three-Year Treasury Index	Five-Year Treasury Index	Monthly Federal Cost of Funds
Weighted Average Term to Next Adjustment	1 mo.	42 mo.	22 mo.	2 mo.	2 mo.	1 mo.	17 mo.	3 mo.	18 mo.	14 mo.	21 mo.	34 mo.	1 mo.
Weighted Average Annual Period Cap	7.29%	2.00%	2.00%	1.00%	0.16%	0.00%	2.00%	1.00%	1.90%	2.00%	2.03%	1.96%	0.00%
Weighted Average Lifetime Cap at December 31, 2005	7.98%	10.78%	10.33%	13.03%	10.61%	12.07%	10.90%	11.74%	10.54%	11.93%	13.12%	12.51%	13.40%
Investment Principal Value as Percentage of Investment Securities at December 31, 2005	6.33%	6.42%	24.46%	0.01%	0.19%	0.94%	0.01%	0.03%	21.55%	0.01%	0.25%	0.06%	0.68%

TRADING SECURITIES AND TRADING SECURITIES SOLD, NOT YET PURCHASED

Trading securities and trading securities sold, not yet purchased are included in the balance sheet as a result of consolidating the financial statements of an affiliated investment fund. Trading securities owned and trading account securities sold, but not yet purchased consisted of securities at fair values as of December 31, 2006. The resulting realized and unrealized gains and losses are reflected in the statements of operations. The fair value of the trading securities was \$18.4 million and the trading securities sold, not yet purchased was \$41.9 million at December 31, 2006.

BORROWINGS

To date, our debt has consisted entirely of borrowings collateralized by a pledge of our investment securities. These borrowings appear on our balance sheet as repurchase agreements. At December 31, 2006, we had established uncommitted borrowing facilities in this market with 30 lenders in amounts which we believe are in excess of our needs. All of our investment securities are currently accepted as collateral for these borrowings. However, we limit our borrowings, and thus our potential asset growth, in order to maintain unused borrowing capacity and thus increase the liquidity and strength of our balance sheet.

For the year ended December 31, 2006, the term to maturity of our borrowings ranged from one day to three years, with a weighted average original term to maturity of 194 days at December 31, 2006. For the year ended December 31, 2005, the term to maturity of our borrowings ranged from one day to three years, with a weighted average original term to maturity of 163 days at December 31, 2005. For the year ended December 31, 2004, the term to maturity of our borrowings ranged from one day to three years, with a weighted average original term to maturity of 211 days at December 31, 2004.

At December 31, 2006, the weighted average cost of funds for all of our borrowings 5.14% and the weighted average term to next rate adjustment was 125 days. At December 31, 2005, the weighted average cost of funds for all of our borrowings was 4.16% and the weighted average term to next rate adjustment was 79 days. At December 31, 2004, the weighted average cost of funds for all of our borrowings was 2.46% and the weighted average term to next rate adjustment was 111 days.

LIQUIDITY

Liquidity, which is our ability to turn non-cash assets into cash, allows us to purchase additional investment securities and to pledge additional assets to secure existing borrowings should the value of our pledged

assets decline. Potential immediate sources of liquidity for us include cash balances and unused borrowing capacity. Unused borrowing capacity will vary over time as the market value of our investment securities varies. Our balance sheet also generates liquidity on an on-going basis through mortgage principal repayments and net earnings held prior to payment as dividends. Should our needs ever exceed these on-going sources of liquidity plus the immediate sources of liquidity discussed above, we believe that in most circumstances our investment securities could be sold to raise cash. The maintenance of liquidity is one of the goals of our capital investment policy. Under this policy, we limit asset growth in order to preserve unused borrowing capacity for liquidity management purposes.

Borrowings under our repurchase agreements increased by \$13.9 billion to \$27.5 billion at December 31, 2006, from \$13.6 billion at December 31, 2005. The increase in borrowings was the result of our deployment of additional capital raised during 2006, which permitted us to increase our borrowings.

We anticipate that, upon repayment of each borrowing under a repurchase agreement, we will use the collateral immediately for borrowing under a new repurchase agreement. We have not at the present time entered into any commitment agreements under which the lender would be required to enter into new repurchase agreements during a specified period of time, nor do we presently plan to have liquidity facilities with commercial banks.

Under our repurchase agreements, we may be required to pledge additional assets to our repurchase agreement counterparties (i.e., lenders) in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (a "margin call"), which may take the form of additional securities or cash. Similarly, if the estimated fair value of investment securities increase due to changes in market interest rates of market factors, lenders may release collateral back to us. Specifically, margin calls result from a decline in the value of the our Mortgage-Backed Securities securing our repurchase agreements, prepayments on the mortgages securing such Mortgage-Backed Securities and to changes in the estimated fair value of such Mortgage-Backed Securities generally due to principal reduction of such Mortgage-Backed Securities from scheduled amortization and resulting from changes in market interest rates and other market factors. Through December 31, 2006, we did not have any margin calls on our repurchase agreements that we were not able to satisfy with either cash or additional pledged collateral. However, should prepayment speeds on the mortgages underlying our Mortgage-Backed Securities and/or market interest rates suddenly increase, margin calls on our repurchase agreements could result, causing an adverse change in our liquidity position.

The following table summarizes the effect on our liquidity and cash flows from contractual obligations for repurchase agreements, the non-cancelable office lease and employment agreements at December 31, 2006.

CONTRACTUAL OBLIGATIONS

(dollars in thousands)	Within One Year	One to Three Years	Three to Five Years	More than Five Years	Total
Repurchase agreements	\$26,114,020	\$ —	\$1,200,000	\$200,000	\$27,514,020
Interest expense on repurchase agreements	148,416	122,532	113,272	38,299	422,519
Long-term operating lease obligations	532	1,064	—	—	1,596
Employment contracts	13,432	—	—	—	13,432
Total	\$26,276,400	\$123,596	\$1,313,272	\$238,299	\$27,951,567

STOCKHOLDERS' EQUITY

During the year ended December 31, 2006, we declared dividends to common shareholders totaling \$102.6 million or \$0.57 per share, of which \$39.0 million was paid on January 26, 2007. During the year ended December 31, 2006, we declared and paid dividends to Series A Preferred shareholders totaling \$14.6 million or \$1.97 per share, and Series B Preferred shareholders totaling \$5.0 million or \$1.08. During the year ended December 31, 2005, we declared and paid dividends to common shareholders totaling \$127.1 million or \$1.04 per share, of which \$12.4 million was paid on January 27, 2006. During the year ended December 31, 2005 we declared and paid dividends to Series A Preferred shareholders totaling \$14.6 million or \$1.97 per share.

On August 16, 2006, the Company entered into an underwriting agreement pursuant to which it sold 40,825,000 shares of its common stock for net proceeds before expenses of approximately \$476.7 million. This transaction settled on August 22, 2006.

On April 6, 2006, the Company entered into an underwriting agreement pursuant to which it sold 39,215,000 shares of its common stock for net proceeds before expenses of approximately \$437.7 million. On April 6, 2006, the Company entered into a second underwriting agreement pursuant to which it sold 4,600,000 shares of its 6% Series B Cumulative Convertible Preferred Stock for net proceeds before expenses of approximately \$111.5 million. Each of these transactions settled on April 12, 2006. The 6% Series B Cumulative Preferred Stock has been treated under GAAP as temporary equity. For the purpose of computing ratios relating to equity measures, the Series B Preferred Stock has been included in equity.

On August 3, 2006 we entered into an ATM Equity OfferingSM Sales Agreement with Merrill Lynch & Co. and Merrill Lynch, Pierce, Fenner & Smith Incorporated (or Merrill Lynch), relating to the sale of shares of our common stock from time to time through Merrill Lynch. Sales of the shares, if any, will be made by means of ordinary brokers' transaction on the New York Stock Exchange. During the quarter ended December 31, 2006 we sold 500,000 shares of our common stock under this program. On August 3, 2006, we also entered into an ATM Equity Sales Agreement with UBS Securities LLC (or UBS Securities), relating to the sale of shares of our common stock from time to time through UBS Securities. Sales of the shares, if any, will be made by means of ordinary brokers' transaction on the New York Stock Exchange. During the quarter ended December 31, 2006, we did not sell any shares of our common stock under this program. We refer to share issuance programs under these two agreements as the ATM Programs.

During the year ended December 31, 2006, 1,598,500 shares of the Company's common stock were issued through the ATM Programs and Equity Shelf Program, totaling net proceeds of \$20.9 million. During the

year ended December 31, 2006, 22,160 options were exercised under the long-term compensation plan for an aggregate exercise price of \$183,000.

During the year ended December 31, 2005, 2,381,550 shares of the Company's common stock were issued through the ESP, totaling net proceeds of \$40.1 million. During the year ended December 31, 2005, 16,128 options were exercised under the long-term compensation plan for an aggregate exercise price of \$253,000. In addition, 24,253 common shares were sold through the dividend reinvestment and direct purchase program for \$440,000 during the year ended December 31, 2005.

During the year ended December 31, 2004, 2,103,525 shares were issued through the Equity Shelf Program totaling net proceeds of \$37.5 million. During the year ended December 31, 2004, 57,000 options were exercised under the long-term compensation plan for an aggregate exercise price of \$856,000. In addition, 127,020 shares were purchased in the dividend reinvestment and direct purchase program at \$2.3 million.

On January 21, 2004, the Company entered into an underwriting agreement pursuant to which the Company raised net proceeds of approximately \$363.6 million in an offering of 20,700,000 shares of common stock. On March 31, 2004, the Company entered into an underwriting agreement pursuant to which the Company raised net proceeds of approximately \$102.9 million through an offering of 4,250,000 shares of 7.875% Series A Cumulative Redeemable Preferred Stock, which settled on April 5, 2004. On October 14, 2004, the Company entered into an underwriting agreement pursuant to which the Company raised net proceeds of approximately \$74.5 million through an offering of 3,162,500 shares of 7.875% Series A Cumulative Redeemable Preferred Stock, which settled on October 19, 2004.

The FIDAC acquisition was completed on June 4, 2004. We issued 2,201,080 common shares to the shareholders of FIDAC, based on the December 31, 2003 closing price of \$18.40. We continue to operate as a self-managed and self-advised real estate investment trust, with FIDAC operating as our wholly-owned taxable REIT subsidiary. We will not pay any consideration under the earn out provisions contained in the merger agreement pursuant to which we acquired FIDAC.

With our "available-for-sale" accounting treatment, unrealized fluctuations in market values of assets do not impact our GAAP or taxable income but rather are reflected on our balance sheet by changing the carrying value of the asset and stockholders' equity under "Accumulated Other Comprehensive Income (Loss)." By accounting for our assets in this manner, we hope to provide useful information to stockholders and creditors and to preserve flexibility to sell assets in the future without having to change accounting methods.

As a result of this mark-to-market accounting treatment, our book value and book value per share are likely to fluctuate far more than if we used historical amortized cost accounting. As a result, comparisons with companies that use historical cost accounting for some or all of their balance sheet may not be meaningful.

The table below shows unrealized gains and losses on the Investment Securities and interest rate swaps in our portfolio.

UNREALIZED GAINS AND LOSSES

(dollars in thousands)	AT DECEMBER 31,				
	2006	2005	2004	2003	2002
Unrealized gain	\$112,596	\$5,027	\$23,021	\$24,886	\$90,507
Unrealized loss	(188,708)	(211,601)	(143,821)	(72,147)	(14,996)
Net unrealized (loss) gain	(\$76,112)	(\$206,574)	(\$120,800)	(\$47,261)	\$75,511
Net unrealized (loss) gain as % of investment securities principal amount	(0.25%)	(1.30%)	(0.63%)	(0.37%)	0.67%
Net unrealized (loss) gain as % of investment securities amortized cost	(0.25%)	(1.28%)	(0.62%)	(0.37%)	0.67%

Unrealized changes in the estimated net market value of investment securities have one direct effect on our potential earnings and dividends: positive mark-to-market changes increase our equity base and allow us to increase our borrowing capacity while negative changes tend to limit borrowing capacity under our capital investment policy. A very large negative change in the net market value of our investment securities might impair our liquidity position, requiring us to sell assets with the likely result of realized losses upon sale. The net unrealized loss on available for sale securities and interest rate swaps was \$76.1 million, or 0.25% of the amortized cost of our investment securities as of December 31, 2006, \$206.6 million, or 1.28% of the amortized cost of our investment securities as of December 31, 2005 and \$120.8 million, or 0.62% of the amortized cost of our investment securities as of December 31, 2004.

Mortgage-Backed Securities with a carrying value of \$7.0 billion were in a continuous unrealized loss position over 12 months at December 31, 2006 in the amount of \$138.2 million. Mortgage-Backed Securities with a carrying value of \$6.4 billion were in a continuous unrealized loss position for less than 12 months at December 31, 2006 in the amount of \$30.2 million. Mortgage-Backed Securities with a carrying value of \$4.6 billion were in a continuous unrealized loss position over 12 months at December 31, 2005 in the amount of \$111.1 million. Mortgage-Backed Securities with a carrying value of \$8.4 billion were in a continuous unrealized loss position for less than 12 months at December 31, 2005 in the amount of \$100.5 million. The decline in value of these securities is solely due to increases in interest rates. All of the Mortgage-Backed Securities are "AAA" rated or carry an implied "AAA" rating. During the years ended December 31, 2006 and 2005, the Company recorded an impairment loss of \$52.3 million and \$83.1 million. The remaining investments are not considered other-than-temporarily impaired since the Company currently has the ability and intent to hold the investments for a period of time or to maturity, if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments. Also, the Company is guaranteed payment on the par value of the securities.

LEVERAGE

Our debt-to-equity ratio at December 31, 2006, 2005, and 2004 was 10.4:1, 9.0:1, and 9.8:1, respectively. We generally expect to maintain a ratio of debt-to-equity of between 8:1 and 12:1, although the ratio may vary from this range from time to time based upon various factors, including our management's opinion of the level of risk of our assets and liabilities, our liquidity position, our level of unused borrowing capacity and over-collateralization levels required by lenders when we pledge assets to secure borrowings.

Our target debt-to-equity ratio is determined under our capital investment policy. Should our actual debt-to-equity ratio increase above the target level due to asset acquisition or market value fluctuations in assets, we will cease to acquire new assets. Our management will, at that time, present a plan to our board of directors to bring us back to our target debt-to-equity ratio; in many circumstances, this would be accomplished over time by the monthly reduction of the balance of our Mortgage-Backed Securities through principal repayments.

ASSET/LIABILITY MANAGEMENT AND EFFECT OF CHANGES IN INTEREST RATES

We continually review our asset/liability management strategy with respect to interest rate risk, mortgage prepayment risk, credit risk and the related issues of capital adequacy and liquidity. Our goal is to provide attractive risk-adjusted stockholder returns while maintaining what we believe is a strong balance sheet.

We seek to manage the extent to which our net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. In addition, we have attempted to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in our portfolio of investment securities by entering into interest rate swaps. At December 31, 2006, we entered into swap agreements with a total notional amount of \$9.3 billion. We agreed to pay a weighted average pay rate of 5.17% and receive a floating rate based on

one month LIBOR. At December 31, 2005, we entered into swap agreements with a total notional amount of \$479.0 million. We agreed to pay a weighted average pay rate of 4.88% and receive a floating rate based on one month LIBOR. The interest rate swap had not settled as of December 31, 2005. We may enter into similar derivative transactions in the future by entering into interest rate collars, caps or floors or purchasing interest-only securities.

Changes in interest rates may also affect the rate of mortgage principal prepayments and, as a result, prepayments on mortgage-backed securities. We will seek to mitigate the effect of changes in the mortgage principal repayment rate by balancing assets we purchase at a premium with assets we purchase at a discount. To date, the aggregate premium exceeds the aggregate discount on our mortgage-backed securities. As a result, prepayments, which result in the expensing of unamortized premium, will reduce our net income compared to what net income would be absent such prepayments.

OFF-BALANCE SHEET ARRANGEMENTS

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, we have not guaranteed any obligations of unconsolidated entities nor do we have any commitment or intent to provide funding to any such entities. As such, we are not materially exposed to any market, credit, liquidity or financing risk that could arise if we had engaged in such relationships.

CAPITAL RESOURCES

At December 31, 2006, we had no material commitments for capital expenditures.

INFLATION

Virtually all of our assets and liabilities are financial in nature. As a result, interest rates and other factors drive our performance far more than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our dividends based upon our net income as calculated for tax purposes; in each case, our activities and balance sheet are measured with reference to historical cost or fair market value without considering inflation.

OTHER MATTERS

We calculate that our qualified REIT assets, as defined in the Internal Revenue Code, are 100% of our total assets at December 31, 2006 and 2005 as compared to the Internal Revenue Code requirement that at least 75% of our total assets be qualified REIT assets. We also calculate that 99.3% and 93.3%, respectively, of our revenue qualifies for the 75% source of income test, and 100% of our revenue qualifies for the 95% source of income test, under the REIT rules for the years ended December 31, 2006 and 2005. We also met all REIT requirements regarding the ownership of our common stock and the distribution of our net income. Therefore, as of December 31, 2006, 2005 and 2004, we believe that we qualified as a REIT under the Internal Revenue Code.

We at all times intend to conduct our business so as not to become regulated as an investment company under the Investment Company Act of 1940, as amended (the "Investment Company Act"). We rely on the exclusion provided by Section 3(c)(5)(C) of the Investment Company Act. Section 3 (c)(5)(C), as interpreted by the staff of the SEC, requires us to invest at least 55% of our assets in "mortgages and other liens on and interests in real estate" (or Qualifying Real Estate Assets) and a least 80% of our assets in Qualifying Real Estate Assets plus real estate related assets. The assets that we acquire, therefore, are limited by the provisions of the Investment Company Act and the rules and regulations promulgated under the Investment Company Act. We calculate that as of December 31, 2006, 2005 and 2004, we were in compliance with this requirement.

MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

DATED: FEBRUARY 26, 2007

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rules 13a-15(f) under the Securities Exchange Act as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's Board of Directors, management and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. As a result, even systems determined to be effective can provide only reasonable assurance regarding the preparation and presentation of financial statements. Moreover, projections of any evaluation of effectiveness to future periods are subject to the risks that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

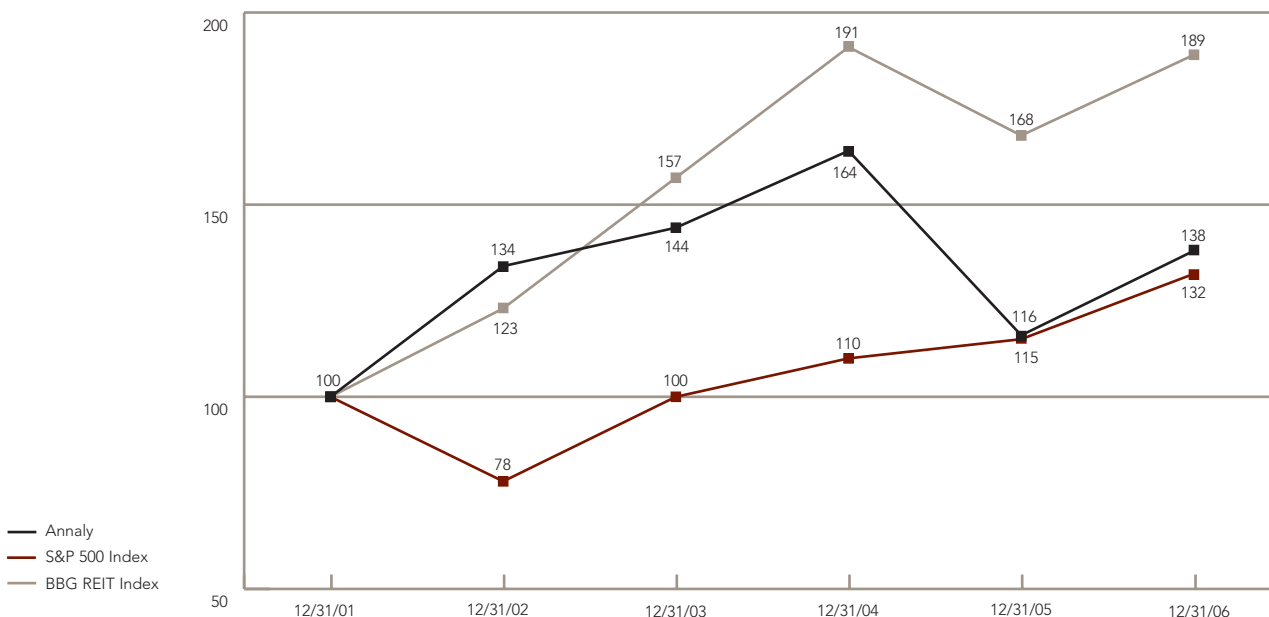
The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2006. In making this assessment, the Company's management used criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*.

Based on management's assessment, the Company's management believes that, as of December 31, 2006, the Company's internal control over financial reporting was effective based on those criteria. There have been no changes in the Company's internal controls over financial reporting that occurred during the quarter ended December 31, 2006 that have materially affected, or are reasonably likely to affect its internal control over financial reporting.

The Company's independent registered public accounting firm, Deloitte & Touche LLP, have issued an audit report on management's assessment of the Company's internal control over financial reporting.

PERFORMANCE ANALYSIS

The following graph provides a comparison of our cumulative total stockholder return and the cumulative stockholder return of the Standard & Poor's Composite-500 Stock Index, or S&P 500, and the Bloomberg REIT Mortgage Index, or BBG REIT Index, an industry index of 32 tax-qualified mortgage REITs. The comparison is for the period from December 31, 2001 to December 31, 2006 and assumes the reinvestment of any dividends. The initial price of our common stock shown in the graph below is based upon the price to public of \$16.00 on December 31, 2001. Upon written request, we will provide stockholders with a list of the REITs included in the BBG REIT Index. The historical information set forth below is not necessarily indicative of future performance.



	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
Annaly	100	134	144	164	116	138
S&P 500 Index	100	78	100	110	115	132
BBG REIT Index	100	123	157	191	168	189

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**TO THE BOARD OF DIRECTORS AND STOCKHOLDERS OF
ANNALY CAPITAL MANAGEMENT, INC.
NEW YORK, NEW YORK**

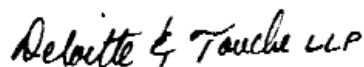
We have audited the accompanying consolidated statements of financial condition of Annaly Capital Management, Inc. and subsidiaries (the "Company") as of December 31, 2006 and 2005, and the related consolidated statements of operations and comprehensive income (loss), stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. We also have audited management's assessment, included in the accompanying Management Report On Internal Control Over Financial Reporting included on page 18, that the Company maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Annaly Capital Management, Inc. and subsidiaries, as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.



New York, New York
February 26, 2007

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2006 AND 2005

(dollars in thousands, except per share data)	December 31, 2006	December 31, 2005
ASSETS		
Cash and cash equivalents	\$91,782	\$4,808
Mortgage-Backed Securities, at fair value	30,167,509	15,929,864
Agency debentures, at fair value	49,500	—
Trading securities, at fair value	18,365	—
Receivable for Mortgage-Backed Securities sold	200,535	13,449
Accrued interest receivable	146,089	71,340
Receivable for advisory and service fees	3,178	3,497
Intangible for customer relationships, net	11,184	15,183
Goodwill	22,966	23,122
Interest rate swaps, at fair value	2,558	—
Other assets	2,314	2,159
Total assets	\$30,715,980	\$16,063,422
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities:		
Repurchase agreements	\$27,514,020	\$13,576,301
Payable for Mortgage-Backed Securities purchased	338,172	933,051
Trading securities sold, not yet purchased, at fair value	41,948	—
Accrued interest payable	83,998	27,994
Dividends payable	39,016	12,368
Other liabilities	—	305
Accounts payable	18,816	8,837
Interest rate swaps, at fair value	20,179	543
Total liabilities	28,056,149	14,559,399
Minority interest in equity of consolidated affiliate	5,324	—
6.00% Series B Cumulative Convertible Preferred Stock: 4,600,000 and 0 authorized, issued and outstanding, respectively	111,466	—
Stockholders' Equity:		
7.875% Series A Cumulative Redeemable Preferred Stock: 7,637,500 authorized 7,412,500 shares issued and outstanding	177,088	177,088
Common stock: par value \$.01 per share; 500,000,000 authorized, 205,345,591 and 123,684,931 shares issued and outstanding, respectively	2,053	1,237
Additional paid-in capital	2,615,016	1,679,452
Accumulated other comprehensive loss	(76,112)	(207,117)
Accumulated deficit	(175,004)	(146,637)
Total stockholders' equity	2,543,041	1,504,023
Total liabilities, minority interest, Series B Preferred Stock and stockholders' equity	\$30,715,980	\$16,063,422

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(dollars in thousands, except per share amounts)	FOR THE YEAR ENDED		
	December 31, 2006	December 31, 2005	December 31, 2004
Interest income	\$1,221,882	\$705,046	\$532,328
Interest expense	1,055,013	568,560	270,116
Net interest income	166,869	136,486	262,212
Other (loss) income:			
Investment advisory and service fees	22,351	35,625	12,512
(Loss) gain on sale of Investment Securities	(3,862)	(53,238)	5,215
Gain on termination of interest rate swaps	10,674	—	—
Income from trading securities	3,994	—	—
Loss on other-than-temporarily impaired securities	(52,348)	(83,098)	—
Total other (loss) income	(19,191)	(100,711)	17,727
Expenses:			
Distribution fees	3,444	8,000	2,860
General and administrative expenses	40,063	26,278	24,029
Total expenses	43,507	34,278	26,889
Impairment of intangible for customer relationships	2,493	—	—
Income before income taxes and minority interest	101,678	1,497	253,050
Income taxes	7,538	10,744	4,458
Income (loss) before minority interest	94,140	(9,247)	248,592
Minority interest	324	—	—
Net Income (loss)	93,816	(9,247)	248,592
Dividends on preferred stock	19,557	14,593	7,745
Net income available (loss related) to common shareholders	\$74,259	(\$23,840)	\$240,847
Net income available (loss related) to common shareholders per average common share:			
Basic	\$0.44	(\$0.19)	\$2.04
Diluted	\$0.44	(\$0.19)	\$2.03
Weighted average number of common shares outstanding:			
Basic	167,666,631	122,475,032	118,223,330
Diluted	167,746,387	122,475,032	118,459,145
Net income (loss)	\$93,816	(\$9,247)	\$248,592
Comprehensive income (loss):			
Unrealized gain (loss) on available-for sale securities	91,873	(222,110)	(68,324)
Unrealized loss on interest rate swaps	(6,404)	(543)	—
Reclassification adjustment for net losses (gains) included in net income or loss	45,536	136,336	(5,215)
Other comprehensive income (loss)	131,005	(86,317)	(73,539)
Comprehensive income (loss)	\$224,821	(\$95,564)	\$175,053

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004

(dollars in thousands, except per share data)	Preferred Stock	Common Stock Par Value	Additional Paid-in Capital	Other Accumulated Comprehensive Income (loss)	Retained (Deficit) Earnings	Total
BALANCE, DECEMBER 31, 2003		\$ 961	\$1,194,159	(\$ 47,261)	\$1,361	\$1,149,220
Net Income					248,592	
Other comprehensive loss				(73,539)		
Comprehensive income						175,053
Exercise of stock options		1	855			856
Net proceeds from direct purchase and dividend reinvestment		1	2,285			2,286
Net proceeds from follow-on offering		207	363,385			363,592
Common shares issued in FIDAC transaction		22	40,478			40,500
Net proceeds from preferred offering	\$177,077					177,077
Net proceeds from equity shelf program		21	37,473			37,494
Preferred dividends declared, \$1.45 per share					(7,745)	(7,745)
Common dividends declared, \$1.98 per share					(237,863)	(237,863)
BALANCE, DECEMBER 31, 2004	\$ 177,077	\$1,213	\$1,638,635	(\$120,800)	\$4,345	\$1,700,470
Net loss					(9,247)	
Other comprehensive Loss				(86,317)		
Comprehensive loss						(95,564)
Reduction in estimated legal cost of preferred offering	11					11
Exercise of stock options			253			253
Net proceeds from direct purchase and dividend reinvestment			440			440
Net proceeds from equity shelf program		24	40,124			40,148
Preferred dividends declared, \$1.97 per share					(14,593)	(14,593)
Common dividends declared, \$1.04 per share					(127,142)	(127,142)
BALANCE, DECEMBER 31, 2005	\$177,088	\$1,237	\$1,679,452	(\$207,117)	(\$146,637)	\$1,504,023
Net income					93,816	
Other comprehensive income				131,005		
Comprehensive income						224,821
Exercise of stock options			183			183
Option expense			1,285			1,285
Net proceeds from follow-on offerings		800	913,200			914,000
Net proceeds from equity shelf program		16	20,896			20,912
Preferred Series A dividends declared \$1.97 per share					(14,594)	(14,594)
Preferred Series B dividends declared \$1.08 per share					(4,966)	(4,966)
Common dividends declared, \$0.57 per share					(102,623)	(102,623)
BALANCE, DECEMBER 31, 2006	\$177,088	\$2,053	\$2,615,016	(\$76,112)	(\$175,004)	\$2,543,041

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2006, 2005, AND 2004

(dollars in thousands)	FOR THE YEAR ENDED		
	December 31, 2006	December 31, 2005	December 31, 2004
Cash flows from operating activities:			
Net income (loss)	\$93,816	(\$9,247)	\$248,592
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Amortization of Mortgage Backed Securities premiums and discounts, net	63,625	154,309	179,602
Amortization of intangibles	1,589	571	130
Loss (gain) on sale of Investment Securities	3,862	53,238	(5,215)
Gain on termination of interest rate swaps	(10,674)	—	—
Stock option expense	1,285	56	317
Net realized gain on trading investments	(1,200)	—	—
Unrealized depreciation on trading investments	1,180	—	—
Market value adjustment on long-term repurchase agreements	(149)	(2,514)	(1,133)
Loss on other-than-temporarily impaired securities	52,348	83,098	—
Impairment of intangibles	2,493	—	—
(Increase) decrease in accrued interest receivable	(76,224)	10,555	(27,964)
Increase in other assets	(238)	(425)	(1,749)
Purchase of trading investments	(44,200)	—	—
Proceeds from sale of trading securities	28,838	—	—
Purchase of trading securities sold, not yet purchased	(16,096)	—	—
Proceeds for securities sold, not yet purchased	55,073	—	—
(Decrease) increase in advisory and service fees receivable	319	(1,138)	(795)
Increase (decrease) in interest payable	56,004	(7,727)	20,732
Increase in accrued expenses and other liabilities	9,978	753	4,400
Net cash provided by operating activities	<u>221,629</u>	<u>281,529</u>	<u>416,917</u>
Cash flows from investing activities:			
Purchase of Mortgage-Backed Securities	(23,196,076)	(7,416,869)	(14,147,323)
Proceeds from sale of Investment Securities	3,040,984	3,231,219	596,962
Principal payments of Mortgage-Backed Securities	5,115,693	7,053,867	6,495,911
Purchase of agency debentures	—	—	(250,000)
Proceeds from called agency debentures	—	130,000	845,000
Cash from FIDAC acquisition	—	—	2,526
Net cash (used in) provided by investing activities	<u>(15,039,399)</u>	<u>2,998,217</u>	<u>(6,456,924)</u>
Cash flows from financing activities:			
Proceeds from repurchase agreements	292,418,807	245,514,548	152,739,827
Principal payments on repurchase agreements	(278,481,088)	(248,646,126)	(147,045,071)
Proceeds from exercise of stock options	183	197	539
Proceeds from termination of interest rate swaps	10,674	—	—
Proceeds from direct purchase and dividend reinvestment	—	440	2,286
Net proceeds from follow-on offerings	914,000	—	363,592
Net proceeds from preferred stock offering	111,466	—	177,077
Net proceeds from equity shelf program and ATM Equity Sales Agreement	20,912	40,148	37,494
Minority interest	5,324	—	—
Dividends paid	(95,534)	(189,998)	(230,131)
Net cash provided by (used in) financing activities	<u>14,904,744</u>	<u>(3,280,791)</u>	<u>6,045,613</u>
Net increase (decrease) in cash and cash equivalents	86,974	(1,045)	5,606
Cash and cash equivalents, beginning of year	4,808	5,853	247
Cash and cash equivalents, end of year	\$91,782	\$4,808	\$5,853
Supplemental disclosure of cash flow information:			
Interest paid	\$999,009	\$576,287	\$249,384
Taxes paid	\$7,242	\$11,740	\$3,462
Noncash financing activities:			
Net change in unrealized loss on available-for-sale securities and interest rate swaps, net of reclassification adjustment	\$131,005	(\$86,317)	(\$73,539)
Dividends declared, not yet paid	\$39,016	\$12,368	\$60,632
Noncash investing and financing activities:			
Noncash acquisition of FIDAC	—	—	\$40,500

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

**ANNALY CAPITAL MANAGEMENT, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004**

I. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Annaly Capital Management, Inc. (the “Company”) was incorporated in Maryland on November 25, 1996. The Company changed its name from Annaly Mortgage Management, Inc. to Annaly Capital Management, Inc. effective August 2, 2006. The Company commenced its operations of purchasing and managing an investment portfolio of mortgage-backed securities on February 18, 1997, upon receipt of the net proceeds from the private placement of equity capital. An initial public offering was completed on October 14, 1997. The Company is a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended. The Company acquired Fixed Income Discount Advisory Company (“FIDAC”) on June 4, 2004. FIDAC is a registered investment advisor and is a taxable REIT subsidiary of the Company. On June 27, 2006, the Company made a majority equity investment of 90% in an affiliated investment fund (the “Fund”). At December 31, 2006, the Fund was invested 100% in equity investments.

A summary of the Company's significant accounting policies follows:

The consolidated financial statements include the accounts of the Company, FIDAC and the Fund. All intercompany balances and transactions have been eliminated. The minority shareholder in the Fund is reflected as minority interest in the consolidated financial statements.

Cash and Cash Equivalents—Cash and cash equivalents include cash on hand and money market funds.

Mortgage-Backed Securities and Agency Debentures—The Company invests primarily in mortgage pass-through certificates, collateralized mortgage obligations and other mortgage-backed securities representing interests in or obligations backed by pools of mortgage loans (collectively, “Mortgage-Backed Securities”). The Company also invests in agency debentures issued by Federal Home Loan Bank (“FHLB”), Federal Home Loan Mortgage Corporation (“FHLMC”), and Federal National Mortgage Association (“FNMA”). The Mortgage-Backed Securities and agency debentures are collectively referred to herein as “Investment Securities.”

Statement of Financial Accounting Standards (“SFAS”) No. 115, Accounting for Certain Investments in Debt and Equity Securities, requires the Company to classify its Investment Securities as either trading investments, available-for-sale investments or held-to-maturity investments. Although the Company generally intends to hold most of its Investment Securities until maturity, it may, from time to time, sell any of its Investment Securities as part of its overall management of its portfolio. Accordingly, SFAS No. 115 requires the Company to classify all of its Investment Securities as available-for-sale. All assets classified as available-for-sale are reported at estimated fair value, based on market prices from independent sources, with unrealized gains and losses excluded from earnings and reported as a separate component of stockholders' equity.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been lower than carrying value, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Unrealized losses on Investment Securities that are considered other than temporary, as measured by the amount of decline in fair value attributable to other-than-temporary factors, are recognized in income and the cost basis of the Investment Securities is adjusted. The loss on other-than-temporarily impaired securities was \$52.3 million during the year ended December 31, 2006 and \$83.1 million during the year ended December 31, 2005. There were no impairment losses recognized in 2004.

SFAS No. 107, *Disclosure About Fair Value of Financial Instruments*, requires disclosure of the fair value of financial instruments for which it is practi-

cable to estimate that value. The fair value of Mortgage-Backed Securities and agency debentures available-for-sale and interest rate swaps is equal to their carrying value presented in the consolidated statements of financial condition. The fair value of trading securities and trading securities sold, not yet purchased is equal to their estimated fair value presented in the consolidated statements of financial condition. The fair value of cash and cash equivalents, accrued interest receivable, receivable for securities sold, receivable for advisory and service fees, repurchase agreements, with less than a one year maturity date, and payable for mortgage-backed securities purchased, dividends payable, accounts payable, and accrued interest payable, generally approximates cost as of December 31, 2006 due to the short term nature of these financial instruments.

Interest income is accrued based on the outstanding principal amount of the Investment Securities and their contractual terms. Premiums and discounts associated with the purchase of the Investment Securities are amortized into interest income over the projected lives of the securities using the interest method. The Company's policy for estimating prepayment speeds for calculating the effective yield is to evaluate historical performance, consensus prepayment speeds, and current market conditions.

Investment Securities transactions are recorded on the trade date. Purchases of newly-issued securities are recorded when all significant uncertainties regarding the characteristics of the securities are removed, generally shortly before settlement date. Realized gain and losses on sale of Investment Securities are determined on the specific identification basis.

Derivative Financial Instruments/Hedging Activity—The Company hedges interest rate risk through the use of derivative financial instruments, comprised of interest rate caps and interest rate swaps (collectively, “Hedging Instruments”). The Company accounts for Hedging Instruments in accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (“SFAS 133”) as amended and interpreted. The Company carries all Hedging Instruments at their fair value, as assets, if their fair value is positive, or as liabilities, if their fair value is negative. As the Company's interest rate swaps are designated as cash flow hedges under SFAS No. 133, the change in the fair value of any such derivative is recorded in other comprehensive income or loss for hedges that qualify as effective. At December 31, 2006 the Company did not have any interest rate caps. The ineffective amount of all Hedging Instruments, if any, is recognized in earnings each year. To date, the Company has not recognized any change in the value of its interest rate swaps in earnings as a result of the hedge or a portion thereof being ineffective.

Upon entering into hedging transactions, the Company documents the relationship between the Hedging Instruments and the hedged liability. The Company also documents its risk-management policies, including objectives and strategies, as they relate to its hedging activities. The Company assesses, both at inception of a hedge and on an on-going basis, whether or not the hedge is “highly effective,” as defined by SFAS 133. The Company discontinues hedge accounting on a prospective basis with changes in the estimated fair value reflected in earnings when (i) it is determined that the derivative is no longer effective in offsetting cash flows of a hedged item (including hedged items such as forecasted transactions); (ii) it is no longer probable that the forecasted transaction will occur; or (iii) it is determined that designating the derivative as a Hedging Instrument is no longer appropriate.

When the Company enters into an interest rate swap, it agrees to pay a fixed rate of interest and to receive a variable interest rate, generally based on the London Interbank Offered Rate (“LIBOR”). The Company's interest rate swaps are designated as cash flow hedges against the benchmark interest rate risk associated with the Company's borrowings.

All changes in the unrealized gains/losses on any interest rate swap are recorded in accumulated other comprehensive income or loss and are reclassified to earnings as interest expense is recognized on the Company's hedged borrowings. If it becomes probable that the forecasted transaction, which in this case refers to interest payments to be made under the Company's short-term borrowing agreements, will not occur by the end of the originally specified time period, as documented at the

inception of the hedging relationship, then the related gain or loss in accumulated other comprehensive income or loss would be reclassified to income or loss.

Realized gains and losses resulting from the termination of an interest rate swap are initially recorded in accumulated other comprehensive income or loss as a separate component of stockholders' equity. The gain or loss from a terminated interest rate swap remains in accumulated other comprehensive income or loss until the forecasted interest payments affect earnings. If it becomes probable that the forecasted interest payments will not occur, then the entire gain or loss would be recognized in earnings.

Credit Risk—The Company has limited its exposure to credit losses on its portfolio of Mortgage-Backed Securities by only purchasing securities issued by FHLMC, FNMA, or GNMA. The payment of principal and interest on the FHLMC and FNMA Mortgage-Backed Securities are guaranteed by those respective agencies, and the payment of principal and interest on the GNMA Mortgage-Backed Securities are backed by the full faith and credit of the U.S. government. All of the Company's Investment Securities have an actual or implied "AAA" rating.

Trading Securities and Trading Securities sold, not yet purchased—Trading securities and trading securities sold, not yet purchased, are included in the balance sheet as a result of consolidating the financial statements of the Fund, and are carried at fair value at December 31, 2006. The realized and unrealized gains and losses from trading securities are recorded in the income from trading securities balance in the accompanying consolidated statements of operations.

Trading account securities sold, not yet purchased represent obligations of the Fund to deliver the specified security at the contracted price, and thereby create a liability to purchase the security in the market at prevailing prices.

Repurchase Agreements—The Company finances the acquisition of its Investment Securities through the use of repurchase agreements. Repurchase agreements are treated as collateralized financing transactions and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements.

Cumulative Convertible Preferred Stock—The Company classifies its Series B Cumulative Convertible Preferred Stock on the consolidated statements of financial condition using the guidance in SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks," and Emerging Issues Task Force ("EITF") Topic D-98, Classification and Measurement of Redeemable Securities*. The Series B Cumulative Convertible Preferred Stock contains fundamental change provisions that allow the holder to redeem the preferred stock for cash if certain events occur. As redemption under these provisions is not solely within the Company's control, the Company has classified the Series B Cumulative Convertible Preferred Stock as temporary equity in the accompanying consolidated statement of financial condition.

The Company has analyzed whether the embedded conversion option should be bifurcated under the guidance in SFAS No. 133 and EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, and has determined that bifurcation is not necessary.

Income Taxes—The Company has elected to be taxed as a REIT and intends to comply with the provisions of the Internal Revenue Code of 1986, as amended (the "Code"), with respect thereto. Accordingly, the Company will not be subjected to federal income tax to the extent of its distributions to shareholders and as long as certain asset, income and stock ownership tests are met. The Company and FIDAC have made a joint election to treat FIDAC as a taxable REIT subsidiary. As such, FIDAC is taxable as a domestic C corporation and subject to federal and state and local income taxes based upon its taxable income.

Use of Estimates—The preparation of the consolidated financial statements in conformity with Generally Accepted Accounting Principles or 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.

Intangible Assets—The Company's acquisition of FIDAC was accounted for using the purchase method. Under the purchase method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. In addition, the cost of FIDAC was allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of purchase price over the fair value of the net assets acquired was recognized as goodwill. Intangible assets are periodically (but not less frequently than annually) reviewed for potential impairment. Intangible assets with an estimated useful life are expected to amortize over a 8.7 year weighted average time period. During the year ended December 31, 2006, the Company recognized \$2.5 million in impairment losses on intangible assets relating to customer relationships. During the years ended December 31, 2005 and 2004, the Company did not have impairment losses.

Stock Based Compensation—On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (Revised 2004)—*Share-Based Recent Payment* ("SFAS No. 123R"). SFAS No. 123R, which replaces SFAS No. 123, requires the Company to measure and recognize in the financial statements the compensation cost relating to share-based payment transactions. The compensation cost should be reassessed based on the fair value of the equity instruments issued. We adopted SFAS No. 123R effective January 1, 2006 under the modified prospective transition method. Accordingly, prior period amounts have not been restated. Under this application, the Company is required to record compensation expense for all awards granted or modified on or after January 1, 2006 and for the unvested portion of all outstanding awards that remain outstanding at the date of adoption. The adoption of SFAS No. 123R resulted in total stock-based compensation expense of approximately \$1.3 million for the year ended December 31, 2006.

The Company elected to recognize compensation expense on a straight-line basis over the requisite service period for the entire award (that is, over the requisite service period of the last separately vesting portion of the award). We estimate fair value using the Black-Scholes valuation model. The assumptions used to value the options granted during the year ended December 31, 2006 are as follows: Expected volatility of 26.50%, expected dividends of 5.57%, expected term in years of 6.8 and risk-free rate of 4.6%. Assumptions used to estimate the compensation expense are determined as follows:

- Expected term (estimated time of outstanding) is estimated using the historical exercise behavior of employees
- Expected volatility is measured using the weighted average of historical daily changes in the market price of our common stock over the expected term of the award
- Expected dividend yield is based on projected dividend yield over the expected term of the award
- Risk-free interest rate is equivalent to the implied yield on zero-coupon U.S. Treasury bonds with a remaining maturity equal to the expected term of the awards; and,
- Forfeitures are based substantially on the history of cancellations of similar awards granted by the Company in prior years.

Prior to the adoption of SFAS No. 123R, we used the intrinsic value method prescribed in APB 25 and also followed the disclosure requirements of SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure* ("SFAS No. 148") which required certain disclosures on a pro forma basis as if the fair value method had been followed for accounting for such compensation.

(dollars in thousands, except per share data)	FOR THE YEAR ENDED	
	December 31, 2005	December 31, 2004
Net (loss) income available to common shareholders, as reported	(\$23,840)	\$240,847
Deduct: Total stock-based employee compensation expense determined under fair value based method	(357)	(149)
Pro-forma net (loss) income available to common shareholders	(\$24,197)	\$240,698
Net (loss) income per share available to common shareholders, as reported:		
Basic	(\$0.19)	\$2.04
Diluted	(\$0.19)	\$2.03
Pro-forma net (loss) income per share available to common shareholders:		
Basic	(\$0.20)	\$2.03
Diluted	(\$0.20)	\$2.03

Recent Accounting Pronouncements—SEC Staff Accounting Bulletin No. 108—In September 2006 the SEC issued Staff Accounting Bulletin (SAB) No. 108 “Considering the effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements (SAB 108)”, which expresses the Staff’s views regarding the process of quantifying financial statement misstatements. SAB 108 is effective for annual financial statements covering the fiscal year ending after November 15, 2006. Registrants are required to quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The techniques most commonly used in practice to accumulate and quantify misstatements are generally referred to as the “rollover” (current year income statement perspective) and “iron curtain” (year-end balance perspective) approaches. The financial statements would require adjustment when either approach results in quantifying a misstatement that is material, after considering all relevant quantitative and qualitative factors. The adoption of SAB 108 on December 31, 2006 has no effect on the Company’s consolidated financial statements.

In April 2006, the FASB issued FSP FIN 46(R)-6, *Determining the Variability to be Considered When Applying FASB Interpretation No. 46(R)* (“FIN 46(R)-6”). FIN 46(R)-6 addresses the approach to determine the variability to consider when applying FIN 46(R). The variability that is considered in applying Interpretation 46(R) may affect (i) the determination as to whether an entity is a variable interest entity (“VIE”), (ii) the determination of which interests are variable in the entity, (iii) if necessary, the calculation of expected losses and residual returns on the entity, and (iv) the determination of which party is the primary beneficiary of the VIE. Thus, determining the variability to be considered is necessary to apply the provisions of Interpretation 46(R). FIN 46(R)-6 is required to be prospectively applied to entities in which the Company first become involved after July 1, 2006 and would be applied to all existing entities with which the Company is involved if and when a “reconsideration event” (as described in FIN 46) occurs. The adoption did not have a material impact on the consolidated financial statements of the Company.

In February 2006, the FASB issued FAS No. 155, *Accounting for Certain Hybrid Instruments* (“FAS 155”), an amendment of FASB Statements No. 133 and 140. Among other things, FAS 155: (i) permits fair value re-measurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation; (ii) clarifies which interest-only strips and principal-only strips are not subject to the requirements of FAS 133; (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation; (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives; and (v) amends FAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. FAS 155 is effective for all financial instruments acquired or issued by the Company after December 31, 2006.

On September 25, 2006, the FASB met and proposed a scope exception under FAS 155 for securitized interests that only contain an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets, and for which the investor does not control the right to accelerate the settlement. If a securitized interest contains any other embedded derivative (for example, an inverse floater), then it would be subject to the bifurcation tests in FAS 133, as would securities purchased at a significant premium. The FASB plans to issue their final position in early 2007.

In July 2006, the FASB issued *FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (“FIN 48”), and related implementation issues. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in the Company’s financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a threshold and measurement attribute for recognition in the financial statements of an asset or liability resulting from a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective as of the beginning of fiscal years that begin after December 15, 2006. There is no impact to the Company from implementing this new standard.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements. SFAS No. 157 requires companies to disclose the fair value of its financial instruments according to a fair value hierarchy (i.e., levels 1, 2, and 3, as defined). Additionally, companies are required to provide enhanced disclosure regarding instruments in the level 3 category (which require significant management judgment), including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities. SFAS No. 157 is effective for the Company on January 1, 2008. The Company is currently evaluating the impact adoption of SFAS No. 157 may have on its consolidated financial statements.

Proposed Accounting Pronouncements—The FASB has added an item to its current proposed amendment relating to the accounting treatment under SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* of transactions where assets purchased from a particular counterparty are financed via a repurchase agreement with the same counterparty. Currently, the Company records such assets and the related financing in the consolidated statement of financial condition, and the corresponding interest income and interest expense in the Company’s consolidated statement of operations and comprehensive (loss) income. For assets representing available-for-sale investment securities, as in the Company’s case, any change in fair value is reported through other comprehensive income under SFAS No. 115, with the exception of impairment losses, which are recorded in the consolidated statement of operations and comprehensive (loss) income as realized losses.

However, a transaction where assets are acquired from and financed under a repurchase agreement with the same counterparty may not qualify for a sale treatment by a seller under an interpretation of SFAS No. 140, which would require the seller to continue to carry such sold assets on their books based on their “continuing involvement” with such assets. Depending on the ultimate outcome of the FASB deliberations, the result may be that the Company would be precluded from recording the assets purchased in the transaction described above as well as the related financing in the Company’s consolidated statement of financial condition and would instead be treating the Company’s net investment in such assets as a derivative.

This potential change in accounting treatment would not affect the economic substance of the transactions but would affect how the transactions would be reported in the Company’s financial statements. The Company’s cash flows, liquidity and ability to pay a dividend would be unchanged, and the Company does not believe the Company’s taxable income or net equity would be affected.

2. MORTGAGE-BACKED SECURITIES

The following tables present the Company's available-for-sale Mortgage-Backed Securities portfolio as of December 31, 2006 and 2005:

December 31, 2006

(dollars in thousands)	Federal Home Loan Mortgage Corporation	Federal National Mortgage Association	Government National Mortgage Association	Total Mortgage-Backed Securities
Mortgage-Backed Securities, gross	\$10,675,235	\$19,085,218	\$324,338	\$30,084,791
Unamortized discount	(21,332)	(56,517)	(204)	(78,053)
Unamortized premium	82,707	133,164	3,271	219,142
Amortized cost	10,736,610	19,161,865	327,405	30,225,880
Gross unrealized gains	35,174	74,498	366	110,038
Gross unrealized losses	(73,125)	(92,548)	(2,736)	(168,409)
Estimated fair value	\$10,698,659	\$19,143,815	\$325,035	\$30,167,509
(dollars in thousands)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
Adjustable rate	\$8,546,363	\$12,764	(\$61,483)	\$8,497,644
Fixed rate	21,679,517	97,274	(106,926)	21,669,865
Total	\$30,225,880	\$110,038	(\$168,409)	\$30,167,509

December 31, 2005

(dollars in thousands)	Federal Home Loan Mortgage Corporation	Federal National Mortgage Association	Government National Mortgage Association	Total Mortgage-Backed Securities
Mortgage-Backed Securities, gross	\$5,689,898	\$9,881,672	\$344,231	\$15,915,801
Unamortized discount	(4,043)	(17,345)	(62)	(21,450)
Unamortized premium	92,228	144,726	5,133	242,087
Amortized cost	5,778,083	10,009,053	349,302	16,136,438
Gross unrealized gains	3,174	1,853	—	5,027
Gross unrealized losses	(80,733)	(124,330)	(6,538)	(211,601)
Estimated fair value	\$5,700,524	\$9,886,576	\$342,764	\$15,929,864
(dollars in thousands)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
Adjustable rate	\$9,844,261	\$3,973	(\$120,480)	9,727,754
Fixed rate	6,292,177	1,054	(91,121)	6,202,110
Total	\$16,136,438	\$5,027	(\$211,601)	\$15,929,864

Actual maturities of Mortgage-Backed Securities are generally shorter than stated contractual maturities. Actual maturities of the Company's Mortgage-Backed Securities are affected by the contractual lives of the underlying mortgages, periodic payments of principal, and prepayments of principal.

The following table summarizes the Company's mortgage-backed securities on December 31, 2006 and 2005 according to their estimated weighted-average life classifications:

(dollars in thousands)	DECEMBER 31, 2006		DECEMBER 31, 2005	
	Fair Value	Amortized Cost	Fair Value	Amortized Cost
Less than one year	\$379,967	\$382,268	\$508,851	\$514,560
Greater than one year and less than five years	21,788,975	21,851,659	12,648,106	12,824,736
Greater than or equal to five years	7,998,567	7,991,953	2,772,907	2,797,142
Total	\$30,167,509	\$30,225,880	\$15,929,864	\$16,136,438

The weighted-average lives of the mortgage-backed securities at December 31, 2006 and 2005 in the table above are based upon data provided through subscription-based financial information services, assuming constant principal prepayment rates to the reset date of each security. The prepayment model considers current yield, forward yield, steepness of the yield curve, current mortgage rates, mortgage rate of the outstanding loans, loan age, margin and volatility.

Mortgage-Backed Securities with a carrying value of \$7.0 billion were in a continuous unrealized loss position over 12 months at December 31, 2006 in the amount of \$138.2 million. Mortgage-Backed Securities with a carrying value of \$6.4 billion were in a continuous unrealized loss position for less than 12 months at December 31, 2006 in the amount of \$30.2 million. Mortgage-Backed Securities with a carrying value of \$4.6

billion were in a continuous unrealized loss position over 12 months at December 31, 2005 in the amount of \$111.1 million. Mortgage-Backed Securities with a carrying value of \$8.4 billion were in a continuous unrealized loss position for less than 12 months at December 31, 2005 in the amount of \$100.5 million. The decline in value of these securities is solely due to increases in interest rates. All of the Mortgage-Backed Securities are "AAA" rated or carry an implied "AAA" rating. During the years ended December 31, 2006 and 2005, the Company recorded impairment losses of \$52.3 million and \$83.1 million, respectively. The remaining investments are not considered other-than-temporarily impaired since the Company currently has the ability and intent to hold the investments for a period of time or to maturity, if necessary, sufficient for a forecasted market price recovery up to or beyond the cost of the investments. Also, the Company is guaranteed payment on the par value of the securities.

The adjustable rate Mortgage-Backed Securities are limited by periodic caps (generally interest rate adjustments are limited to no more than 1% every nine months) and lifetime caps. The weighted average lifetime cap was 9.8% at December 31, 2006 and 10.3% at December 31, 2005.

During the year ended December 31, 2006, the Company realized \$3.9 million in net losses from sales of Investment Securities. During year ended December 31, 2005, the Company realized \$53.2 million in net gains from sales of Mortgage-Backed Securities.

3. AGENCY DEBENTURES

At December 31, 2006, the Company owned agency debentures with a carrying value of \$49.6 million, including the unrealized loss of \$120,000. At December 31, 2005, the Company did not own agency debentures.

4. REPURCHASE AGREEMENTS

The Company had outstanding \$27.5 billion and \$13.6 billion of repurchase agreements with weighted average borrowing rates of 5.14% and 4.16%, and weighted average remaining maturities of 125 days and 79 days as of December 31, 2006 and December 31, 2005, respectively. Investment Securities pledged as collateral under these repurchase agreements had an estimated fair value of \$28.6 billion at December 31, 2006 and \$14.3 billion at December 31, 2005.

At December 31, 2006 and December 31, 2005, the repurchase agreements had the following remaining maturities:

(dollars in thousands)	December 31, 2006	December 31, 2005
Within 30 days	\$22,778,703	\$10,575,945
30 to 59 days	2,285,317	1,250,356
60 to 89 days	200,000	—
90 to 119 days	—	—
Over 120 days	2,250,000	1,750,000
Total	\$27,514,020	\$13,576,301

The Company did not have an amount at risk greater than 10% of the equity of the Company with any counterparties as of December 31, 2006.

The Company had an amount at risk greater than 10% of the equity of the Company with the following counterparty at December 31, 2005.

(dollars in thousands)	Amount at Risk (1)	Weighted Average Days to Maturity
UBS Securities LLC	\$179,959	121

(1) Equal to the sum of fair value of securities sold plus accrued interest income minus the sum of repurchase agreements plus accrued interest expense.

The Company has entered into repurchase agreements which provide the counterparty with the right to call the balance prior to maturity date. The repurchase agreements totaled \$1.4 billion and the market value of the option to call is \$1.4 million. Management has determined that the call option is not required to be bifurcated under the provisions of FASB No. 133 as it is deemed clearly and closely related to the debt instrument, therefore the option value is not recorded in the consolidated financial statements.

5. INTEREST RATE SWAPS

In connection with the Company's interest rate risk management strategy, the Company hedges a portion of its interest rate risk by entering into derivative financial instrument contracts. As of December 31, 2006, such instruments are comprised of interest rate swaps, which in effect modify the cash flows on repurchase agreements. The use of interest rate swaps creates exposure to credit risk relating to potential losses that could be recognized if the counterparties to these instruments fail to perform their obligations under the contracts. In the event of a default by the counterparty, the Company could have difficulty obtaining its Mortgage-Backed Securities pledged as collateral for swaps. The Company does not anticipate any defaults by its counterparties.

The Company's swaps are used to lock-in the fixed rate related to a portion of its current and anticipated future 30-day term repurchase agreements.

The table below presents information about the Company's swaps outstanding at December 31, 2006.

(dollars in thousands)	Notional Amount	Weighted Average Pay Rate	Weighted Average Receive Rate	Net Estimated Fair Value/Carrying Value
	\$9,328,000	5.17%	5.35%	(\$17,621)

In 2006, the Company had a \$10.7 million realized gain on the termination of interest rate swaps with a notional value of \$1.2 billion. At December 31, 2005, there were no swap contracts that had settled.

6. PREFERRED STOCK AND COMMON STOCK

(A) STOCK ISSUANCES

On August 16, 2006, the Company entered into an underwriting agreement pursuant to which it sold 40,825,000 shares of its common stock for net proceeds before expenses of approximately \$476.7 million. This transaction settled on August 22, 2006.

On April 6, 2006, the Company entered into an underwriting agreement pursuant to which it sold 39,215,000 shares of its common stock for net proceeds before expenses of approximately \$437.7 million. On April 6, 2006, the Company entered into a second underwriting agreement pursuant to which it sold 4,600,000 shares of its 6% Series B Cumulative Convertible Preferred Stock for net proceeds before expenses of approximately \$111.5 million. Both of these transactions settled on April 12, 2006.

On August 3, 2006, the Company entered into an ATM Equity Offeringsm Sales Agreement with Merrill Lynch & Co. and Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch"), relating to the sale of shares of its common stock from time to time through Merrill Lynch. Sales of the shares, if any, are made by means of ordinary brokers' transaction on the New York Stock Exchange. During the year ended December 31, 2006, 500,000 shares of the Company's common stock were issued pursuant to this program, totaling \$6.7 million in net proceeds.

On August 3, 2006, the Company entered into an ATM Equity Sales Agreement with UBS Securities LLC ("UBS Securities"), relating to the sale of shares of its common stock from time to time through UBS Securities. Sales of the shares, if any, are made by means of ordinary brokers' transaction on the New York Stock Exchange. During the year ended December 31, 2006, no shares of the Company's common stock were issued pursuant to this program.

During the year ended December 31, 2006, the Company declared dividends to common shareholders totaling \$102.6 million or \$.57 per share, of which \$39.0 million were paid on January 26, 2007. During the year ended December 31, 2006, the Company declared and paid dividends to Series A preferred shareholders totaling \$14.6 million or \$1.97 per share and Series B Preferred shareholders totaling \$5.0 million or \$1.08 per share. During the year ended December 31, 2006, 1,098,500 shares of the Company's common stock were issued through the Equity Shelf Program, totaling net proceeds of \$14.2 million. During the year ended December 31, 2006, 22,160 options were exercised under the long-term compensation plan for an aggregate exercise price of \$183,000.

During the year ended December 31, 2005, the Company declared dividends to common shareholders totaling \$127.1 million, the Company declared and paid dividends to preferred shareholders totaling \$14.6 million or \$1.97 per share. During the twelve months ended December 31, 2005, 2,381,550 shares of the Company's common stock were issued through the Equity Shelf Program, totaling net proceeds of \$40.1 million. During the year ended December 31, 2005, 16,128 options were exercised under the long-term compensation plan for an aggregate exercise price of \$253,000. In addition, 24,253 common shares were sold through the dividend reinvestment and direct purchase program for \$440,000 during the year ended December 31, 2005.

During the year ended December 31, 2004, 2,103,525 shares were issued through the Equity Shelf Program, totaling net proceeds of \$37.5 million. During the year ended December 31, 2004, 57,000 options were exercised under the long-term compensation plan for an aggregate exercise price of \$856,000. In addition, 127,020 shares were purchased in the dividend reinvestment and direct purchase program at \$2.3 million.

(B) PREFERRED STOCK

At December 31, 2006, the Company had issued and outstanding 7,412,500 shares of Series A Cumulative Redeemable Preferred Stock, with a par value \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series A preferred stock must be paid a dividend at a rate of 7.875% per year on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends. The Series A preferred stock is redeemable at \$25.00 per share plus accrued and unpaid dividends (whether or not declared) exclusively at the Company's option commencing on April 5, 2009 (subject to the Company's right under limited circumstances to redeem the Series A preferred stock earlier in order to preserve its qualification as a REIT). The Series A preferred stock is senior to the Company's common stock and is on parity with the Series B preferred stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up.

The Series A preferred stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series A preferred stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series A preferred stock, together with 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 apart for payment. In addition, certain material and adverse changes to the terms of the Series A preferred stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series A preferred stock and Series B preferred stock. Through December 31, 2006, the Company had declared and paid all required quarterly dividends on the Series A preferred stock.

7. NET INCOME (LOSS) PER COMMON SHARE

The following table presents a reconciliation of the net income (loss) and shares used in calculating basic and diluted earnings per share for the years ended December 31, 2006, 2005 and 2004.

	FOR THE YEAR ENDED		
	December 31, 2006	December 31, 2005	December 31, 2004
Net income (loss)	\$93,816	(\$9,247)	\$248,592
Less: Preferred stock dividends	19,557	14,593	7,745
Net income available (loss related) to common shareholders	\$74,259	(\$23,840)	\$240,847
Weighted average shares of common stock outstanding-basic	167,667	122,475	118,223
Add: Effect of dilutive stock options	79	—	236
Weighted average shares of common stock outstanding-diluted	167,746	122,475	118,459

The Series B Cumulative Convertible Preferred Stock was anti-dilutive for the year ended December 31, 2006. Because the Company had a net loss related to common shareholders for the year ended December 31, 2005, options to purchase 2,333,593 shares of common stock were considered anti-dilutive for the year ended December 31, 2005. Options to purchase 12,500 of common stock were outstanding and considered anti-dilutive as their exercise price exceeded the average stock price for the year ended December 31, 2004.

8. LONG-TERM STOCK INCENTIVE PLAN

The Company has adopted a long term stock incentive plan for executive officers, key employees and non-employee directors (the "Incentive

Plan"). The Incentive Plan authorizes the Compensation Committee of the board of directors to grant awards, including non-qualified options as well as incentive stock options as defined under Section 422 of the Code. The Incentive Plan authorizes the granting of options or other awards for an aggregate of the greater of 500,000 shares or 9.5% of the diluted outstanding shares of the Company's common stock, up to ceiling of 8,932,921 shares. Stock options are issued at the current market price on the date of grant, subject to an immediate or four year vesting in four equal installments with a contractual term of 5 or 10 years. The grant date fair value is calculated using the Black-Scholes option valuation model.

At December 31, 2006, the Company had issued and outstanding 4,600,000 shares of Series B Cumulative Convertible Preferred Stock, with a par value \$0.01 per share and a liquidation preference of \$25.00 per share plus accrued and unpaid dividends (whether or not declared). The Series B preferred stock must be paid a dividend at a rate of 6% per year on the \$25.00 liquidation preference before the common stock is entitled to receive any dividends.

The Series B preferred stock is not redeemable. The Series B preferred stock is convertible into shares of common stock at a conversion rate that adjusts from time to time upon the occurrence of certain events, including if the Company distributes to its common shareholders in any calendar quarter cash dividends in excess of \$0.11 per share. Initially, the conversion rate was 1.7730 shares of common shares per \$25 liquidation preference. Commencing April 5, 2011, the Company has the right in certain circumstances to convert each Series B preferred stock into a number of common shares based upon the then prevailing conversion rate. The Series B preferred stock is also convertible into common shares at the option of the Series B preferred shareholder at any time at the then prevailing conversion rate. The Series B preferred stock is senior to the Company's common stock and is on parity with the Series A preferred stock with respect to dividends and distributions, including distributions upon liquidation, dissolution or winding up. The Series B preferred stock generally does not have any voting rights, except if the Company fails to pay dividends on the Series B preferred stock for six or more quarterly periods (whether or not consecutive). Under such circumstances, the Series B preferred stock, together with 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 apart for payment. In addition, certain material and adverse changes to the terms of the Series B preferred stock cannot be made without the affirmative vote of holders of at least two-thirds of the outstanding shares of Series B preferred stock and Series A preferred stock. Through December 31, 2006, the Company had declared and paid all required quarterly dividends on the Series B preferred stock.

	FOR THE YEAR ENDED					
	December 31, 2006		December 31, 2005		December 31, 2004	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Options outstanding at the beginning of year	2,333,593	\$16.10	1,645,721	\$15.66	1,063,259	\$14.28
Granted	737,250	11.72	737,750	17.08	639,750	17.39
Exercised	(22,160)	8.25	(16,128)	12.21	(57,288)	9.40
Forfeited	(60,000)	15.39	—	—	—	—
Expired	(3,688)	13.69	(33,750)	17.87	—	—
Options outstanding at the end of year	2,984,995	\$15.10	2,333,593	\$16.10	1,645,721	\$15.66
Options exercisable at the end of the year	1,298,496	\$15.28	831,906	\$13.84	540,721	\$11.62

The weighted average remaining contractual term was approximately 7.3 years for stock options outstanding and approximately 5.9 years for stock options exercisable as of December 31, 2006. As of December 31, 2006, there was approximately \$2.8 million of total unrecognized compensation cost related to nonvested share-based compensation awards. That cost is expected to be recognized over a weighted average period of 2.6 years.

The following table summarizes information about stock options outstanding at December 31, 2006:

Range of Exercise Prices	Total Options Outstanding	Weighted Average Exercise Price on Total Outstanding	Weighted Average Remaining Contractual Life (Years) on Total Outstanding	Total Options Exercisable	Weighted Average Exercise Price On Exercisable	Weighted Average Remaining Contractual Life (Years) on Exercisable
\$7.94–\$19.99	2,974,995	\$15.08	7.34	1,288,496	\$15.24	5.97
\$20.00–\$29.99	10,000	20.53	0.99	10,000	20.53	0.99
	2,984,995	\$15.10	7.32	1,298,496	\$15.28	5.93

9. INCOME TAXES

As a REIT, the Company is not subject to Federal income tax on earnings distributed to its shareholders. Most states recognize REIT status as well. The Company has decided to distribute the majority of its income and retain a portion of the permanent difference between book and taxable income arising from Section 162(m) of the Code pertaining to employee remuneration.

During the year ended December 31, 2006, the Company recorded \$3.1 million of income tax expense for income attributable to FIDAC, its taxable REIT subsidiary, and the portion of earnings retained based on Code Section 162(m) limitations. During the year ended December 31, 2006, the Company recorded \$4.5 million of income tax expense for a portion of earnings retained based on Section 162(m) limitations. The statutory combined federal, state, and city corporate tax rate is 45%. This amount is applied to the amount of estimated REIT taxable income retained (if any, and only up to 10% of ordinary income as all capital gain income is distributed) and to taxable income earned at the taxable subsidiaries. Thus, as a REIT, our effective tax rate is significantly less as we are allowed to deduct dividend distributions.

During the year ended December 31, 2005, the Company recorded \$8.7 million of income tax expense for income attributable to FIDAC, its taxable REIT subsidiary, and the portion of earnings retained based on Code Section 162(m) limitations. During the year ended December 31, 2005, the Company recorded \$2.0 million of income tax expense for a portion of earnings retained based on Section 162(m) limitations. During the year ended December 31, 2004, the Company recorded \$4.5 million of income tax expense for income attributable to FIDAC and the portion of earnings retained based on Code Section 162(m) limitations.

10. LEASE COMMITMENTS

The Company has a noncancelable lease for office space, which commenced in May 2002 and expires in December 2009. Office rent expense was \$618,000, \$573,000, and \$591,000 for the years ended December 31, 2006, 2005 and 2004, respectively. The expense was net of sub-lease payments received of \$91,000, \$84,000, and \$7,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

The Company's aggregate future minimum lease payments are as follows:

(dollars in thousands)	Total per Year
2007	\$532
2008	532
2009	532
Total remaining lease payments	\$1,596

11. INTEREST RATE RISK

The primary market risk to the Company is interest rate risk. Interest rates are highly sensitive to many factors, including governmental monetary and tax policies, domestic and international economic and political considerations and other factors beyond the Company's control. Changes in the general level of interest rates can affect net interest income, which is the difference between the interest income earned on interest-earning assets and the interest expense incurred in connection with the interest bearing liabilities, by affecting the spread between the interest-earning assets and interest-bearing liabilities. Changes in the level of interest rates also can affect the value of the Investment Securities and the Company's ability to realize gains from the sale of these assets. A decline in the value of the Investment Securities pledged as collateral for borrowings under repurchase agreements could result in the counterparties demanding additional collateral pledges or liquidation of some of the existing collateral to reduce borrowing levels. Liquidation of collateral at losses could have an adverse accounting impact, as discussed in Note 3.

The Company seeks to manage the extent to which net income changes as a function of changes in interest rates by matching adjustable-rate assets with variable-rate borrowings. The Company may seek to mitigate the potential impact on net income of periodic and lifetime coupon adjustment restrictions in the portfolio of Investment Securities by entering into interest rate agreements such as interest rate caps and interest rate swaps. As of December 31, 2006, the Company entered into interest rate swaps to pay a fixed rate and receive a floating rate of interest, with total notional amount of \$9.3 billion.

Changes in interest rates may also have an effect on the rate of mortgage principal prepayments and, as a result, prepayments on Mortgage-Backed Securities. The Company will seek to mitigate the effect of changes in the

mortgage principal repayment rate by balancing assets purchased at a premium with assets purchased at a discount. To date, the aggregate premium exceeds the aggregate discount on the Mortgage-Backed Securities. As a result, prepayments, which result in the expensing of unamortized premium, will reduce net income compared to what net income would be absent such prepayments.

12. CONTINGENCIES

From time to time, the Company is involved in various claims and legal actions arising in the ordinary course of business. In the opinion of management, the ultimate disposition of these matters will not have a material effect on the Company's consolidated financial statements.

13. SUMMARIZED QUARTERLY RESULTS (UNAUDITED)

The following is a presentation of the quarterly results of operations for the year ended December 31, 2006.

(dollars in thousands, except per share data)	March 31, 2006	June 30, 2006	September 30, 2006	December 31, 2006
Interest income	\$194,882	\$280,171	\$339,737	\$407,092
Interest expense	167,512	242,473	295,726	349,302
Net interest income	27,370	37,698	44,011	57,790
Other (loss) income:				
Investment advisory and service fees	6,997	5,210	4,966	5,178
(Loss) gain on sale of Investment Securities	(7,006)	(1,239)	(446)	4,829
Gain on termination of interest rate swaps	—	—	8,414	2,260
Income from trading securities	—	—	612	3,382
Loss on other-than-temporarily impaired securities	(26,730)	(20,114)	—	(5,504)
Total other (loss) income	(26,739)	(16,143)	13,546	10,145
Expenses:				
Distribution fees	1,170	755	724	795
General and administrative expenses	7,177	8,985	11,682	12,219
Total expenses	8,347	9,740	12,406	13,014
Impairment of intangible for customer relationships	1,148	1,345	—	—
(Loss) Income before income taxes and minority interest	(8,864)	10,470	45,151	54,921
Income taxes	2,085	1,892	2,273	1,288
(Loss) income before minority interest	(10,949)	8,578	42,878	53,633
Minority interest	—	—	28	296
Net (loss) income	(10,949)	8,578	42,850	53,337
Dividends on preferred stock	3,648	5,163	5,373	5,373
Net (loss related) income available to common shareholders	(\$14,597)	\$3,415	\$37,477	\$47,964
Weighted average number of basic common shares outstanding	123,693,851	158,632,865	181,767,106	205,092,330
Weighted average number of diluted common shares outstanding	123,693,851	158,703,614	189,952,159	213,455,555
Net (loss related) income available to common shareholders per average common share:				
Basic	(\$0.12)	\$0.02	\$0.21	\$0.23
Diluted	(\$0.12)	\$0.02	\$0.20	\$0.23

The following is a presentation of the quarterly results of operations for the year ended December 31, 2005.

(dollars in thousands, except per share data)	March 31, 2005	June 30, 2005	September 30, 2005	December 31, 2005
Interest income	\$176,289	\$171,595	\$177,474	\$179,688
Interest expense	113,993	133,758	155,043	165,766
Net interest income	62,296	37,837	22,431	13,922
Other income (loss):				
Investment advisory and service fees	6,309	9,669	10,945	8,702
Gain (loss) on sale of Investment Securities	580	11,435	32	(65,285)
Loss on other-than-temporarily impaired securities	—	—	—	(83,098)
Total other income (loss)	6,889	21,104	10,977	(139,681)
Expenses:				
Distribution Fees	1,610	2,126	2,414	1,850
General and administrative expenses	6,664	6,800	6,455	6,359
Total expenses	8,274	8,926	8,869	8,209
Income (loss) before income taxes	60,911	50,015	24,539	(133,968)
Income taxes	1,578	3,022	3,353	2,791
Net income (loss)	59,333	46,993	21,186	(136,759)
Dividends on preferred stock	3,648	3,648	3,648	3,649
Net income available (loss related) to common shareholders	\$55,685	\$43,345	\$17,538	(\$140,408)
Weighted average number of basic common shares outstanding	121,270,867	121,740,256	123,169,910	123,684,931
Weighted average number of diluted common shares outstanding	121,564,320	122,013,050	123,330,645	123,684,931
Net income available (loss related) to common shareholders per average common share:				
Basic	\$0.46	\$0.36	\$0.14	(\$1.14)
Diluted	\$0.46	\$0.36	\$0.14	(\$1.14)

The following table sets forth, for the periods indicated, the high, low, and closing sales prices per share of our common stock as reported on the New York Stock Exchange composite tape and the cash dividends declared per share of our common stock.

	Stock Prices		
	High	Low	Close
First Quarter ended March 31, 2006	\$12.82	\$11.34	\$12.14
Second Quarter ended June 30, 2006	\$14.04	\$11.57	\$12.81
Third Quarter ended September 30, 2006	\$13.25	\$12.17	\$13.14
Fourth Quarter ended December 31, 2006	\$14.42	\$13.01	\$13.91
	High	Low	Close
First Quarter ended March 31, 2005	\$20.01	\$17.34	\$18.76
Second Quarter ended June 30, 2005	\$20.01	\$17.68	\$17.93
Third Quarter ended September 30, 2005	\$18.05	\$12.49	\$12.95
Fourth Quarter ended December 31, 2005	\$12.90	\$10.90	\$10.94
		Common Dividends Declared Per Share	
First Quarter ended March 31, 2006		\$0.11	
Second Quarter ended June 30, 2006		\$0.13	
Third Quarter ended September 30, 2006		\$0.14	
Fourth Quarter ended December 31, 2006		\$0.19	
First Quarter ended March 31, 2005		\$0.45	
Second Quarter ended June 30, 2005		\$0.36	
Third Quarter ended September 30, 2005		\$0.13	
Fourth Quarter ended December 31, 2005		\$0.10	

We intend to pay quarterly dividends and to distribute to our stockholders all or substantially all of our taxable income in each year (subject to certain adjustments). This will enable us to qualify for the tax benefits accorded to a REIT under the Code. We have not established a minimum dividend payment level and our ability to pay dividends may be adversely affected for the reasons described under the caption "Risk Factors." All distributions will be made at the discretion of our board of directors and will depend on our earnings, our financial condition, maintenance of our REIT status and such other factors as our board of directors may deem relevant from time to time. No dividends can be paid on our common stock unless we have paid full cumulative dividends on our preferred stock. From the date of issuance of our preferred stock through December 31, 2006, we have paid full cumulative dividends on our preferred stock.

CORPORATE OFFICERS

Michael A. J. Farrell
Chairman of the Board,
President &
Chief Executive Officer

Wellington J. Denahan-Norris
Vice Chairman,
Chief Investment Officer &
Chief Operating Officer

Kathryn F. Fagan
Chief Financial Officer &
Treasurer

R. Nicholas Singh
Executive Vice President,
General Counsel, Secretary &
Chief Compliance Officer

James P. Fortescue
Executive Vice President
Head of Liabilities

Kristopher Konrad
Executive Vice President
Co-Head of Portfolio Management

Rose-Marie Lyght
Executive Vice President
Co-Head of Portfolio Management

Jeremy Diamond
Managing Director

Ronald D. Kazel
Managing Director

BOARD OF DIRECTORS

Michael A. J. Farrell
Chairman of the Board,
President &
Chief Executive Officer

Wellington J. Denahan-Norris
Vice Chairman,
Chief Investment Officer &
Chief Operating Officer

Kevin P. Brady
Founder & Chief Executive Officer
TaxStream

Jonathan D. Green
President & Chief Executive Officer
Rockefeller Group International, Inc

John A. Lambiase
Former Managing Director
Salomon Brothers, Inc

E. Wayne Nordberg
Senior Director
Ingalls & Synder, LLC

Donnell A. Segalas
Managing Partner &
Chief Executive Officer
Pinnacle Asset Management, L.P.

CORPORATE HEADQUARTERS

Annaly Capital Management, Inc.
1211 Avenue of the Americas, Suite 2902
New York, NY 10036

LEGAL COUNSEL

**Kirkpatrick & Lockhart Preston
Gates Ellis LLP**
1601 K. Street, N.W.
Washington, D.C. 20006

AUDITORS

Deloitte & Touche LLP
Two World Financial Center
New York, NY 10281-1434

STOCK TRANSFER AGENT

Shareholder inquiries concerning dividend payments, lost certificates, change of address:

Mellon Investors Services, LLC
P.O. Box 3315
South Hackensack, NJ 07606-1163
800-301-5234
www.melloninvestor.com/isd

STOCK EXCHANGE LISTING

The common stock is listed on the New York Stock Exchange (symbol: NLY).

The Series A preferred stock is listed on the New York Stock Exchange (symbol: NLY-A).

ANNUAL SHAREHOLDERS MEETING

The Annual Meeting will be held Thursday, May 24, 2007 at 9:00 a.m. at:

New York Marriott Marquis
1535 Broadway
New York, NY 10036

SHAREHOLDER COMMUNICATIONS

Copies of the Company's Annual Report and 2006 Form 10-K may be obtained by writing the Secretary, by calling the investor relations hot line at **1-888-8annaly**, or by visiting our website **www.annaly.com**.

ADDITIONAL INFORMATION

The Company has included as exhibits to its annual report on Form 10-K for fiscal year ended 2006 certificates of the Company's Chief Executive Officer and Chief Financial Officer certifying the quality of the Company's public disclosure controls, and the Company has submitted to the New York Stock Exchange (NYSE) in 2006, a certificate of the Company's Chief Executive Officer certifying that he is not aware of any violations by the Company of the NYSE corporate governance listing standards.

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New York, NY 10036
1.888.8annaly
www.annaly.com

