APEX MORTGAGE CAPITAL INC
Form 10-Q
May 15, 2002

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

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

For the quarterly period ended: MARCH 31, 2002

OR

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

For the transition period from to

Commission File Number: 001-13637

APEX MORTGAGE CAPITAL, INC.

(Exact name of Registrant as specified in its Charter)

Maryland	**95-4650863**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
865 South Figueroa Street Los Angeles, California	**90017**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code **(213) 244-0000**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ý No o

APPLICABLE ONLY TO CORPORATE ISSUERS:

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

Common Stock ($0.01 par value)	24,797,000 as of May 10, 2002

APEX MORTGAGE CAPITAL, INC.

FORM 10-Q

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Apex Mortgage Capital, Inc.

Balance Sheets
(Unaudited)

	March 31, 2002	December 31, 2001
Assets		
Cash and cash equivalents	$ 7,432,000	$ 4,330,000
Fixed income trading securities, at fair value (Note 3)	703,973,000	437,954,000
Fixed income securities available-for-sale, at fair value (Note 3)	1,741,696,000	1,067,575,000
Equity securities available-for-sale, at fair value (Note 3)	4,882,000	6,028,000
Forward contracts, at fair value (Note 5)	2,860,000	
Interest rate swaps, at fair value (Note 5)	22,107,000	4,620,000
Accrued interest receivable	14,302,000	8,580,000
Principal payments receivable	424,000	485,000
Receivable for unsettled securities	100,199,000	5,520,000
Other assets	442,000	333,000
	$ 2,598,317,000	$ 1,535,425,000
Liabilities and Stockholders Equity		
Liabilities		
Reverse repurchase agreements (Note 4)	$ 2,351,750,000	$ 1,376,850,000
Accrued interest payable	2,674,000	975,000
Dividend payable	12,476,000	12,596,000
Forward contracts, at fair value (Note 5)		3,275,000
Accrued expenses and other liabilities	16,914,000	11,699,000
	2,383,814,000	1,405,395,000
Stockholders Equity		
Preferred stock, par value $0.01 per share; 50,000,000 shares authorized; no shares outstanding		
Common stock, par value $0.01 per share; 100,000,000 shares authorized; 24,762,000 (2002) and 15,555,500 (2001) shares outstanding	248,000	155,000
Additional paid-in-capital	267,531,000	175,802,000

Accumulated other comprehensive loss		(12,438,000)		(7,837,000)
Accumulated deficit		(40,838,000)		(38,090,000)
		214,503,000		130,030,000
	$	2,598,317,000	$	1,535,425,000

See accompanying notes to financial statements

Apex Mortgage Capital, Inc.

Statements of Operations
(Unaudited)

	Three Months Ended March 31, 2002	Three Months Ended March 31, 2001
Interest Income:		
Fixed income securities	$ 27,254,000	$ 10,978,000
Cash and cash equivalents	55,000	42,000
Total interest income	27,309,000	11,020,000
Interest Expense	12,705,000	7,076,000
Net Interest Income	14,604,000	3,944,000
Dividend Income	126,000	188,000
Operating Income Before General and Administrative Expenses	14,730,000	4,132,000
General and Administrative Expenses:		
Management fee	319,000	88,000
Incentive fee	2,650,000	
Insurance	83,000	83,000
Professional fees	27,000	23,000
Directors fees	22,000	15,000
Non-employee stock options	27,000	1,000
Other	170,000	59,000
Total general and administrative expense	3,298,000	269,000
Operating Income, Net of General and Administrative Expenses	11,432,000	3,863,000
Net (Loss) from Investment and Derivative Activities (Note 3)	(1,704,000)	(2,458,000)
Reclassification of Previously Unrealized Gains		1,742,000
Net Income Before Cumulative Effect of Change in Accounting Principle	9,728,000	3,147,000
Cumulative Effect of Change in Accounting Principle		(2,173,000)
Net Income	$ 9,728,000	$ 974,000

Net Income Per Share Before Cumulative Effect of Change in Accounting Principle:				
Basic	$	0.53	$	0.55
Diluted	$	0.53	$	0.54
Effect of Accounting Change Per Share:				
Basic	$		$	(0.38)
Diluted	$		$	(0.37)
Net Income Per Share:				
Basic	$	0.53	$	0.17
Diluted	$	0.53	$	0.17
Weighted Average Number of Shares Outstanding:				
Basic		18,315,861		5,753,000
Diluted		18,427,683		5,783,000

See accompanying notes to financial statements

Apex Mortgage Capital, Inc.

Statement of Stockholders Equity
(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders Equity	Comprehensive Income / (Loss)
Balance, December 31, 2001	15,555,500	$ 155,000	$ 175,802,000	$ (7,837,000)	$ (38,090,000)	$ 130,030,000	
Issuance of common stock	9,206,500	93,000	91,702,000			91,795,000	
Issuance of stock options to non-employees			27,000			27,000	
Net income					9,728,000	9,728,000	$ 9,728,000
Other comprehensive income (loss):							
Net change in unrealized (loss) on available-for-sale securities				(21,967,000)		(21,967,000)	(21,967,000)
Net change in deferred gain on terminated interest rate swaps				(121,000)		(121,000)	(121,000)
Net change in unrealized gain on interest rate swaps classified as cash flow hedges				17,487,000		17,487,000	17,487,000
Comprehensive income							$ 5,127,000
Dividends declared					(12,476,000)	(12,476,000)	
Balance, March 31, 2002	24,762,000	$ 248,000	$ 267,531,000	$ (12,438,000)	$ (40,838,000)	$ 214,503,000	

See accompanying notes to financial statements

Apex Mortgage Capital, Inc.

Statements of Cash Flows
(Unaudited)

	For the Quarter Ended March 31, 2002	For the Quarter Ended March 31, 2001
Operating Activities:		
Net income	$ 9,728,000	$ 974,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization	(81,000)	(1,730,000)
Net loss on investment and derivative activities	1,704,000	2,458,000
Cumulative effect of change in accounting principle		2,173,000
Reclassification of previously unrealized gains		(1,742,000)
Trading activities	(273,846,000)	(6,336,000)
Change in assets and liabilities:		
Accrued interest receivable	(5,722,000)	(9,000)
Other assets	(109,000)	75,000
Accrued interest payable	1,699,000	83,000
Accrued expenses and other liabilities	5,215,000	(125,000)
Net cash (used in) operating activities	(261,412,000)	(4,179,000)
Investing Activities:		
Purchase of fixed income securities available-for sale	(810,655,000)	
Proceeds from sales of fixed income securities available-for-sale	5,520,000	
Proceeds from sales of equity securities	1,117,000	
Principal payments on fixed income securities available-for-sale	14,374,000	
Net cash (used in) investing activities	(789,644,000)	
Financing Activities:		
Net change in reverse repurchase agreements	974,900,000	10,313,000
Dividend distributions	(12,537,000)	(2,035,000)
Issuance of common stock	91,795,000	
Net cash provided by financing activities	1,054,158,000	8,278,000
Net Increase in Cash and Cash Equivalents	3,102,000	4,099,000
Cash and Cash Equivalents at Beginning of Period	4,330,000	140,000
Cash and Cash Equivalents at End of Period	$ 7,432,000	$ 4,239,000
Supplemental Disclosure of Cash Flow Information:		
Cash paid for interest	$ 11,006,375	$ 8,146,000
Noncash investing and financing activities:		

Change in accumulated other comprehensive income	(4,601,000)	4,275,000
Change in principal payments receivable	61,000	288,000
Change in receivable for unsettled securities	(94,679,000)	
Change in dividends declared, not yet paid	(120,000)	2,111,000

See accompanying notes to financial statements

Apex Mortgage Capital, Inc.

Notes to Financial Statements

(Unaudited)

Note 1 - The Company

Apex Mortgage Capital, Inc. (the Company) was incorporated in Maryland on September 15, 1997. The Company commenced its operations of acquiring and managing a portfolio of mortgage-related assets on December 9, 1997, upon receipt of the net proceeds from the initial public offering of the Company s common stock. The Company uses its equity capital and borrowed funds to seek to generate income based on the difference between the yield on its investments and the cost of its borrowings. The Company is structured for tax purposes as a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended (the Code).

The Company has entered into a Management Agreement (the Management Agreement), as amended, with TCW Investment Management Company (the Manager), a wholly owned subsidiary of The TCW Group, Inc., under which the Manager manages the Company s day-to-day operations, subject to the direction and oversight of the Company s Board of Directors.

Note 2 - Summary of Significant Accounting Policies and Certain Risks

Overview

Certain information and note disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial statements. The unaudited financial statements should be read in conjunction with the audited financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2001. The accounting policies used in the preparation of these interim financial statements were consistent with those used in the preparation of the financial statements for the year ended December 31, 2001, unless otherwise noted. Certain reclassifications may have been made to the prior period financial statements to conform to the current period presentation.

Derivatives and Hedging Transactions

The Company may enter into interest rate swaps and other financial instruments in order to mitigate the impact of rising interest rates on the cost of its short-term borrowings. The Company may also enter into forward contracts to sell U.S. Treasury securities and other financial instruments in order to mitigate the negative impact of rising interest rates on the fair value of its fixed income securities. Such financial instruments are generally referred to as derivatives.

The Company adopted SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, on January 1, 2001. Prior to adopting SFAS No. 133, the Company accounted for changes in fair values of the forward contracts through adjustments to accumulated other comprehensive income (loss). Following adoption of SFAS No. 133, the Company recognizes changes in fair values of forward contracts as a component of net gain (loss) on investment and derivative activities in the statements of operations.

Under SFAS No. 133, all derivatives are recorded at fair value and presented as either assets or liabilities on the Company s balance sheets. As of March 31, 2002, the Company has interest rate swaps that qualify as cash flow hedges under SFAS No. 133. Changes in fair values of the swaps are not reflected in current earnings, but are reflected in other comprehensive income. To the extent changes in the fair value of the cash flow hedges are deemed to be due to ineffectiveness of the hedges, such changes are reflected in net gain (loss) on investment and derivative activities in the statements of operations. However, the Company s swaps outstanding at March 31, 2002 are deemed to be fully effective as hedges.

Note 3 Fixed Income and Equity Securities

At March 31, 2002, fixed income and equity securities consisted of the following:

(in thousands)	Fixed Income Trading Securities	Fixed Income Securities Available-For-Sale	Equity Securities Available-For-Sale
Principal Amount	$ 703,229	$ 1,759,259	$ 4,370
Unamortized Premium (Discount)	(6,363)	18,513	(958)
Adjusted Cost	696,866	1,777,772	3,412
Gross Unrealized Gains	12,547		1,470
Gross Unrealized Losses	(5,440)	(36,076)	
Fair Value	$ 703,973	$ 1,741,696	$ 4,882

At December 31, 2001, fixed income and equity securities consisted of the following:

(in thousands)	Fixed Income Trading Securities	Fixed Income Securities Available-For-Sale	Equity Securities Available-For-Sale
Principal Amount	$ 432,630	$ 1,071,009	$ 5,145
Unamortized Premium (Discount)	(9,266)	11,044	(958)
Adjusted Cost	423,364	1,082,053	4,187
Gross Unrealized Gains	14,725	180	1,841
Gross Unrealized Losses	(135)	(14,658)	
Fair Value	$ 437,954	$ 1,067,575	$ 6,028

The contractual final maturity of the mortgage loans supporting fixed income mortgage securities is generally between 15 and 30 years at origination. Because of prepayments on the underlying mortgage loans, the actual weighted-average maturity is expected to be substantially less. Fixed-rate mortgage securities composed over 98% of the Company s portfolio of fixed income securities at March 31, 2002 and December 31, 2001. The expected average remaining maturity of the Company s other fixed income securities at March 31, 2002 and December 31, 2001 was less than one year.

Adjustable-rate mortgage securities composed approximately 0.6% and 1.1% of the Company s portfolio of fixed income securities at March 31, 2002 and December 31, 2001, respectively. A portion of the adjustable-rate mortgage securities in the Company s portfolio are backed by loans subject to periodic and lifetime caps that limit the amount the securities effective interest rates can change during any given period and over the lives of the assets. At March 31, 2002 and December 31, 2001, the portion of adjustable-rate mortgage securities subject to periodic and lifetime caps had an average periodic cap equal to 2.0% per annum and an average lifetime cap equal to 11.3%.

During the quarter ended March 31, 2002, the Company reported a net loss on investment and derivative activities of $1,704,000 in the statement of operations. This loss consisted of a net loss of $481,000 on closed forward contracts, a loss of $232,000 on the sale of $99,881,000 of fixed income securities classified as available-for-sale, a gain of $17,000 on the sale of $6,535,000 of fixed income trading securities, a gain of $341,000 on the sale of $1,117,000 of equity securities available-for-sale, and an unrealized loss of $1,349,000 on fixed income trading securities.

During the quarter ended March 31, 2001, the Company reported a net loss on investment and derivative activities of $2,458,000 in the statement of operations. This loss was the result of $9,082,000 in losses on closed forward contracts, $3,444,000 in gains on the sale of $142,809,000 of fixed income trading securities and reported gains of $3,180,000 from the net increase in fair market value of fixed income trading securities.

Note 4 - Reverse Repurchase Agreements

The Company has entered into reverse repurchase agreements to finance certain of its investments. These agreements are secured by a portion of the Company s investments and bear interest rates that have historically moved in close relationship to LIBOR.

At March 31, 2002, the Company had outstanding $2,351,750,000 of reverse repurchase agreements with a weighted average current borrowing rate of 1.87% and a maturity of 1.0 month. The reverse repurchase agreements were collateralized by securities with an estimated fair value of $2,432,624,000.

At December 31, 2001, the Company had outstanding $1,376,850,000 of reverse repurchase agreements with a weighted average current borrowing rate of 1.89% and a maturity of 1.0 months. The reverse repurchase agreements were collateralized by securities with an estimated fair value of $1,440,014,000.

Note 5 Derivative Financial Instruments and Hedging Activities

The Company has entered into interest rate swap agreements as summarized below. Under these agreements, the Company receives a floating rate and pays a fixed rate. The swaps qualify as cash flow hedges for accounting purposes, and effectively fix the interest rate paid on $1,500,000,000, as of March 31, 2002, of current and anticipated future borrowings under reverse repurchase agreements.

Interest Rate Swaps at March 31, 2002:

Current Notional Amount (000)	Average Fixed Rate	Floating Rate	Average Termination Date	Unrealized Gains (000)
$1,500,000	4.374%	1Mo LIBOR	12/7/2007	$22,107

Interest Rate Swaps at December 31, 2001:

Current Notional Amount (000)	Average Fixed Rate	Floating Rate	Average Termination Date	Unrealized Gains (000)
$850,000	4.239%	1Mo LIBOR	3/3/2008	$4,620

During the year ended December 31, 2000, the Company terminated outstanding interest rate swap agreements with a combined notional amount of $386,213,000, which resulted in a deferred gain of $5,554,000. The deferred gain is being amortized as an adjustment to interest expense over the remaining lives of the original swap agreements, and the remaining unamortized amount is included in accumulated other comprehensive income (loss) as of December 31, 2001. During the quarters ended March 31, 2002 and 2001, $121,000 and $1,152,000, respectively, of the deferred gain was amortized. The remaining deferred gain will be fully amortized by May 31, 2002.

At March 31, 2002, the Company held $7,500,000 in cash as collateral from a swap counterparty.

At December 31, 2001, the Company held $2,500,000 in cash as collateral from a swap counterparty.

At March 31, 2002, the Company had open forward contracts to sell U.S. Treasury notes with terms stated below:

Current Notional Amount ($000)	Average Termination Date	Net Unrealized Gains ($000)	Average Maturity of Underlying Securities
$625,000	4/16/2002	$2,860	5.45 Years

At December 31, 2001, the Company had open forward contracts to sell U.S. Treasury notes with terms stated below:

Current Notional Amount ($000)	Average Termination Date	Net Unrealized Losses ($000)	Average Maturity of Underlying Securities
$359,000	1/14/2002	($3,275)	5.57 Years

Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with the financial statements and notes to those statements included elsewhere in this Quarterly Report on Form 10-Q and our audited financial statements for the year ended December 31, 2001 included in our Annual Report on Form 10-K previously filed with the SEC.

SAFE HARBOR/FORWARD LOOKING STATEMENTS

Certain information contained in this Quarterly Report on Form 10-Q constitutes forward-looking statements which can be identified by the use of forward-looking terminology such as may, will, should, expect, anticipate, estimate, intend, continue, or believes or the negat other variations thereon or comparable terminology. Discussed below are some important factors that would cause actual results to differ materially from those in any forward-looking statements, including changes in interest rates; domestic and foreign business, market, financial or legal conditions; differences in the actual allocation of the assets of the Company from those assumed; and the degree to which assets are hedged and the effectiveness of the hedge, among others. In addition, the degree of risk is increased by the Company s leveraging of its assets. For additional discussion of factors that could cause actual results to differ from those contained in such forward-looking statements, see Principal Risks and Special Considerations , Item 7 Management s Discussion and Analysis of Financial Conditions and Results of Operations and Item 7A Quantitative and Qualitative Disclosures About Market Risk in the Company s annual report on Form 10-K for the year ended December 31, 2001. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

GENERAL

Apex Mortgage Capital, Inc. (the Company), a Maryland corporation, was formed on September 15, 1997, primarily to acquire United States agency and other highly rated, single-family real estate adjustable and fixed rate mortgage related assets. The Company commenced operations on December 9, 1997 following the initial public offering of the Company s Common Stock. The Company s principal executive offices are located at 865 South Figueroa Street, Suite 1800, Los Angeles, California 90017, and its telephone number is (213) 244-0000.

The Company uses its equity capital and borrowed funds to seek to generate income based on the difference between the yield on its mortgage related assets and the cost of its borrowings. The Company has elected to be taxed as a real estate investment trust (REIT) under the Internal Revenue Code of 1986, as amended (the Code). The Company will not generally be subject to federal taxes on its income to the extent that it distributes its net income to its stockholders and maintains its qualification as a REIT.

The day-to-day operations of the Company are managed by an external management company, TCW Investment Management Company (the Manager), subject to the direction and oversight of the Company s Board of Directors. A majority of the Board of Directors are unaffiliated with The TCW Group, Inc. (TCW and, together with its subsidiaries and affiliates, the TCW Group) or the Manager. The Manager is a wholly-owned subsidiary of TCW. The Manager was established in 1987 and the TCW Group began operations in 1971 through one of its affiliates. The Company s investment management team are selected members of the TCW Group s Mortgage-Backed Securities Group (the MBS Group), all of whom have over thirteen years of experience in raising and managing mortgage capital. The Company has elected to be externally managed by the Manager to take advantage of the existing operational systems, expertise and economies of scale associated with the Manager s current business operations, among other reasons. The Manager s key officers have experience in raising and managing mortgage capital, mortgage finance and the purchase and administration of mortgage related assets.

RECENT EVENTS

Dividend Declaration. On February 19, 2002, the Company s Board of Directors declared a dividend distribution of $0.50 per common share. The dividend was paid on April 26, 2002, to stockholders of record on March 28, 2002.

On March 5, 2002, the Company issued 9,200,000 shares of common stock in a follow on public offering. The Company received proceeds (net of underwriting discounts, commissions and other expenses) of $91,795,000 from this offering. The Company leveraged the new equity by entering into additional reverse repurchase agreements, and used the combined proceeds from the offering and the new borrowings primarily to purchase additional mortgage-related securities.

Reporting Period. Unless otherwise noted, this report describes the Company s operations and developments through the date hereof.

STRATEGY

To achieve its business objective and generate dividend yields that provide a competitive rate of return for its stockholders, the Company s strategy is to:

purchase primarily single-family fixed and adjustable rate mortgage related assets;

manage the credit risk of its mortgage related assets through, among other activities (i) carefully selecting mortgage related assets to be acquired, (ii) complying with the Company s investment policy, (iii) actively monitoring the ongoing credit quality and servicing of its mortgage related assets, and (iv) maintaining appropriate capital levels and allowances for possible credit losses;

finance purchases of mortgage related assets with the net proceeds of equity offerings and, to the extent permitted by the Company s leverage policy, to utilize leverage to increase potential returns to stockholders through borrowings (primarily reverse repurchase agreements) with interest rates that will also reflect changes in short-term market interest rates;

seek to structure its borrowings in accordance with its interest rate risk management policy;

utilize interest rate swaps, forward contracts on U.S. Treasury notes, interest rate caps and similar financial instruments to mitigate interest rate risks;

seek to minimize prepayment risk primarily by structuring a diversified portfolio with a variety of prepayment characteristics; and

purchase equity and other securities issued by financial entities on an opportunistic basis.

There can be no assurance that the Company will be able to generate competitive earnings and dividends while holding primarily high quality mortgage related assets and maintaining a disciplined risk-control profile.

The Company may attempt to increase the return to stockholders over time by: (i) raising additional capital in order to increase its ability to invest in additional mortgage related assets; (ii) lowering its effective borrowing costs through direct funding with collateralized lenders, in addition to using Wall Street intermediaries, and investigating the possibility of using collateralized commercial paper and medium-term note programs; and (iii) improving the efficiency of its balance sheet structure by issuing uncollateralized subordinated debt and other forms of capital.

THE MANAGEMENT AGREEMENT

The Company has renewed its Management Agreement with the Manager for a one year term ending on December 31, 2002. The Manager is primarily involved in two activities: (i) asset/liability management acquisition, financing, hedging, management and disposition of mortgage related assets, including credit and prepayment risk management; and (ii) capital management oversight of the Company s structuring, analysis, capital raising and investor relations activities. In conducting these activities, the Manager formulates operating strategies for the Company, arranges for the acquisition of mortgage related assets by the Company, arranges for various types of financing for the Company, monitors the performance of the Company s mortgage related assets and provides certain administrative and managerial services in connection with the operation of the Company. The Manager is required to manage the business affairs of the Company in conformity with the policies that are approved and monitored by the Company s Board of Directors. The Manager is required to prepare regular reports for the Company s Board of Directors that will review the Company s acquisitions of mortgage related assets, portfolio composition and characteristics, credit quality, performance and compliance with the policies approved by the Company s Board of Directors.

At all times, the Manager is subject to the direction and oversight of the Company s Board of Directors and has only such functions and authority as the Company delegates to it. The Manager is responsible for the day-to-day operations of the Company.

The Management Agreement may be renewed for additional one-year terms at the discretion of the unaffiliated directors, unless previously terminated by the Company or the Manager upon written notice. Except in the case of a termination or non-renewal by the Company for cause, upon termination or non-renewal of the Management Agreement by the Company, the Company is obligated to pay the Manager a termination or non-renewal fee, which may be significant. The termination or non-renewal fee shall be equal to the fair market value of the Management Agreement without regard to the Company s termination right, as determined by an independent appraisal. The selection of the independent appraiser shall be subject to the approval of the unaffiliated directors. Neither the fair market value of the Management Agreement nor the various factors which the appraiser may find relevant in its determination of the fair market value can be determined at this time.

The fair market value of the Management Agreement will be affected by significant variables, including (i) the historical management fees paid to the Manager, (ii) any projections of future management fees to be paid to the Manager determined by the independent appraiser, (iii) the relative valuations of agreements similar to the Management Agreement and (iv) other factors, all of which may be unrelated to the performance of the Manager.

The Management Agreement may be assigned by the Manager to an affiliate of TCW without the consent of the Company. The Management Agreement may be assigned to a non-affiliate of TCW only with the approval of a majority of the unaffiliated directors.

Manager Compensation

The Manager will receive annual base management compensation based on the Average Net Invested Capital of the Company, payable monthly in arrears, equal to 3/4 of 1% of Average Net Invested Capital. The term Average Net Invested Capital means the month end sum of (1) the Company s total stockholders equity computed in accordance with generally accepted accounting principles plus (2) any unsecured debt that has been approved for inclusion by the

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unaffiliated directors at issuance plus or minus (3) an adjustment to exclude the impact of any unrealized gains, losses or other items that do not affect realized net income. Accordingly, incurring collateralized debt to finance specific investment purchases does not ordinarily increase Average Net Invested Capital.

The Manager shall also be entitled to receive as incentive compensation for each fiscal quarter, an amount equal to 30% of the Net Income of the Company, before incentive compensation, in excess of the amount that would produce an annualized Return on Equity equal to the Ten-Year U.S. Treasury Rate plus 1%. The incentive compensation calculation and payment will be made quarterly in arrears. The term Return on Equity is calculated for any quarter by dividing the Company s Net Income for the quarter by its Average Net Worth for the quarter. For purposes of calculating the incentive compensation payable, the definition Return on Equity is not related to the actual distributions received by stockholders or to an individual investor s actual return on investment. For such calculations, the Net Income of the Company means the taxable income of the Company (including net capital gains, if any) before the Manager s incentive compensation, net operating loss deductions arising from losses in prior periods and deductions permitted by the Code in calculating taxable income for a REIT plus the effects of adjustments, if any, necessary to record hedging and interest transactions in accordance with generally accepted accounting principles. A deduction for all of the Company s interest expenses for borrowed funds is taken into account in calculating Net Income. Average Net Worth for any period means the arithmetic average of the sum of the gross proceeds from any offering of its equity securities by the Company, before deducting any underwriting discounts and commissions and other expenses and costs relating to the offerings, plus the Company s retained earnings (without taking into account any losses incurred in prior periods) computed by taking the average of such values at the end of each month during such period, minus the cumulative amounts paid by the Company to repurchase its shares.

The ability of the Company to achieve an annualized Return on Equity in excess of the Ten-Year U.S. Treasury Rate plus 1%, and of the Manager to earn the incentive compensation described in the preceding paragraph, is dependent upon the level and volatility of interest rates, the Company s ability to react to changes in interest rates and to utilize successfully the operating strategies described herein, and other factors, many of which are not within the Company s or the Manager s control. The Manager s base compensation shall be calculated by the Manager within 15 days after the end of each month, and such calculation shall be promptly delivered to the Company. The Company is obligated to pay the base compensation within 30 days after the end of each month. The Manager shall compute the quarterly incentive compensation within 45 days after the end of each fiscal quarter, and the Company shall pay the incentive compensation with respect to each fiscal quarter within 15 days following the delivery to the Company of the Manager s written statement setting forth the computation of the incentive compensation for such quarter. The Company s Board of Directors shall review and approve the calculation of base and incentive compensations paid to the Manager quarterly, one quarter in arrears, during each scheduled quarterly Board of Directors meeting. Quarterly incentive compensation is subject to an annual adjustment so that the incentive compensation is based on earnings for the entire year. The Company believes that this compensation arrangement benefits its stockholders because it ties the Manager s compensation to Return on Equity and, in periods of low earnings, the Manager s incentive compensation is reduced or eliminated, thereby lowering the Company s operating expenses.

POLICIES

The Company s current investment policies are set forth in its Annual Report on Form 10-K for the year ended December 31, 2001.

FINANCIAL CONDITION

Fixed Income Securities

At March 31, 2002 and December 31, 2001, the Company held $2,445,669,000 and $1,505,529,000 of fixed income securities, respectively. The original maturity of a significant portion of the fixed income securities ranges from fifteen to thirty years; the actual maturity is subject to change based on the prepayments of the underlying mortgage loans.

The following table is a schedule of fixed income securities held listed by security type (dollars in thousands):

	March 31, 2002		December 31, 2001	
Fixed Income Securities	**Carrying Value**	**Percent of Portfolio**	**Carrying Value**	**Percent of Portfolio**
Mortgage Securities:				
Adjustable Rate (1)	$ 14,683	0.60%	$ 16,196	1.08%
Fixed Rate	2,425,829	99.19%	1,483,881	98.56%
Other Fixed Income Securities	5,157	0.21%	5,452	0.36%
Totals	$ 2,445,669	100.00%	$ 1,505,529	100.00%

(1) At March 31, 2002 and December 31, 2001, the interest rate indices for 98% and 2% of the adjustable rate mortgage securities were based on the one-year U.S. Treasury rate and the six-month London Inter-Bank Offered Rate, respectively.

The following table shows various weighted average characteristics of the fixed income securities held by the Company at March 31, 2002 (dollars in thousands):

Security Type	**Par Amount**	**Par as a Percent of Category**	**Adjusted Cost Basis**	**Market Price**	**Current Coupon**	**Weighted Average Life (1)**
20 Year Agency Pass-throughs	$ 169,367	6.88%	96.88%	101.18%	6.50%	4.2
30 Year Agency Pass-throughs	2,196,370	89.19%	101.14%	99.32%	6.50%	8.1
AAA CMOs	71,914	2.92%	95.59%	101.56%	6.68%	3.2

Total Fixed Rate Holdings		2,437,651	98.99%	100.68%	99.52%	6.50%	7.7
Other Fixed Income Securities		10,400	0.42%	58.42%	49.59%	13.32%	0.5
Adjustable Rate Holdings		14,437	0.59%	98.65%	101.71%	6.48%	1.0
Category Total	$	2,462,488	100.00%	100.49%	99.32%	6.53%	7.6

The following table shows various weighted average characteristics of the fixed income securities by the Company at December 31, 2001 (dollars in thousands):

Security Type		Par Amount	Percent of Total Par Amount	Adjusted Cost Basis	Market Price	Current Coupon	Weighted Average Life (1)
20 Year Agency Pass-throughs	$	187,529	12.47%	97.09%	101.88%	6.50%	3.6
30 Year Agency Pass-throughs		1,203,215	80.02%	101.25%	100.15%	6.50%	6.8
AAA CMOs		86,600	5.76%	96.09%	101.38%	6.69%	2.5
Total Fixed Rate Holdings		1,477,344	98.25%	100.42%	100.44%	6.51%	6.2
Other Fixed Income Securities		10,400	0.69%	60.33%	52.42%	13.46%	0.8
Adjustable Rate Holdings		15,895	1.06%	98.57%	101.89%	7.07%	1.0
Total Portfolio	$	1,503,639	100.00%	100.12%	100.13%	6.56%	6.1

(1) The weighted average life of the fixed rate mortgage securities is based upon market prepayment expectations as of the dates shown. The actual weighted average life could be longer or shorter depending on the actual prepayment rates experienced over the life of the securities. The weighted average life shown for the adjustable rate mortgage assets represents the average time until the next coupon reset date. All averages are shown in years.

Equity Securities

At March 31, 2002 and December 31, 2001 the Company held $4,882,000 and $6,028,000 of equity securities, respectively. Equity securities consist primarily of investment in equities issued by other real estate investment trusts.

At March 31, 2002, equity securities consisted of the following:

(In thousands)	Shares Held		Adjusted Cost		Fair Value
Common Stock:					
Dynex Capital, Inc.	75	$	122	$	264
Total Common Stock			122		264

Convertible Preferred Stock:			
Capstead Mortgage Corporation, Series B	388	3,290	4,618
Total Convertible Preferred Stock		3,290	4,618
Total Equity Securities		$ 3,412	$ 4,882

At December 31, 2001, equity securities consisted of the following:

(In thousands)	Shares Held	Adjusted Cost	Fair Value
Common Stock:			
Dynex Capital, Inc.	75	$ 122	$ 158
Total Common Stock		122	158
Convertible Preferred Stock:			
Capstead Mortgage Corporation, Series B	480	4,065	5,870
Total Convertible Preferred Stock		4,065	5,870
Total Equity Securities		$ 4,187	$ 6,028

PRINCIPAL RISKS AND SPECIAL CONSIDERATIONS

Leverage Risk. The Company employs a leveraging strategy of generally borrowing up to 92% of its total assets to finance the acquisition of additional mortgage related assets. The Company s borrowing may, at times, exceed 92% of its total assets. In the event borrowing costs exceed the income on its mortgage related assets, the Company will experience negative cash flow and incur losses. Another risk of leverage is the possibility that the value of the collateral securing the borrowings will decline. In such event, additional collateral or repayment of borrowings would be required. The Company could be required to sell mortgage related assets under adverse market conditions in order to maintain liquidity. If these sales were made at prices lower than the carrying value of the mortgage related assets, the Company would experience losses.

Interest Rate Risk. There is the possibility that the value of the Company s mortgage related assets may fall since fixed income securities generally fall when interest rates rise. The longer the term of a fixed income instrument, the more sensitive it will be to fluctuations in value from interest rate changes. Changes in interest rates may have a significant effect on the Company s operations, because it may hold mortgage related assets with long terms to maturity. Rising interest rates will negatively impact the Company s borrowings since the value of the collateral securing the borrowing will decline in value, requiring additional collateral or repayments of borrowing. This could reduce the level of borrowings and reduce returns. Also, when interest rates rise, the Company s holding of mortgage related assets can reduce returns if the owners of the underlying mortgages pay-off their mortgages later than anticipated. This is known as *extension risk*. When interest rates drop, the Company s holdings of the mortgage related assets can reduce returns if the owners of the underlying mortgages pay off their mortgages sooner than anticipated since the funds prepaid will have to be invested at the then lower prevailing rate. This is known as *prepayment risk*. In addition, when interest rates drop, not only can the value of mortgage related assets drop, but the yield can drop, particularly where the yield on the security is tied to interest rates, such as adjustable mortgages.

Liquidity Risk. There is the possibility that the Company may lose money or be prevented from earning capital gains if it cannot sell a mortgage related asset at a time and price that is most beneficial to the Company. The Company is subject to liquidity risk because it invests in mortgage securities which have experienced periods of illiquidity.

Credit Risk. Credit risk is the possibility that the Company could lose money if an issuer is unable to meet its financial obligations, such as the payment of principal and/or interest on an instrument, or goes bankrupt. The Company may invest a portion of its assets in mortgage related assets which are not guaranteed by the U.S. Government or investment grade, which may make the Company subject to substantial credit risk. This is especially true during periods of economic uncertainty or during economic down-turns.

Equity Risk. Equity risk is the possibility that the Company could lose money if its equity investments decline in value. Such a decline could be caused by a number of factors, including, but not limited to, overall market conditions, suspension or omission of dividends, bankruptcies and litigation. This is especially true during periods of economic uncertainties and economic downturns.

Failure to Maintain REIT Status Risk. Failure to maintain REIT status risk refers to the possibility that the Company may become subject to federal income tax as a regular corporation. The Company intends at all times to maintain substantially all of its investments in, and otherwise conduct its business in a manner consistent with, the REIT Provisions of the Code. If the Company fails to qualify as a REIT, it would be treated as a regular corporation for federal tax purposes. This would result in the Company being subject to federal income tax that would further result in a substantial reduction of cash available for distribution to stockholders.

Failure to Maintain Investment Company Act Exemption Risk. The Company intends to conduct its business so as not to become a regulated investment company under the Investment Company Act. As a result, the Company s ownership of certain mortgage related assets may be limited by the Investment Company Act. This could have the effect of adversely affecting the Company s operations and returns to stockholders. In addition, if the Company fails to qualify for the exemption from registration as an investment company, its ability to use leverage would be substantially reduced. This could reduce income to the Company and returns to stockholders.

Hedging Instruments

There can be no assurance that the Company will enter into hedging activities or that, if entered into, such activities will have the desired beneficial impact on the Company s results of operations or financial condition. Moreover, no hedging activity can completely insulate the Company from the risks associated with changes in interest rates and prepayment rates.

Hedging involves risk and typically involves costs, including transaction costs. Such costs increase dramatically as the period covered by the hedging increases and during periods of rising and volatile interest rates. The Company may increase its hedging activity and, thus, increase its hedging costs during such periods when interest rates are volatile or rising and hedging costs have increased. The Company intends generally to hedge as much of the interest rate risk as the Manager determines is in the best interest of the stockholders of the Company given the cost of such hedging transactions and the Company s desire to maintain its status as a REIT. The Company s policies do not contain specific requirements as to the percentages or amount of interest rate risk that the Manager is required to hedge.

The Company utilizes interest rate swap agreements as a tool to manage interest rate risk. Under the swap agreements, the Company receives a floating rate and pays a fixed rate. The notional amount of each agreement is matched against a like amount of current and anticipated borrowings under reverse repurchase agreements to mitigate the potential effect on cash flows and net interest income of rising interest rates by effectively fixing the rate paid on the matched borrowings over the life of the contract. In the absence of such financial instruments, interest expense on reverse repurchase agreements and similar short-term borrowings, which mature and reprice frequently, can increase faster than the Company can adjust its interest-earning assets and increase interest income, because the Company s mortgage related securities generally have much longer maturities and have fixed rates of interest.

The interest rate swap agreements entered into by the Company are classified as cash flow hedges for accounting purposes, and meet the requirements of SFAS No. 133 for such classification. Therefore, changes in the fair value of the agreements are reported in accumulated other comprehensive income, a component of stockholders equity, and do not affect net income in the period of the change. Periodic exchanges of cash flows with the counterparties to the agreements are recorded as adjustments to interest expense. If the Company were to terminate the swap agreements prior to their contractual termination dates, or change current or anticipated borrowings so that they were no longer appropriately matched to the swap agreements, the agreements might no longer qualify for hedge accounting treatment. In that case, changes in their fair values would affect net income.

Borrowings hedged by interest rate swaps are used primarily to acquire and hold fixed income securities available-for-sale. Changes in the fair values of securities available-for-sale are also reported in accumulated other comprehensive income, a component of stockholders equity. Changes in fair values of the securities only affect periodic earnings when they are sold or if they have an other-than-temporary impairment. Therefore, earnings volatility is reduced by the use of the swap agreements as cash flow hedges and the acquisition of available-for-sale securities with the borrowings hedged by the agreements. Impairment of the available-for-sale securities or decisions to sell the securities prior to their expected maturities could result in unanticipated earnings volatility.

At March 31, 2002, the Company had entered into interest rate swap agreements summarized below.

Current Notional Amount (000)	Weighted Average Life	Average Fixed Rate	Floating Rate	Average Termination Date	Unrealized Gains (000)
$1,500,000	4.5 years	4.374%	1Mo LIBOR	12/7/2007	$22,107

At December 31, 2001, the Company had entered into interest rate swap agreements summarized below.

Current Notional Amount (000)	Weighted Average Life	Average Fixed Rate	Floating Rate	Average Termination Date	Unrealized Gains (000)
$850,000	6.6 years	4.239%	1Mo LIBOR	3/3/2008	$4,620

At various times the Company has used forward contracts to sell U.S. Treasury securities as a means to mitigate the effect of rising interest rates on the fair value of its mortgage related securities. The fair values of these forward contracts generally move in the opposite direction of the fair values of the mortgage related securities, and approximately in the same proportion when the maturities and other terms are appropriately matched. When interest rates rise, the fair value of the Mortgage Related securities declines, but the increasing fair values of the forward contracts help to preserve net asset value relative to the changing fair value of the short-term borrowings used to fund them.

The Company s forward contracts do not meet the criteria for hedge accounting under SFAS No. 133. Therefore, changes in their fair values affect current earnings, as do changes in the fair values of the securities to which they are matched such securities are classified as trading securities. Although the changes in the fair values of the forward contracts and the trading securities are offsetting, the contracts are not fully effective as hedges, and there can be significant volatility in periodic earnings to the extent they are not.

At March 31, 2002, the Company had open forward contracts to sell U.S. Treasury notes with terms stated below.

Current Notional Amount (000)	Average Contract Price	Fair Value of Contracts (000)	Average Termination Date	Unrealized Gains (Losses) (000)
$625,000	102.712	$639,093	4/16/2002	$2,860

At December 31, 2001, the Company had open forward contracts to sell U.S. Treasury notes with terms stated below.

Current Notional Amount (000)	Average Contract Price	Fair Value of Contracts (000)	Average Termination Date	Unrealized Gains (Losses) (000)
$359,000	100.825	$365,235	1/14/2002	($3,275)

The contracts were entered into to mitigate the negative impact of rising interest rates on certain fixed income securities that generally have a market weighted average duration approximately equal to the contracts shown above.

Liabilities

The Company has entered into reverse repurchase agreements to finance certain of its mortgage-backed securities. These agreements are secured by a portion of the Company s mortgage-backed securities and bear interest rates that have historically moved in close relationship to LIBOR.

At March 31, 2002, the Company had outstanding $2,351,750,000 of reverse repurchase agreements with a weighted average current borrowing rate of 1.87% and a maturity of 1.0 months. The reverse repurchase agreements were collateralized by securities with an estimated fair value of $2,432,624,000.

At December 31, 2001, the Company had outstanding $1,376,850,000 of reverse repurchase agreements with a weighted average current borrowing rate of 1.89% and a maturity of 1.0 months. The reverse repurchase agreements were collateralized by mortgage-backed securities with an estimated fair value of $1,440,014,000.

The Company had $32,064,000 and $28,545,000 of other liabilities at March 31, 2002 and December 31, 2001, respectively, consisting primarily of accrued interest payable, dividend payable, and accrued expense and other liabilities at March 31, 2002 and accrued interest payable, unrealized loss on forward contracts and accrued expenses and other liabilities at December 31, 2001. The Company anticipates settling all other liabilities within one year.

Results of Operations for the Three Months Ended March 31, 2002

Overview

For the three months ended March 31, 2002, the Company s net income was $9,728,000, or $0.53 per common share on a basic and diluted basis, based on a weighted common average of 18,315,861 and 18,427,683 shares outstanding, respectively. That compares to net income of $974,000, or $0.17 per common share on both a basic basis and diluted basis, based on a weighted average of 5,753,000 and 5,783,000 shares outstanding for the three months ended March 31, 2001. The weighted average number of shares used to calculate net income per diluted share includes the effect of the assumed exercise of outstanding stock options.

Net Interest Income

Net interest income for the three months ended March 31, 2002 was $14,604,000 consisting of interest income on fixed income securities and cash balances less interest expense on reverse repurchase agreements compared to $3,944,000 for the three months ended March 31, 2001. The Company reported dividend income of $126,000 from dividends on equity investments for the three months ended March 31, 2002 compared to $188,000 for the three months ended March 31, 2001.

The following table reflects the average balances for each category of the Company s interest earning assets as well as the Company s interest bearing liabilities, with the corresponding effective rate of interest annualized (dollars in thousands):

AVERAGE BALANCE AND RATE TABLE

(Dollars in thousands)

	For the Quarter Ended March 31, 2002		For the Quarter Ended March 31, 2001	
	Average Balance	Effective Rate	Average Balance	Effective Rate
Interest Earning Assets:				
Mortgage Securities	$ 1,673,427	6.48%	$ 577,232	7.39%
Other Fixed Income Assets	6,157	9.63%	6,699	18.98%
Cash and Cash Equivalents	9,273	2.37%	3,343	5.03%
Total Interest Earning Assets	1,688,857	6.47%	587,274	7.51%
Interest Bearing Liabilities:				
Reverse Repurchase Agreements	1,570,692	3.24%	562,610	5.03%
Net Interest Earning Assets and Spread	$ 118,165	3.23%	$ 24,664	2.48%

The effective yield data is computed by dividing the annualized net interest income or expense including hedging transactions as applicable into the average daily balance shown.

The following table reflects the average balances for the Company s equity securities (dollars in thousands):

AVERAGE BALANCE AND RATE TABLE

(Dollars in thousands)

	For the Quarter Ended March 31, 2002		For the Quarter Ended March 31, 2001	
	Average Balance	Effective Dividend Yield	Average Balance	Dividend Yield
Equity securities	$ 4,519	4.07%	$ 13,082	5.75%

Following is a table that shows the approximate amounts of the change in interest income and expense between 2002 and 2001 that was a function of rate and volume changes, and the amount of the change that cannot be ascribed specifically to either rate or volume changes.

RATE / VOLUME TABLE

(Dollars in thousands)

	Three Months Ended March 31, 2002 compared to 2001		
	Total Change	Changes Due to Volume (1)	Rates (1)
Interest-Earning Assets			
Fixed Income Securities	$ 16,276	$ 20,598	$ (4,325)
Cash and Cash Equivalents	13	(149)	124
Total Interest Income	$ 16,289	$ 20,449	$ (4,201)
Interest-Bearing Liabilities			
Reverse Repurchase Agreements	$ 5,629	$ 12,682	$ (7,053)
Total Interest Expense	$ 5,629	$ 12,682	$ (7,053)

Change in Net Interest Income	$	10,660	$	7,767	$	2,852

(1) Changes in interest income/expense not arising from volume or rate variances are allocated proportionately to rate and volume.

A portion of the change in interest expense in the table above is related to the Company s use of interest rate swaps. Periodic settlements of the swap agreements with their counter-parties result in adjustments to interest expense associated with the reverse repurchase agreements hedged by the swaps. During the quarter ended March 31, 2001, interest expense was decreased by $1,152,000 from amortization of deferred gains on terminated swap contracts. During the quarter ended March 31, 2002, interest expense was increased by $5,691,000 paid to swap counterparties and decreased by $121,000 from amortization of deferred gains on terminated swap contracts.

General and Administrative Expenses

The Company incurred operating expenses of $3,298,000 for the three months ended March 31, 2002 consisting of management fees, incentive fees, professional, insurance and other expenses compared to $269,000 for the three months ended March 31, 2001.

The primary reasons for the higher operating expenses in first quarter 2002 compared to first quarter 2001 were that management fees, especially incentive fees, were much higher because of substantially improved operating income. Also, the recently completed stock offerings resulted in additional capital and an increase in the Company s investment portfolio which yielded higher net operating income compared to prior periods .

Net Gain (Loss) on Investment and Derivative Activities

During the quarter ended March 31, 2002, the Company reported a net loss on investment and derivative activities of $1,704,000 in the statement of operations. This loss consisted of a net loss of $481,000 on closed forward contracts, a loss of $232,000 on the sale of $99,881,000 of fixed income securities available-for-sale, a gain of $17,000 on the sale of $6,535,000 of fixed income trading securities, a gain of $341,000 on the sale of $1,117,000 of equity securities available-for-sale, and an unrealized loss of $1,349,000 on trading securities.

During the quarter ended March 31, 2001, the Company realized $3,444,000 in gains on the sale of $142,809,000 of fixed income securities, reported gains of $3,180,000 from the net increase in fair market value of fixed income securities held for trading and realized $9,082,000 in losses on closed forward contracts.

Accounting Changes

During the quarter ended March 31, 2001, the Company adopted SFAS No. 133 and the related amendments. This adoption resulted in a transition adjustment that reclassified $2,173,000 of net losses on unrealized and deferred gains and losses on investment securities and forward contracts from accumulated other comprehensive income to current income. Also, deferred gains on interest rate swaps previously designated as hedges were reclassified from other liabilities to accumulated other comprehensive income.

Also during the quarter ended March 31, 2001, the Company reclassified $594,469,000 of its mortgage securities from the available-for-sale category to the trading category for investments accounted for under SFAS No. 115. This change resulted in the reclassification of $1,742,000 net unrealized gains from accumulated other comprehensive income to current income, in addition to net unrealized gains included in the SFAS No. 133 transition adjustment discussed above.

No such accounting changes were made during the quarter ended March 31, 2002.

Liquidity and Capital Resources

The Company s primary sources of funds as of March 31, 2002 and December 31, 2001, consisted of reverse repurchase agreements totaling $2,351,750,000 and $1,376,850,000, respectively. The Company expects to continue to borrow funds in the form of reverse repurchase agreements. At March 31, 2002, the Company had borrowing arrangements with over twenty different investment banking firms. Increases in short-term interest rates could negatively impact the valuation of the Company s mortgage assets which could limit the Company s borrowing ability or cause its lenders to initiate margin calls.

The Company will also rely on the cash flow from operations, primarily monthly principal and interest payments to be received on the mortgage assets, for liquidity.

The Company believes that equity capital, combined with the cash flow from operations and the utilization of borrowings, will be sufficient to enable the Company to meet anticipated liquidity requirements. If the Company s cash resources are at any time insufficient to satisfy the Company s liquidity requirements, the Company may be required to liquidate mortgage assets or sell debt or additional equity securities. If required, the sale of mortgage assets at prices lower than the carrying value of such assets would result in losses.

The Company may in the future increase its capital resources by making additional offerings of equity and debt securities, including classes of preferred stock, common stock, commercial paper, medium-term notes, CMOs and senior or subordinated notes. All debt securities, other borrowings, and classes of preferred stock will be senior to the Common Stock in a liquidation of the Company. The effect of additional equity offerings may be the dilution of stockholders equity of the Company or the reduction of the price of shares of the Common Stock, or both. The Company is unable to estimate the amount, timing or nature of additional offerings as they will depend upon market conditions and other factors.

Inflation

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

II. ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

MARKET RISK

The Company s two primary components of market risk are interest rate risk and equity price risk as discussed below.

Interest Rate Risk

Effect on Net Interest Income. The Company invests in fixed-rate mortgage assets that are expected to be funded with short-term borrowings. During periods of rising interest rates, the borrowing costs associated with funding such fixed-rate assets are subject to increase while the income earned on such assets may remain substantially unchanged. This would result in a narrowing of the net interest spread between the related assets and borrowings and may even result in losses. The Company may enter into derivative transactions seeking to mitigate the negative impact of a rising interest rate environment. Hedging techniques will be based, in part, on assumed levels of prepayments of the Company s mortgage assets. If prepayments are slower or faster than assumed, the life of the mortgage assets will be longer or shorter which would reduce the effectiveness of the Company s hedging techniques and may result in losses on such transactions. Hedging techniques involving the use of derivative securities are highly complex and may produce volatile returns. The hedging activity of the Company will also be limited by the asset and sources of income requirements applicable to the Company as a REIT.

Extension Risk. Fixed-rate assets are generally acquired with a projected weighted average life based on certain assumptions regarding prepayments. In general, when a fixed-rate mortgage asset is acquired with borrowings, the Company may, but is not required to, enter into an interest rate swap agreement or other hedging instrument that effectively fixes the Company s borrowing costs for a period close to the anticipated average life of the related asset. This strategy is designed to protect the Company from rising interest rates because the borrowing costs are fixed for the duration of the asset. However, if prepayment rates decrease in a rising interest rate environment, the life of the mortgage asset could extend beyond the term of the swap agreement or other hedging instrument. This situation could negatively impact the Company as borrowing costs would no longer be fixed after the end of the hedging instrument while the income earned on the asset would remain fixed. This situation may also cause the market value of the Company s mortgage assets to decline with little or no offsetting gain from the related hedging transactions. In certain situations, the Company may be forced to sell assets and incur losses to maintain adequate liquidity.

Prepayment Risk. Fixed-rate assets in combination with hedging instruments are also subject to prepayment risk. In falling interest rate scenarios, the fixed-rate mortgage assets may prepay faster such that the average life becomes shorter than its related hedging instrument. If this were to happen, the Company would potentially need to reinvest at rates lower than that of the related hedging instrument. This situation may result in the narrowing of interest rate spreads or may cause losses.

Forward Contract Risk. The Company may also enter in forward contracts to sell U.S. Treasury notes in addition to or instead of interest rate swap agreements. These forward contracts are generally expected to mitigate the impact of rising interest rates on the fair value of the Company s fixed income securities. However, if the interest rate spread between mortgage securities and U.S. Treasury notes were to widen, the fair value of the Company s portfolio would generally be expected to decline. In addition, the use of forward contracts to sell U.S. Treasury notes generally does not directly impact borrowing costs in the same manner as interest rate swap agreements. Therefore, the use of such forward contracts could result in net income volatility during periods of interest rate volatility.

The Company also invests in adjustable-rate mortgage assets that are typically subject to periodic and lifetime interest rate caps that limit the amount an adjustable-rate mortgage asset s interest rate can change during any given period, as well as the minimum rate payable. The Company s borrowings will not be subject to similar restrictions. Hence, in a period of increasing interest rates, interest rates on its borrowings could increase without limitation by caps, while the interest rates on its mortgage assets are generally limited by caps. This problem will be magnified to the extent the Company acquires mortgage assets that are not fully indexed. Further, some adjustable-rate mortgage assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. This could result in receipt by the Company of less cash income on its adjustable-rate mortgage assets than is required to pay interest on the related borrowings. These factors could lower the Company s net interest income or cause a net loss during periods of rising interest rates, which would negatively impact the Company s financial condition, cash flows and results of operations.

The Company intends to fund a substantial portion of its acquisitions of adjustable-rate mortgage assets with borrowings that have interest rates based on indices and repricing terms similar to, but of somewhat shorter maturities than, the interest rate indices and repricing terms of the mortgage assets. Thus, the Company anticipates that in most cases the interest rate indices and repricing terms of its mortgage assets and its funding sources will not be identical, thereby creating an interest rate mismatch between assets and liabilities. While the historical spread between relevant short-term interest rate indices has been relatively stable, there have been periods, especially during the 1979-1982 and 1994 interest rate environments, when the spread between such indices was volatile. During periods of changing interest rates, such interest rate mismatches could negatively impact the Company s financial condition, cash flows and results of operations.

Prepayment rates generally increase when prevailing interest rates fall below the interest rates on existing mortgage assets. In addition, prepayment rates generally increase when the difference between long-term and short-term interest rates declines. Prepayments of mortgage assets could adversely affect the Company s results of operations in several ways. The Company anticipates that a substantial portion of its adjustable-rate mortgage assets may bear initial teaser interest rates that are lower than their fully indexed rates (the applicable index plus a margin). In the event that such an adjustable-rate mortgage asset is prepaid prior to or soon after the time of adjustment to a fully indexed rate, the Company will have held the mortgage asset while it was less profitable and lost the opportunity to receive interest at the fully indexed rate over the expected life of the adjustable-rate mortgage asset. In addition, the prepayment of any mortgage asset that had been

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purchased at a premium by the Company would result in the immediate write-off of any remaining capitalized premium amount and consequent reduction of the Company s net interest income by such amount. Finally, in the event that the Company is unable to acquire new mortgage assets to replace the prepaid mortgage assets, its financial condition, cash flow and results of operations could be materially adversely affected.

Effect on Fair Value. Another component of interest rate risk is the effect changes in interest rates will have on the market value of the Company s assets. This is the risk that the market value of the Company s assets will increase or decrease at different rates than that of the Company s liabilities including its hedging instruments.

The Company primarily assesses its interest rate risk by estimating the duration of its assets and the duration of its liabilities including all hedging instruments. Duration essentially measures the market price volatility of financial instruments as interest rates change. The Company generally calculates duration using various financial models and empirical data.

The following sensitivity analysis table shows the estimated impact on the fair value of the Company s interest rate sensitive investments net of its hedging instruments and reverse repurchase agreement liabilities assuming rates instantaneously fall one hundred basis points and rise one hundred basis points. (Dollars are in thousands except per share amounts.)

	Fair Value for Scenario Shown		
	Interest Rates Fall 100 Basis Points	Unchanged	Interest Rates Rise 100 Basis Points
Interest Rate Sensitive Instruments	$ 225,797	$ 213,994	$ 162,244
Change in Fair Value	$11,803		($51,750)
Change as a Percent of Fair Value	(0.48%)		(2.12%)
Change as a Percent of Stockholders Equity	(5.52%)		(24.19%)
Change on a Per Share Basis	($0.48)		($2.09)

It is important to note that the impact of changing interest rates on fair value can change significantly when interest rates change beyond one hundred basis points from current levels. Therefore, the volatility in fair value for the Company could increase significantly when interest rates change beyond one hundred basis points. In addition, there are other factors that impact the fair value of the Company s interest rate sensitive investments and hedging instruments such as the shape of the yield curve, market expectations as to future interest rate changes and other market conditions. Accordingly, there may be differences between the fair value changes shown above and actual changes in fair value as interest rates change and those differences may be material.

The Company has established an interest rate risk management policy that is intended to mitigate the negative impact of changing interest rates. The Company generally intends to mitigate interest rate risk by targeting the difference between the market weighted average duration on its mortgage related assets funded with secured borrowings to the market weighted average duration of such borrowings to one year or less, taking into account all hedging transactions. The Company generally does not intend to have any specific duration target for the portion its mortgage related assets that are not funded by secured borrowings.

There can be no assurance that the Company will be able to limit such duration differences and there may be periods of time when the duration difference will be greater than one year.

Equity Price Risk

Another component of market risk for the Company is equity price risk. This is the risk that the market value of the Company s equity investments will decrease. The following table shows the impact on the Company s fair value as the price of its equity securities change assuming price decreases of 10% and increases of 10%. Actual price decreases or increases may be greater or smaller. (Dollars are in thousands except per share amounts.)

	Fair Value for Scenario Shown		
	Prices Decrease 10%	Unchanged	Prices Increase 10%
Equity Investments	$ 4,394	$ 4,882	$ 5,370
Change in Fair Value	(488)		488
Change as a Percent of Fair Value	(10%)		10%
Change as a Percent of Stockholders Equity	(0.2%)		0.2%
Change on a Per Share Basis	(0.02)		0.02

Although there is no direct link between changes in fair value and changes in earnings in many cases, a decline in fair value for the Company may translate into decreased earnings over the remaining life of the investment portfolio.

If the fair market value of the Company s portfolio were to decline significantly, the Company s overall liquidity may be impaired which could result in the Company being required to sell assets at losses.

The Company s analysis of risks is based on management s experience, estimates, models and assumptions. These analyses rely on models of financial information which utilize estimates of fair value and interest rate sensitivity. Actual economic conditions or implementation of investment decisions by the Manager may produce results that differ significantly from the estimates and assumptions used in the Company s models and the projected results shown in the above tables and in this report. These analyses contain certain forward-looking statements and are subject to the Safe Harbor contained in the Private Securities Litigation Reform Act of 1995.

PART II. **OTHER INFORMATION**

Item 1. Legal Proceedings

None.

Item 2. Changes in Securities

None.

Item 3. Defaults Upon Senior Securities

Not Applicable.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

Item 6. Exhibits and Reports on Form 8-K

Exhibits

The exhibits listed on the Exhibit List, which appears below following the signature page, are included or incorporated by reference in this Quarterly Report.

Reports on Form 8-K

On February 27, 2002, we filed a current report on Form 8-K, announcing that on February 22, 2002 our Board of Directors declared a dividend of $0.50 per share of common stock for the first quarter 2002. We also attached (i) a form of underwriting agreement by and among the Company, Credit Suisse First Boston, as representative, and the several underwriters listed on Schedule A thereto, and (ii) an opinion and consent of Ballard Spahr Andrews & Ingersoll dated February 27, 2002, as to the legality of the shares being issued.

On February 28, 2002, we filed a current report on Form 8-K, attaching an opinion and consent of Ballard Spahr Andrews & Ingersoll dated February 28, 2002, as to the legality of the shares being issued.

SIGNATURES

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

Apex Mortgage Capital, Inc.
(Registrant)

Dated: May 15, 2002	/s/ Philip A. Barach Philip A. Barach President and Chief Executive Officer (Principal Executive Officer)
Dated: May 15, 2002	/s/ David S. DeVito David S. DeVito Chief Financial Officer (Principal Accounting Officer)

EXHIBIT INDEX

Pursuant to Item 601(a)(2) of Regulation S-K, this exhibit index immediately precedes the exhibits.

The following exhibits are part of this Quarterly Report on Form 10-Q (and are numbered in accordance with Item 601 of Regulation S-K).

Exhibit No.	**Description**
3.1	Articles of Amendment and Restatement of the Company, as filed with the State Department of Assessments and Taxation of Maryland on November 25, 1997, (previously filed as Exhibit 3.1 to the Company's Registration Statement on Form S-11, Commission File No. 333-36069, Amendment No. 3, filed November 21, 1997 and incorporated herein by reference).
3.2	Articles Supplementary relating to the Company's Series A Junior Participating Preferred Stock, as filed with the State Department of Assessments and Taxation of the State of Maryland on July 26, 1999 (previously filed as Exhibit 3.1 to the Company's Current Report on Form 8-K, dated June 30, 1999 and filed July 23, 1999, and incorporated herein by reference).
3.3	Amended and Restated Bylaws of the Company (previously filed as Exhibit 4.4 to the Company's S-3 filed on November 27, 2001 and incorporated herein by reference).
4.1	Form of Share Certificate for our common stock (previously filed as Exhibit 4.3 to the Company's Current Report on Form 8-K, dated June 30, 1999 and filed July 27, 1999, and incorporated herein by reference).
4.2	Shareholder Rights Agreement between the Company and The Bank of New York, as Rights Agent (including as Exhibit B the form of Rights Certificate) (previously filed as Exhibit 4.1 to the Company's Current Report on Form 8-K, dated June 30, 1999 and filed July 27, 1999, and incorporated herein by reference).