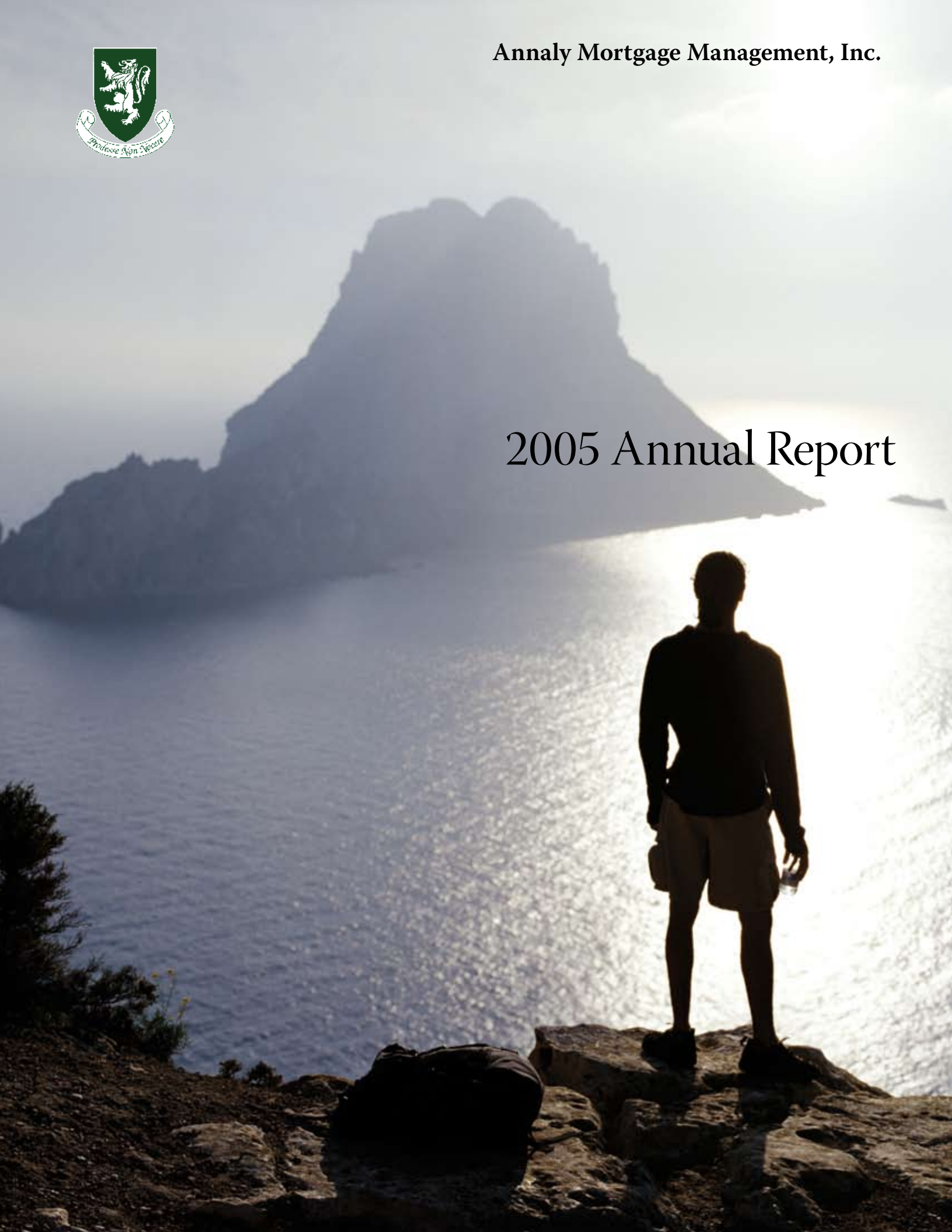




Annaly Mortgage Management, Inc.

# 2005 Annual Report



## ANNUAL REPORT 2005



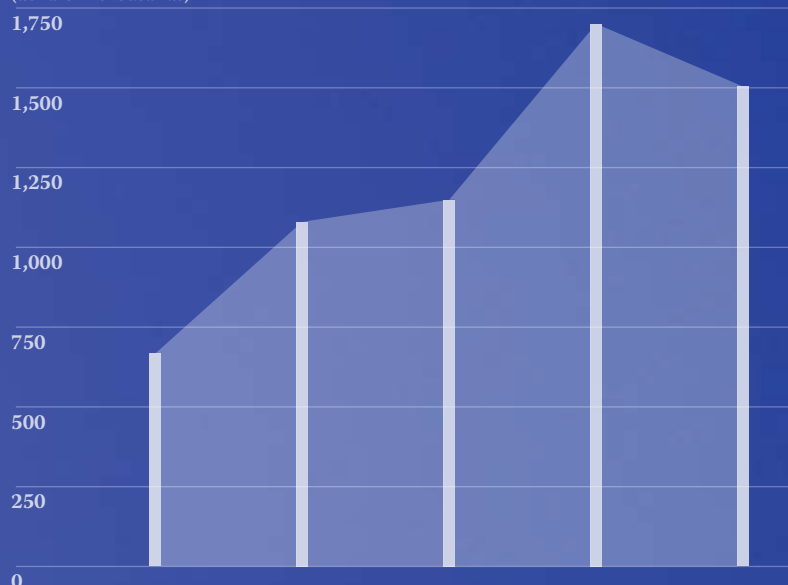
*Our family crest and its motto “Prodesse non Nocere” are the trademarks of the Company. The description figuratively means ‘Proceed without fear.’ That symbolizes the confidence we try to instill in our investors. It is reinforced by years of reliable, highly competitive investment performance.*

## TABLE OF CONTENTS

2	Corporate Profile
3	The Annaly Team
4	Letter From The Chairman
6	FIDAC
8	Selected Financial Data
9	Management’s Discussion and Analysis of Financial Condition and Results of Operations
18	Management Report On Internal Control Over Financial Reporting
19	Report of Independent Registered Public Accounting Firm
20	Consolidated Statements of Financial Condition
21	Consolidated Statements of Operations and Comprehensive Income
22	Consolidated Statements of Stockholders’ Equity
23	Consolidated Statements of Cash Flows
24	Notes To Consolidated Financial Statements
32	Common Stock and Market Information
IBC	Corporate Information

The Year 2005 was a challenging year for Annaly as the Federal Reserve Bank increased rates eight times, continuing a policy set in motion on June 30, 2004. The pressure on short term borrowing costs resulted in a significant portfolio rebalancing commencing in the end of the year. While earnings per share declined as a result of economic conditions and the portfolio rebalancing, a dividend of \$1.04 per share or 6.4% based on average share price throughout the year was paid to shareholders. FIDAC, which was acquired in June 2004, increased net assets under management by 20% and generated over \$27,000,000 in fee income during its first full year as a wholly owned subsidiary. Our objective is to protect shareholders' capital while providing a competitive dividend yield.

(dollars in thousands)

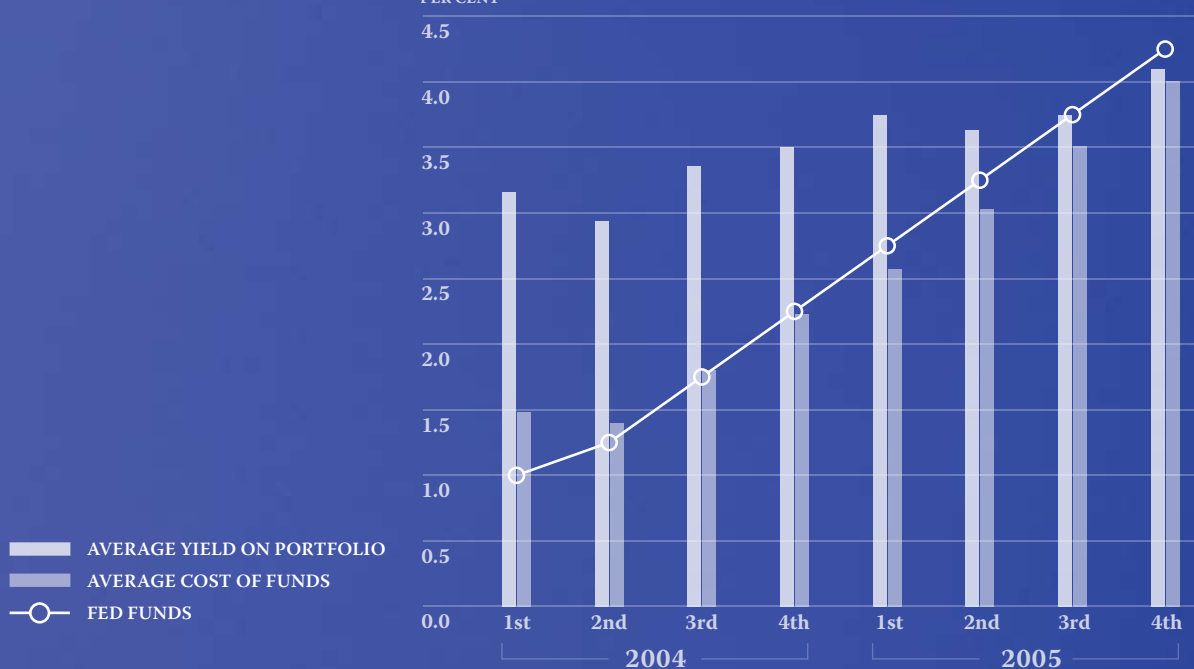


(dollars in thousands)

**STOCKHOLDERS' EQUITY**

2001 \$667,357 2002 \$1,080,066 2003 \$1,149,220 2004 \$1,700,470 2005 \$1,504,023

PER CENT



Annaly Mortgage 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 are therefore required to pay out at least 90% of our earnings to our shareholders in order to avoid taxation at the corporate 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 with a combination of adjustable-, floating-, and fixed-rate Mortgage-Backed Securities so that it can perform well 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.

**Wellington J. Denahan-Norris**

*Vice Chairman,  
Chief Investment Officer  
& Chief Operating Officer*

**Kathryn F. Fagan**

*Chief Financial Officer  
& Treasurer*

**Michael A. J. Farrell**

*Chairman, President &  
Chief Executive Officer*

**R. Nicholas Singh**

*Executive Vice President,  
General Counsel, Secretary &  
Chief Compliance Officer*





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. Since our IPO in October 1997, Annaly has raised almost \$1.5 billion in subsequent offerings, making Annaly one of the largest mortgage REITs. 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 navigate volatile markets 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.

# Annaly Team

**Kristopher Konrad**  
*Senior Vice President*

**Rose-Marie Lyght**  
*Senior Vice President*

**Ronald D. Kazel**  
*Managing Director*

**James P. Fortescue**  
*Senior Vice President*

**Jeremy Diamond**  
*Managing Director*



Dear Fellow Shareholders,

I always welcome this opportunity to look in the rear view mirror and make a few observations on the direction from which we have come and where we may be going. In 2004's annual letter, I spoke about the 'Greenspan Put' and how it was no longer valid to rely on the central banks of the world to spur growth or maintain stability simply by manipulating interest rates lower. In his final full year as Chairman, apparently Alan Greenspan understood this. He cemented his legacy by following his predecessor, Paul Volcker, who also raised interest rates so the new chairman would have the flexibility to refrain or continue, as necessary. Unlike Volcker, however, Greenspan's target was not necessarily inflation, but rather the unregulated boom in housing finance that has pumped up the economy since September 11, 2001. According to the statistics, about 70% of the increase in household wealth has come from housing since 9/11. More than half of all the job growth has come from housing related activity, and 50% of the increase in Gross Domestic Product followed that. My opinion is that the housing market broke in the summer of 2005. The government statistics will confirm this in the coming months, but essentially these numbers will be too late to stop the Fed from continuing its campaign to deflate the latest asset bubble. Raising the Fed Funds rate as an instrument of monetary policy is a hammer, not a scalpel, and the Federal Reserve will, as usual, go too far in using it and cause some sort of economic event that will lead to an easing of monetary policy.

There is a lot of discussion about the amount of foreign capital finding its way into the U.S. markets. I have decided to christen this the 'Greenspan Call'. The United States is paying relatively higher rates than its competitors because, as a debtor nation with two huge deficits—the current account deficit and the budget deficit—it has to. Chairman Greenspan, frustrated with the lack of spending discipline in Washington, took rates higher because he knows we have no choice but to recycle the dollars that U.S. consumers are spending on imported products into U.S. Government financial assets. Alan Greenspan has been calling these dollars home by keeping short term rates at the higher end of where they have been for the past several years. As outlined in last year's annual letter, the choices for future generations got tougher in 2005. We can expect that to stay the same for years to come, mostly because America usually does the right thing: In this case it will be to pay the bill that is due on all of the excessive borrowing that has taken place over the past 15 years. This will mean higher taxes and deeper cuts in entitlements on both the Federal and local levels.

At a dinner we hosted last summer, we gathered together some of the best investment minds we know to debate, among other things, the existence of a housing bubble. The consensus seemed to be that 'there's no bubble in my neighborhood'. But I think that the person who hit it on the head was Jim Grant, editor of *Grant's Interest Rate Observer*. He submitted that the greater problem was that we are in a debt bubble. I agree. The world is faced with the reality of government deficits in every major currency. The Fed is not alone in its battle to control, criticize and



MICHAEL A. J. FARRELL

fund its government's fiscal requirements. These growing bubbles are dictating spending and political policies and will do so well into the future. As I write this letter, gold—the ultimate reservoir of safety—is skyrocketing, as investors seek to limit their exposure to paper currencies. Ultimately, this leads to weak economic growth and to steeper yield curves, where our investments perform best. Rarely has NLY and FIDAC been faced with such a luxury in the past. Indeed, Annaly, launched in 1997, was born in a flat and inverted yield curve and only got the benefit of a steep yield curve in 2001. In cyclical fashion, this began to be taken away again in the summer of 2003. Those who remember some conference calls in 2003 may remember us analyzing this effect and saying, "This is not a great picture for our nation, but it is a great picture for our business." As an American citizen, I recognize the pain that this outcome will cause for our nation, but as businesspeople our responsibility is to exploit the opportunities in favor of our shareholders. As 2005 played out, we prepared our business for the inevitable change in sentiment and shape of the yield curve. While others stretched for returns in the form of credit risk, mortgage derivatives, new business models or extra leverage, we stuck to our discipline of using AAA mortgage-backed securities. It cost us some earnings, especially in the last two quarters of 2005, but I believe this discipline will only be appreciated by investors when viewed through history's rear view mirror.

We are at an inflection point as a nation. The American consumer is the world's largest economy, driving the wealth, standards of living and economies of many nations. We have a negative savings rate. Household real estate assets are 150% of Gross Domestic Product; the last asset category to reach this lofty rate was equities during the Tech bubble. The U.S. debt-to-income ratio is currently at 126%. It has risen as much in the past 5 years as it did in the previous 15 years. In 1986 it stood at 75%. In 1956, it was at 50%. As U.S. consumers choose, or are forced, to rebalance these ratios, it will undoubtedly slow down the domestic and foreign economies that rely so much on them.

Our management decisions and results in 2005 reflect the market conditions that typically accompany the end of the tightening phase of an interest rate cycle. With this as an operating background, Annaly generated \$1.04 in dividends for shareholders.

Many people would consider this a doom and gloom letter, but that is not my perspective. I see this as a challenge for the American people and economy and, perhaps unlike other countries, we collectively have the will, the capitalist tools and the structure by which we will correct and reinvent ourselves. For prudent, long term investors, it will be a generational opportunity to acquire assets at extremely attractive valuations. For Annaly and FIDAC, we are positioned to exploit this outcome as it occurs.

*Prodesse non Nocere.*



March 17, 2006

*"our responsibility is to  
exploit the opportunities in  
favor of our shareholders."*



# FIDAC

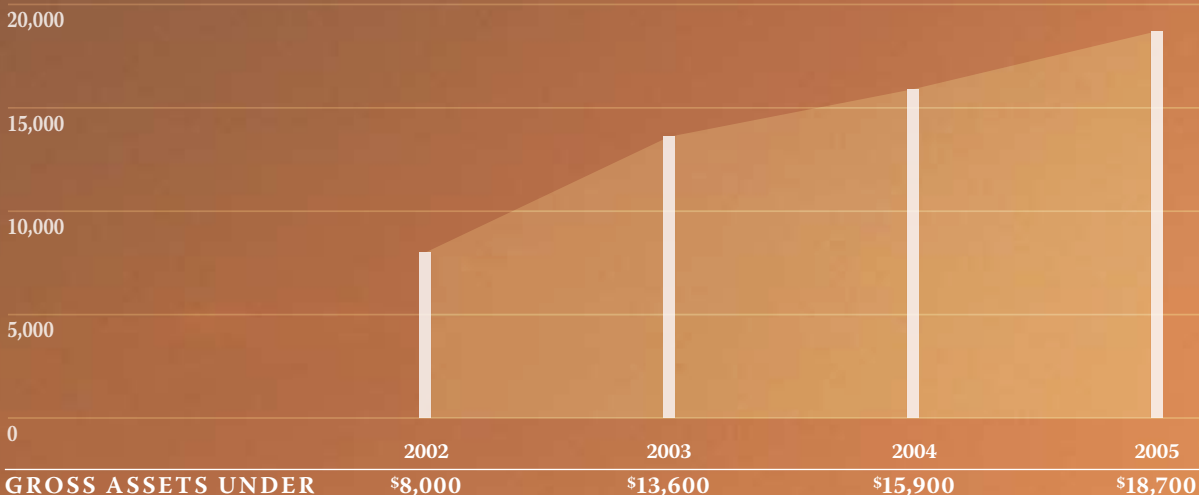
## FIXED INCOME DISCOUNT ADVISORY COMPANY

The FIDAC Global Distribution Network 2005



The FIDAC acquisition in June 2004 has had an immediate positive impact for Annaly shareholders. FIDAC generated over \$27 million in net fee income in 2005 which blended with Annaly's spread income to benefit shareholders. The addition of FIDAC also increases assets under management. At December 31, 2005, FIDAC managed, advised or sub-advised approximately \$18.7 billion in gross assets through numerous off-shore 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.

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 some of the most challenging fixed income markets in memory. By prudently executing its strategy of applying leverage to liquid, high-quality, short-duration assets, and by not taking performance bonuses in any of its investment vehicles, FIDAC has consistently produced superior risk-adjusted returns.



**GROSS ASSETS UNDER MANAGEMENT**

(dollars in millions)



The team managing Annaly fulfills the same roles at FIDAC. FIDAC earns management fees for executing the same general strategy as Annaly. 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 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 focus of the business model—to capture the spread between the yield on these assets and the cost to finance their acquisition, without introducing credit or other business risks—enables investors to more easily evaluate management performance. 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.



# FIDAC

## SELECTED FINANCIAL DATA

(dollars in thousands, except for per share data)	For the Year Ended December 31, 2005	For the Year Ended December 31, 2004	For the Year Ended December 31, 2003	For the Year Ended December 31, 2002	For the Year Ended December 31, 2001
<b>Statement of Operations Data:</b>					
Interest income	\$705,046	\$532,328	\$337,433	\$404,165	\$263,058
Interest expense	568,560	270,116	182,004	191,758	168,055
<b>Net interest income</b>	<b>\$136,486</b>	<b>\$262,212</b>	<b>\$155,429</b>	<b>\$212,407</b>	<b>\$95,003</b>
<b>Other (loss) income:</b>					
Investment advisory and service fees	35,625	12,512	—	—	—
(Loss) gain on sale of investment securities	(53,238)	5,215	40,907	21,063	4,586
Loss on other than temporarily impaired Securities	(83,098)	—	—	—	—
<b>Total other (loss) income</b>	<b>(100,711)</b>	<b>17,727</b>	<b>40,907</b>	<b>21,063</b>	<b>4,586</b>
<b>Expenses</b>					
Distribution fees	8,000	2,860	—	—	—
General and administrative expenses	26,278	24,029	16,233	13,963	7,311
<b>Total Expenses:</b>	<b>34,278</b>	<b>26,889</b>	<b>16,233</b>	<b>13,963</b>	<b>7,311</b>
Income before income taxes	1,497	253,050	180,103	219,507	92,278
Income taxes	10,744	4,458	—	—	—
<b>Net (loss) income</b>	<b>(9,247)</b>	<b>248,592</b>	<b>180,103</b>	<b>219,507</b>	<b>92,278</b>
Dividends on preferred stock	14,593	7,745	—	—	—
<b>Net (loss) income related to common shareholders</b>	<b>(\$23,840)</b>	<b>\$240,847</b>	<b>\$180,103</b>	<b>\$219,507</b>	<b>\$92,278</b>
Basic net (loss) income per average common share	(\$0.19)	\$2.04	\$1.95	\$2.68	\$2.23
Diluted net (loss) income per average common share	(\$0.19)	\$2.03	\$1.94	\$2.67	\$2.21
Dividends declared per common share	\$1.04	\$1.98	\$1.95	\$2.67	\$1.75
Dividends declared per preferred share	\$1.97	\$1.45	—	—	—
<b>Balance Sheet Data:</b>	<b>December 31, 2005</b>	<b>December 31, 2004</b>	<b>December 31, 2003</b>	<b>December 31, 2002</b>	<b>December 31, 2001</b>
Mortgage-Backed Securities, at fair value	\$15,929,864	\$19,038,386	\$11,956,512	\$11,551,857	\$7,575,379
Agency Debentures, at fair value	—	390,509	978,167	—	—
Total assets	16,063,422	19,560,299	12,990,286	11,659,084	7,717,314
Repurchase agreements	13,576,301	16,707,879	11,012,903	10,163,174	6,367,710
Total liabilities	14,559,399	17,859,829	11,841,066	10,579,018	7,049,957
Stockholders' equity	1,504,023	1,700,470	1,149,220	1,080,066	667,357
Number of common shares outstanding	123,684,931	121,263,000	96,074,096	84,569,206	59,826,975
<b>Other Data:</b>	<b>For the Year Ended December 31, 2005</b>	<b>For the Year Ended December 31, 2004</b>	<b>For the Year Ended December 31, 2003</b>	<b>For the Year Ended December 31, 2002</b>	<b>For the Year Ended December 31, 2001</b>
Average total assets	\$18,724,075	\$17,293,174	\$12,975,039	\$10,486,423	\$5,082,852
Average investment securities	18,543,749	16,399,184	12,007,333	9,575,365	4,682,778
Average borrowings	17,408,828	15,483,118	11,549,368	9,128,933	4,388,900
Average equity	1,614,743	1,550,076	1,122,633	978,107	437,376
Yield on average interest earning assets	3.80%	3.25%	2.81%	4.22%	5.62%
Cost of funds on average interest bearing liabilities	3.27%	1.74%	1.58%	2.10%	3.83%
Interest rate spread	0.53%	1.51%	1.23%	2.12%	1.79%
<b>Financial Ratios:</b>					
Net interest margin (net interest income/average total assets)	0.73%	1.52%	1.20%	2.03%	1.87%
G&A expense as a percentage of average total assets	0.14%	0.14%	0.13%	0.13%	0.14%
G&A expense as a percentage of average equity	1.63%	1.55%	1.45%	1.43%	1.67%
Return on average total assets	(0.05%)	1.44%	1.39%	2.09%	1.82%
Return on average equity	(0.57%)	16.04%	16.04%	22.44%	21.10%

*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.*

## 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, changes in government regulations affecting our business, and our ability to maintain our qualification as a REIT for federal income tax purposes, and risks associated with FIDAC's investment advisory business, including FIDAC's clients' removal of assets FIDAC manages, FIDAC's regulatory requirements, and competition in the investment management business. 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, 2005. 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 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.

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 27% and 29% for the years ended December 31, 2005 and 2004, 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.

During the fourth quarter of 2005, the Company sold assets and began purchasing assets in the current rate environment. With the federal funds interest rate continuing to rise in the fourth quarter of the year, the Company sold lower yielding assets and began replacing them with higher yielding assets. Certain assets that were purchased in the much lower interest rate environment of 2003 and 2004 are unlikely to recover to their amortized cost basis and were not providing attractive returns on a cash flow basis.

We have shortened contractual maturities on borrowings, such that our weighted average contractual maturity on our repurchase agreements was 163 days at December 31, 2005, as compared to 211 days at December 31, 2004. The reason maturities have shortened is because the three year repurchase agreements are closer to maturity date. Additional three year repurchase agreements have not been entered into, due to the level of funding rates being offered.

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



(ratios for the quarters have been annualized, dollars in thousands)	Average Investment Securities Held <sup>(1)</sup>	Total Interest Income	Yield on Average Interest Earning Assets	Average Balance of Repurchase Agreements	Total Interest Expense	Average Cost of Funds	Net Interest Income (loss)	Net Interest Rate Spread
Quarter Ended December 31, 2005	\$17,551,868	\$179,688	4.10%	\$16,547,971	\$165,766	4.01%	\$13,922	0.09%
Quarter Ended September 30, 2005	\$18,906,350	\$177,474	3.75%	\$17,672,690	\$155,043	3.51%	\$22,431	0.24%
Quarter Ended June 30, 2005	\$18,918,577	\$171,595	3.63%	\$17,658,408	\$133,758	3.03%	\$37,837	0.60%
Quarter Ended March 31, 2005	\$18,798,200	\$176,289	3.75%	\$17,756,241	\$113,993	2.57%	\$62,296	1.18%

(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, 2005	28%
September 30, 2005	28%
June 30, 2005	27%
March 31, 2005	25%
December 31, 2004	27%
September 30, 2004	25%
June 30, 2004	33%
March 31, 2004	31%

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.

## 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. 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 \$83.1 million at December 31, 2005. There were no such adjustments for the years ended December 31, 2004 and 2003.

**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.

## RESULTS OF OPERATIONS

### NET INCOME SUMMARY

For the year ended December 31, 2005, our net loss was \$9.2 million or \$0.19 basic loss per average share related to common shareholders, as compared to \$248.6 million net income or \$2.04 basic earnings per average share for the year ended December 31, 2004. For the year ended December 31, 2003, our net income was \$180.1 million or \$1.95 basic earnings per average share related to common shareholders. Net income per average share decreased by \$2.23 and total net income decreased \$257.8 million for the year ended December 31, 2005, when compared to the year ended December 31, 2004. 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 (loss) income summary for the years ended December 31, 2005, 2004 and 2003.

### NET (LOSS) INCOME SUMMARY

(dollars in the thousands, except for per share data)	Year Ended December 31, 2005	Year Ended December 31, 2004	Year Ended December 31, 2003
Interest income	\$705,046	\$532,328	\$337,433
Interest expense	568,560	270,116	182,004
<b>Net interest income</b>	<b>136,486</b>	<b>262,212</b>	<b>155,429</b>
<b>Other (loss) income:</b> Investment advisory and service fees	35,625	12,512	—
(Loss) gain on sale of investment securities	(53,238)	5,215	40,907
Loss on other-than-temporarily impaired securities	(83,098)	—	—
<b>Total other (loss) income</b>	<b>(100,711)</b>	<b>17,727</b>	<b>40,907</b>
<b>Expenses:</b>			
Distribution fees	8,000	2,860	—
General and administrative expenses	26,278	24,029	16,233
<b>Total expenses</b>	<b>34,278</b>	<b>26,889</b>	<b>16,233</b>
Income before income taxes	1,497	253,050	180,103
Income taxes	10,744	4,458	—
<b>Net (loss) income</b>	<b>(9,247)</b>	<b>248,592</b>	<b>180,103</b>
Dividends on preferred stock	14,593	7,745	—
<b>Net (loss) income related to common shareholders</b>	<b>(\$23,840)</b>	<b>\$240,847</b>	<b>\$180,103</b>
Weighted average number of basic common shares outstanding	122,475,032	118,223,330	92,215,352
Weighted average number of diluted common shares outstanding	122,475,032	118,459,145	93,031,253
<b>Basic net (loss) income per average common share</b>	<b>(\$0.19)</b>	<b>\$2.04</b>	<b>\$1.95</b>
<b>Diluted net (loss) income per average common share</b>	<b>(\$0.19)</b>	<b>\$2.03</b>	<b>\$1.94</b>
Average total assets	\$18,724,075	\$17,293,174	\$12,975,039
Average equity	1,614,743	1,550,076	1,122,633
Return on average total assets	(0.05%)	1.44%	1.39%
Return on average equity	(0.57%)	16.04%	16.04%

### INTEREST INCOME AND AVERAGE EARNING ASSET YIELD

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. We had average earning assets of \$12.0 billion for the year ended December 31, 2003. Our primary source of income is interest income. Our interest income was \$705 million for the year ended December 31, 2005, \$532.3 million for the year ended December 31, 2004, and \$337.4 million for the year ended December 31, 2003. The yield on average investment securities was 3.80%, 3.25%, and 2.81% for the respective periods.

### INTEREST EXPENSE AND THE COST OF FUNDS

We anticipate that our largest expense will be the cost of borrowed funds. 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. We had average borrowed funds of \$11.5 billion and total interest expense of \$182.0 million for the year ended December 31, 2003. Our average cost of funds was 3.27% for the year ended December 31, 2005 and 1.74% for the year ended December 31, 2004 and 1.58% for the year December 31, 2003. 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 2004 increased by \$88.1 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 16 basis points and the average borrowed funds increased by \$4.0 billion for the year ended December 31, 2004, when compared to the year ended December 31, 2003. 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 0.06% 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 will continue to experience an increase in funding cost.

The following table 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, 2005, 2004, 2003, 2002, and 2001 and the four quarters in 2005.

#### AVERAGE COST OF FUNDS

(Ratios for the four quarters in 2005 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, 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 Year Ended December 31, 2001	\$4,388,900	\$168,055	3.83%	3.88%	3.73%	0.15%	(0.05%)	0.10%
For the Quarter Ended December 31, 2005	\$16,547,972	\$165,766	4.01%	4.10%	4.46%	(0.36%)	(0.09%)	(0.45%)
For the Quarter Ended September 30, 2005	\$17,672,690	\$155,043	3.51%	3.54%	3.91%	(0.37%)	(0.03%)	(0.40%)
For the Quarter Ended June 30, 2005	\$17,658,408	\$133,758	3.03%	3.05%	3.43%	(0.38%)	(0.02%)	(0.40%)
For the Quarter Ended March 31, 2005	\$17,756,241	\$113,993	2.57%	2.58%	3.02%	(0.44%)	(0.01%)	(0.45%)

#### NET INTEREST INCOME

Our net interest income which equals interest income less interest expense, totaled \$136.5 million for the year ended December 31, 2005, \$262.2 million for the year ended December 31, 2004 and \$155.4 million for the year ended December 31, 2003. Our net interest income decreased because the increase in the cost of funding on our repurchase agreements was only partially offset by the increase in yield on our investment securities. 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 0.53% for the year ended December 31, 2005 as compared to 1.51% for the year ended December 31, 2004. This 98 basis point decrease was the result in the increased funding cost of 153 basis points, offset by the increase in yield of 55 basis points. Our net interest income increased \$106.8 million for the year ended December 31, 2004 over the prior year. Our net interest income increased because of the increase in our assets that resulted from the common stock and preferred stock offerings during 2004.

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, 2005, 2004, 2003, 2002, and 2001 and the four quarters in 2005.

#### NET INTEREST INCOME

(Ratios for the four quarters in 2005 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, 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 Year Ended December 31, 2001	\$4,682,778	\$263,058	5.62%	\$4,388,900	\$168,055	3.83%	\$95,003	1.79%
For the Quarter Ended December 31, 2005	\$17,551,868	\$179,688	4.10%	\$16,547,972	\$165,766	4.01%	\$13,922	0.09%
For the Quarter Ended September 30, 2005	\$18,906,350	\$177,474	3.75%	\$17,672,690	\$155,043	3.51%	\$22,431	0.24%
For the Quarter Ended June 30, 2005	\$18,918,577	\$171,595	3.63%	\$17,658,408	\$133,758	3.03%	\$37,837	0.60%
For the Quarter Ended March 31, 2005	\$18,798,200	\$176,289	3.75%	\$17,756,241	\$113,993	2.57%	\$62,296	1.18%

#### INVESTMENT ADVISORY AND SERVICE FEES

FIDAC is a registered investment advisor that 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, 2005, FIDAC had under management approximately \$2.3 billion in net assets and \$18.7 billion in gross assets, compared to \$1.9 billion in net assets and \$15.9 billion in gross assets at December 31, 2004. Net investment advisory and service fees for the year ended December 31, 2005 totaled \$27.6 million, 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 \$400 million from December 31, 2004 to December 31, 2005, net assets under management began to decline after September 30, 2005 due both to the reduction of their market value and redemptions. In addition, during the first quarter of 2006, FIDAC was notified that an additional \$130 million in

net assets would be removed from its management although FIDAC would continue to receive advisory fees on these assets until June 1, 2006. FIDAC's net advisory fees are included in our consolidated financial statements post our acquisition of FIDAC on June 4, 2004.

#### GAINS AND LOSSES ON SALES OF INVESTMENT SECURITIES

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. For the year ended December 31, 2003, we sold Mortgage-Backed Securities with an aggregate historical amortized cost of \$2.8 billion for an aggregate gain of \$40.9 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. During the year ended December 31, 2003 the amount of sales were higher than in prior years, with the majority of sales occurring during the second quarter. The sales in 2003 occurred because of declining interest rates, which caused fixed rate securities to appreciate significantly and we determined to take advantage of the appreciation. The gain on sale of assets for the year ended December 31, 2004 declined by \$35.7 million over the prior year. The 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.

#### LOSS ON OTHER-THAN-TEMPORARILY IMPAIRED SECURITIES

During the fourth quarter of 2005, in connection with the portfolio rebalancing discussed above, the Company reviewed each of its securities to determine if an other-than-temporary impairment charge would be necessary. It was determined that 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. Approximately \$2.9 billion face amount of securities were reclassified as other-than-temporarily impaired, with an approximate loss of \$83 million.

#### GENERAL AND ADMINISTRATIVE EXPENSES

General and administrative (or G&A) expenses were \$26.3 million for the year ended December 31, 2005, \$24.0 million for the year ended December 31, 2004, \$16.2 million for the year ended December 31, 2003. G&A expenses as a percentage of average total assets was 0.14%, 0.14%, and 0.13% for the years ended December 31, 2005, 2004, and 2003, respectively. The increase in G&A expenses of \$2.3 million for the year December 31, 2005, was primarily the result of increased salaries, directors and officers insurance and additional costs related to FIDAC. Staff increased from 20 at the end of 2003 to 30 at the end of 2004 and 31 at the end of 2005. Salaries and bonuses for the years ended December 31, 2005, 2004, and 2003 were \$18.8 million, \$17.2 million and \$11.5 million. Even with the increased asset base, G&A expense as a percentage of average assets has not increased significantly. The table below shows our total G&A expenses as compared to average total assets and average equity for the years ended December 31, 2005, 2004, 2003, 2002, and 2001, and the four quarters in 2005.

#### G&A EXPENSES AND OPERATING EXPENSE RATIOS

(Ratios for the four quarters in 2005 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, 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 Year Ended December 31, 2001	\$7,311	0.14%	1.67%
For the Quarter Ended December 31, 2005	\$6,359	0.14%	1.66%
For the Quarter Ended September 30, 2005	\$6,455	0.13%	1.58%
For the Quarter Ended June 30, 2005	\$6,800	0.14%	1.64%
For the Quarter Ended March 31, 2005	\$6,664	0.14%	1.61%

#### NET INCOME AND RETURN ON AVERAGE EQUITY

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 and \$180.1 million for the year ended December 31, 2003. Our return on average equity was (0.57%) for the year ended December 31, 2005, 16.04% for the year ended December 31, 2004, and 16.04% for the year ended December 31, 2003. 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 increase in our net income in 2004, from 2003, was the result of us deploying additional capital of approximately \$581.0 million from December 31, 2003 to December 31, 2004 into our strategy. To a lesser extent, the seven months of advisory fee income from FIDAC aided in the income growth for the year 2004.

*The table below shows our net interest income, net investment advisory and service fees, gain on sale of Mortgage-Backed Securities, G&A expenses, loss on other-than-temporarily impaired securities and income taxes each as a percentage of average equity, and the return on average equity for the years ended December 31, 2005, 2004, 2003, 2002, and 2001 and for the four quarters in 2005.*

#### COMPONENTS OF RETURN ON AVERAGE EQUITY

(Ratios for the four quarters in 2005 have been annualized)	Net Interest Income/Average Equity	Net Investment Advisory and Service Fees/ Average Equity	(Loss) gain on Sale of Mortgage- Backed Securities/ Average Equity	Loss on other- than-temporarily impaired securities	G&A Expenses/ Average Equity	Income Taxes/ Average Equity	Return on Average Equity
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 Year Ended December 31, 2001	21.72%	—	1.05%	—	1.67%	—	21.10%
For the Quarter Ended December 31, 2005	3.64%	1.79%	(17.05%)	(21.70%)	1.66%	0.73%	(35.71%)
For the Quarter Ended September 30, 2005	5.50%	2.09%	0.01%	—	1.58%	0.82%	5.20%
For the Quarter Ended June 30, 2005	9.15%	1.82%	2.76%	—	1.64%	0.73%	11.36%
For the Quarter Ended March 31, 2005	15.06%	1.13%	0.14%	—	1.61%	0.38%	14.34%

## FINANCIAL CONDITION

## INVESTMENT SECURITIES

All of our Mortgage-Backed Securities at December 31, 2005, 2004, and 2003 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 an implied "AAA" rating. We mark-to-market all of our earning assets to fair value.

All of our Agency Debentures are callable and carry an implied "AAA" rating. 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, 2005, 2004, and 2003 we had on our balance sheet a total of \$21.5 million, \$1.1 million and \$1.5, 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 \$242.1 million, \$427.0 million and \$301.3

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 \$7.1 billion for the year ended December 31, 2005, \$6.5 billion for the year ended December 31, 2004, and \$8.3 billion for the year ended December 31, 2003. The overall prepayment speed for the year ended December 31, 2005, 2004, and 2003 was 27%, 29%, and 42% respectively. During the year ended December 31, 2005, the CPR declined to 27%, from 29%, due to a decline in refinancing activity. During the year ended December 31, 2003, the annual prepayment speed was the highest in our history at 42%. 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, 2005, 2004, 2003, 2002, and 2001 and September 30, 2005, June 30, 2005, and March 31, 2005.

## INVESTMENT SECURITIES

(dollars in thousands)	Principal Amount	Net Premium	Amortized Cost	Amortized Cost/ Principal Amount	Estimated Fair Value	Estimated Fair Value/ Principal Amount	Weighted Average Yield
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 December 31, 2001	\$7,399,941	\$137,269	\$7,537,210	101.86%	\$7,575,379	102.37%	4.41%
At September 30, 2005	\$18,884,571	\$375,985	\$19,260,557	101.99%	\$18,956,001	101.38%	3.96%
At June 30, 2005	\$19,300,333	\$401,356	\$19,701,690	102.08%	\$19,556,836	101.33%	3.78%
At March 31, 2005	\$18,887,801	\$416,542	\$19,304,343	102.21%	\$19,091,063	101.08%	3.61%

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 Index Level	Weighted Average Net Margin	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, 2005	\$9,699,133	4.76%	3.12%	1.64%	22 months	10.26%	4.74%	60.94%
At December 31, 2004	\$13,544,872	4.23%	2.45%	1.78%	24 months	10.12%	3.24%	70.83%
At December 31, 2003	\$9,294,934	3.85%	2.25%	1.60%	23 months	9.86%	2.47%	73.29%
At December 31, 2002	\$7,007,062	4.10%	2.51%	1.59%	11 months	10.37%	2.33%	62.55%
At December 31, 2001	\$5,793,250	5.90%	3.95%	1.95%	24 months	11.49%	3.87%	78.29%
At September 30, 2005	\$12,437,763	4.56%	2.82%	1.74%	23 months	10.26%	3.91%	65.86%
At June 30, 2005	\$12,934,382	4.43%	2.61%	1.82%	24 months	10.30%	3.69%	67.02%
At March 31, 2005	\$13,464,087	4.29%	2.50%	1.79%	22 months	10.06%	3.46%	71.28%

## FIXED-RATE INVESTMENT SECURITY CHARACTERISTICS

(dollars in thousands)	Principal Amount	Weighted Average Coupon Rate	Weighted Average Asset Yield	Principal Amount as % of Total Investment Securities
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 December 31, 2001	\$1,606,691	6.92%	6.33%	21.71%
At September 30, 2005	\$6,446,808	5.23%	4.06%	34.14%
At June 30, 2005	\$6,365,952	5.22%	3.96%	32.98%
At March 31, 2005	\$5,423,714	5.31%	3.99%	28.72%

At December 31, 2005 and 2004, 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, 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	1-Year Treasury Index	2-Year Treasury Index	3-Year Treasury Index	5-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.	17mo.	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%

## ADJUSTABLE-RATE INVESTMENT SECURITIES BY INDEX—DECEMBER 31, 2004

	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	1-Year Treasury Index	2-Year Treasury Index	3-Year Treasury Index	5-Year Treasury Index	Monthly Federal Cost of Funds
Weighted Average Term to Next Adjustment	1 mo.	27 mo.	34 mo.	2 mo.	1 mo.	0 mo.	5 mo.	3 mo.	25 mo.	10 mo.	17 mo.	31 mo.	0 mo.
Weighted Average Annual Period Cap	8.01%	1.07%	2.18%	1.00%	0.17%	0.82%	2.00%	1.00%	1.86%	2.00%	2.00%	2.00%	2.00%
Weighted Average Lifetime Cap at December 31, 2004	8.88%	9.86%	10.08%	13.03%	10.65%	12.13%	10.58%	11.66%	10.31%	11.92%	12.96%	12.59%	13.39%
Investment Principal Value as Percentage of Investment Securities at December 31, 2004	8.67%	2.50%	22.96%	0.01%	0.22%	0.98%	0.01%	0.05%	34.31%	0.01%	0.25%	0.07%	0.79%

## 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, 2005, we had established uncommitted borrowing facilities in this market with 32 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, 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. For the year ended December 31, 2003, the term to maturity of our borrowings ranged from one day to

three years, with a weighted average original term to maturity of 203 days at December 31, 2003.

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. At December 31, 2003, the weighted average cost of funds for all of our borrowings was 1.51% and the weighted average term to next rate adjustment was 90 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 decreased by \$3.1 billion to \$13.6 billion at December 31, 2005, from \$16.7 billion at December 31, 2004. The decrease in borrowings was the result of lower assets from the sale of securities to facilitate the repositioning of our portfolio and lower borrowing capacity from the decline in equity.

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, 2005, 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, 2005.*

(dollars in thousands)	Within One Year	One to Three Years	Three to Five Years	More than Five Years	Total
Repurchase agreements	\$12,176,301	\$1,400,000	—	—	\$13,576,301
Interest expense on repurchase agreements	76,381	22,250	—	—	98,631
Long-term operating lease obligations	530	1,596	—	—	2,126
Employment contracts	7,106	—	—	—	7,106
<b>Total</b>	<b>\$12,260,318</b>	<b>\$1,423,846</b>	<b>—</b>	<b>—</b>	<b>\$13,684,164</b>

## STOCKHOLDERS' EQUITY

During the year ended December 31, 2005, we declared 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 preferred shareholders totaling \$14.6 million or \$1.97 per share. During the year ended December 31, 2004, we declared and paid dividends to common shareholders totaling \$237.9 million or \$1.98 per share, of which \$60.6 million was paid on January 7, 2005. During the year ended December 31, 2004 we declared and paid dividends to preferred shareholders totaling \$7.7 million or \$1.45 per share. 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.

During the year 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. Also, 24,253 common shares were sold through the dividend reinvestment and direct purchase program for \$440,000 during the year ended December 31, 2005.

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.

FIDAC's shareholders may also receive additional shares of our common stock as an earn-out in 2006 worth up to \$49,500,000 if FIDAC meets specific performance goals under the merger agreement. We cannot calculate how many shares we will issue under the earn-out provisions since that will vary depending upon whether and the extent to which FIDAC achieves specific performance goals. Even if FIDAC achieves specific performance goals for a fiscal year, the number of additional shares to be issued to the FIDAC shareholders will vary depending on our average share price for the first 20 trading days of the following fiscal year.

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 in our portfolio.

### UNREALIZED GAINS AND LOSSES

(dollars in thousands)	At December 31, 2005	At December 31, 2004	At December 31, 2003	At December 31, 2002	At December 31, 2001
Unrealized gain	\$5,027	\$23,021	\$24,886	\$90,507	\$53,935
Unrealized loss	(211,601)	(143,821)	(72,147)	(14,996)	(15,766)
<b>Net unrealized (loss) gain</b>	<b>(\$206,574)</b>	<b>(\$120,800)</b>	<b>(\$47,261)</b>	<b>\$75,511</b>	<b>\$38,169</b>
Net unrealized losses as % of investment securities principal amount	(1.30%)	(0.63%)	(0.37%)	0.67%	0.52%
Net unrealized losses as % of investment securities amortized cost	(1.28%)	(0.62%)	(0.37%)	0.67%	0.51%

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 gains (loss) on available for sale securities was (\$206.6 million), or (1.28%) of the amortized cost of our investment securities as of December 31, 2005, (\$120.8 million), or (0.62%) of the amortized cost of our investment securities as of December 31, 2004 and (\$47.3 million), or (0.37%) of the amortized cost of our investment securities as of December 31, 2003. 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. Mortgage-Backed Securities with a carrying value of \$2.2 billion were in a continuous unrealized loss position over 12 months at December 31, 2004 in the amount of \$34.1 million. Mortgage-

Backed Securities with a carrying value of \$13.1 billion were in a continuous unrealized loss position for less than 12 months at December 31, 2004 in the amount of \$105.3 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. At December 31, 2005, \$2.9 billion in Mortgage-Backed Securities were deemed to be other-than-temporarily impaired, which resulted in a loss of \$83.1 million. At September 30, 2005, our investments that were in a loss position were not considered other-than-temporarily impaired since at the time the Company had the intent 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. With the continued increase in the Federal Funds rate during the quarter, however, management determined during the fourth quarter that it did not intend to hold some of its securities until maturity and would reposition a portion of its assets. 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 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 table below shows our equity capital base as reported and on a historical amortized cost basis at December 31, 2005, 2004, 2003, 2002, and 2001 and September 30, 2005, June 30, 2005 and March 31, 2005. Issuances of common stock, the level of earnings as compared to dividends declared, and other factors influence our historical cost equity capital base. The reported equity capital base is influenced by these factors plus changes in the "Net Unrealized Gains (Losses) on Assets Available for Sale" account.

### STOCKHOLDERS' EQUITY

(dollars in thousands, except per share data)	7.875% Series A Cumulative Redeemable Preferred Stock	Historical Common Stock Equity Base	Net Unrealized Gains (Losses) on Assets Available for Sale	Reported Common Stock Equity Base (Book Value)	Historical Common Stock Equity Per Share	Reported Common Stock Equity (Book Value) Per Share
At December 31, 2005	\$177,088	\$1,534,052	(\$207,117)	\$1,326,935	\$12.40	\$10.73
At December 31, 2004	\$177,077	\$1,644,193	(\$120,800)	\$1,523,393	\$13.56	\$12.56
At December 31, 2003	—	\$1,196,481	(\$47,261)	\$1,149,220	\$12.45	\$11.96
At December 31, 2002	—	\$1,004,555	\$75,511	\$1,080,066	\$11.88	\$12.77
At December 31, 2001	—	\$629,188	\$38,169	\$ 667,357	\$10.52	\$11.15
At September 30, 2005	\$177,088	\$1,686,827	(\$304,555)	\$1,382,272	\$13.64	\$11.18
At June 30, 2005	\$177,088	\$1,668,253	(144,853)	\$1,523,400	\$13.61	\$12.43
At March 31, 2005	\$177,077	\$1,645,579	(\$213,280)	\$1,432,299	\$13.57	\$11.81

### LEVERAGE

Our debt-to-equity ratio at December 31, 2005, 2004, and 2003 was 9.0:1, 9.8:1, and 9.6:1, 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, 2005, we entered into swap agreements with a total notional amount of \$479.0 million. We agree 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.

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, 2005, 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, 2005 and 2004 as compared to the Internal Revenue Code requirement that at least 75% of our total assets be qualified REIT assets. We also calculate that 100% 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, 2005 and 2004. 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, 2005, 2004 and 2003, 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"). If we were to become regulated as an investment company, then our use of leverage would be substantially reduced. The Investment Company Act exempts entities that are "primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" (qualifying interests). Under current interpretation of the staff of the SEC, in order to qualify for this exemption, we must maintain at least 55% of our assets directly in qualifying interests. In addition, unless certain mortgage securities represent all the certificates issued with respect to an underlying pool of mortgages, the mortgage-backed securities may be treated as securities separate from the underlying mortgage loans and, thus, may not be considered qualifying interests for purposes of the 55% requirement. We calculate that as of December 31, 2005, 2004 and 2003 we were in compliance with this requirement.

#### OTHER INFORMATION

The Company has included as exhibits to its annual report on Form 10-K for fiscal year ended 2005 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 in 2005, a certificate of the Company's Chief Executive Officer certifying that he is not aware of any violation by the Company of New York Stock Exchange corporate governance listing standards.

### MANAGEMENT REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING Dated: March 9, 2006

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, 2005. 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 its assessment, the Company's management believes that, as of December 31, 2005, the Company's internal control over financial reporting was effective based on those criteria.



**To the Board of Directors and Stockholders of Annaly Mortgage Management, Inc.**  
New York, New York

We have audited the accompanying consolidated statements of financial condition of Annaly Mortgage Management, Inc. and Subsidiary (the "Company") as of December 31, 2005 and 2004, and the related consolidated statements of operations and comprehensive (loss) income, stockholders' equity, and of cash flows for each of the three years in the period ended December 31, 2005. We also have audited management's assessment, included in the accompanying Management Report On Internal Control Over Financial Reporting dated March 9, 2006, that the Company maintained effective internal control over financial reporting as of December 31, 2005, 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 the Company as of December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, 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, 2005, 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, 2005, based on the criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.



**Deloitte & Touche LLP**  
New York, New York  
March 9, 2006

**CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**  
**December 31, 2005 and 2004**

**ASSETS**

(dollars in thousands, except for share data)

	December 31, 2005	December 31, 2004
Cash and cash equivalents	\$4,808	\$5,853
Mortgage-Backed Securities, at fair value	15,929,864	19,038,386
Agency debentures, at fair value	—	390,509
Receivable for Mortgage-Backed Securities sold	13,449	1,025
Accrued interest receivable	71,340	81,557
Receivable for advisory and service fees	3,497	2,359
Intangible for customer relationships, net	15,183	15,613
Goodwill	23,122	23,122
Other assets	2,159	1,875
<b>Total assets</b>	<b>\$16,063,422</b>	<b>\$19,560,299</b>

**LIABILITIES AND STOCKHOLDERS' EQUITY****LIABILITIES:**

Repurchase agreements	\$13,576,301	\$16,707,879
Payable for Mortgage-Backed Securities purchased	933,051	1,044,683
Accrued interest payable	27,994	35,721
Dividends payable	12,368	60,632
Other liabilities	305	2,819
Accounts payable	8,837	8,095
Interest rate swaps, at fair value	543	—
<b>Total liabilities</b>	<b>14,559,399</b>	<b>17,859,829</b>

**STOCKHOLDERS' EQUITY:**

<b>7.875% Series A Cumulative Redeemable Preferred Stock:</b> 8,000,000 authorized 7,412,500 shares issued and outstanding	177,088	177,077
<b>Common stock:</b> par value \$.01 per share; 500,000,000 authorized, 123,684,931 and 121,263,000 shares issued and outstanding, respectively	1,237	1,213
Additional paid-in capital	1,679,452	1,638,635
Accumulated other comprehensive loss	(207,117)	(120,800)
Retained (deficit) earnings	(146,637)	4,345
Total stockholders' equity	1,504,023	1,700,470
<b>Total liabilities and stockholders' equity</b>	<b>\$16,063,422</b>	<b>\$19,560,299</b>

See notes to financial statements.

## CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE (LOSS) INCOME

Years ended December 31, 2005, 2004 and 2003

(dollars in thousands, except per share amounts)	For the Year Ended December 31, 2005	For the Year Ended December 31, 2004	For the Year Ended December 31, 2003
Interest income	\$705,046	\$532,328	\$337,433
Interest expense	568,560	270,116	182,004
<b>Net interest income</b>	<b>136,486</b>	<b>262,212</b>	<b>155,429</b>
<b>Other (loss) income:</b>			
Investment advisory and service fees	35,625	12,512	—
(Loss) gain on sale of Investment Securities	(53,238)	5,215	40,907
Loss on other than—temporarily impaired securities	(83,098)	—	—
<b>Total other (loss) income</b>	<b>(100,711)</b>	<b>17,727</b>	<b>40,907</b>
<b>Expenses:</b>			
Distribution fees	8,000	2,860	—
General and administrative expenses	26,278	24,029	16,233
<b>Total expenses</b>	<b>34,278</b>	<b>26,889</b>	<b>16,233</b>
Income before income taxes	1,497	253,050	180,103
Income taxes	10,744	4,458	—
Net (loss) income	(9,247)	248,592	180,103
Dividends on preferred stock	14,593	7,745	—
<b>Net (loss) income related to common shareholders</b>	<b>(\$23,840)</b>	<b>\$240,847</b>	<b>\$180,103</b>
<b>Net (loss) income per average common share:</b>			
<b>Basic</b>	<b>(\$0.19)</b>	<b>\$2.04</b>	<b>\$1.95</b>
<b>Diluted</b>	<b>(\$0.19)</b>	<b>\$2.03</b>	<b>\$1.94</b>
<b>Weighted average number of common shares outstanding:</b>			
<b>Basic</b>	<b>122,475,032</b>	<b>118,223,330</b>	<b>92,215,352</b>
<b>Diluted</b>	<b>122,475,032</b>	<b>118,459,145</b>	<b>93,031,253</b>
Net (loss) income	(\$9,247)	\$248,592	\$180,103
<b>Comprehensive (loss) income:</b>			
Unrealized loss on available-for sale securities	(222,110)	(68,324)	(81,865)
Unrealized loss on interest rate swaps	(543)	—	—
Reclassification adjustment for net losses (gains) included in net income or loss	136,336	(5,215)	(40,907)
Other comprehensive loss	(86,317)	(73,539)	(122,772)
<b>Comprehensive (loss) income</b>	<b>(\$95,564)</b>	<b>\$175,053</b>	<b>\$57,331</b>

See notes to financial statements

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

Years ended December 31, 2005, 2004 and 2003

(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
<b>BALANCE, JANUARY 1, 2003</b>		<b>\$846</b>	<b>\$1,003,200</b>	<b>\$75,511</b>	<b>\$509</b>	<b>\$1,080,066</b>
Net Income					180,103	
Other comprehensive loss				(122,772)		
Comprehensive income						57,331
Exercise of stock options		1	913			914
Net proceeds from direct purchase and dividend reinvestment		2	4,199			4,201
Net proceeds from follow-on offering		93	151,222			151,315
Net proceeds from equity shelf program offering		19	34,625			34,644
Common dividends declared, \$1.95 per share					(179,251)	(179,251)
<b>BALANCE, DECEMBER 31, 2003</b>		<b>\$961</b>	<b>\$1,194,159</b>	<b>(\$47,261)</b>	<b>\$1,361</b>	<b>\$1,149,220</b>
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)
<b>BALANCE, DECEMBER 31, 2004</b>	<b>\$177,077</b>	<b>\$1,213</b>	<b>\$1,638,635</b>	<b>(\$120,800)</b>	<b>\$4,345</b>	<b>\$1,700,470</b>
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)
<b>BALANCE, DECEMBER 31, 2005</b>	<b>\$177,088</b>	<b>\$1,237</b>	<b>\$1,679,452</b>	<b>(\$207,117)</b>	<b>(\$146,637)</b>	<b>\$1,504,023</b>

See notes to financial statements



## CONSOLIDATED STATEMENTS OF CASH FLOWS

Years ended December 31, 2005, 2004 and 2003

(dollars in thousands)

	For the Year Ended December 31, 2005	For the Year Ended December 31, 2004	For the Year Ended December 31, 2003
<b>Cash flows from operating activities:</b>			
Net (loss) income	(\$9,247)	\$248,592	\$180,103
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>			
Amortization of Mortgage-Backed Securities premiums and discounts, net	154,309	179,602	216,570
Amortization of intangibles	571	130	—
Loss (gain) on sale of Investment Securities	53,238	(5,215)	(40,907)
Stock option expense	56	317	121
Market value adjustment on long-term repurchase agreement	(2,514)	(1,133)	1,607
Loss on other-than-temporarily impaired securities	83,098	—	—
Decrease (increase) in accrued interest receivable	10,555	(27,964)	(2,833)
Increase in other assets	(425)	(1,749)	(776)
(Increase) decrease in advisory and service fees receivable	(1,138)	(795)	—
(Decrease) increase in accounts payable	(7,727)	20,732	55
Increase in accrued expenses and other liabilities	753	4,400	979
<b>Net cash provided by operating activities</b>	<b>281,529</b>	<b>416,917</b>	<b>354,919</b>
<b>Cash flows from investing activities:</b>			
Purchase of Mortgage-Backed Securities	(7,416,869)	(14,147,323)	(11,404,133)
Purchase of agency debentures	—	(250,000)	(1,735,940)
Proceeds from sale of Investment Securities	3,231,219	596,962	2,899,267
Proceeds from called agency debentures	130,000	845,000	746,000
Principal payments of Mortgage-Backed Securities	7,053,867	6,495,911	8,290,724
Cash from FIDAC acquisition	—	2,526	—
<b>Net cash provided by (used in) investing activities</b>	<b>2,998,217</b>	<b>(6,456,924)</b>	<b>(1,204,082)</b>
<b>Cash flows from financing activities:</b>			
Proceeds from repurchase agreements	245,514,548	152,739,827	117,066,588
Principal payments on repurchase agreements	(248,646,126)	(147,045,071)	(116,217,261)
Proceeds from exercise of stock options	197	539	792
Proceeds from direct purchase and dividend reinvestment	440	2,286	4,201
Net proceeds from follow-on offerings	—	363,592	151,315
Net proceeds from preferred stock offering	—	177,077	—
Net proceeds from equity shelf program	40,148	37,494	34,644
Dividends paid	(189,998)	(230,131)	(191,595)
<b>Net cash (used in) provided by financing activities</b>	<b>(3,280,791)</b>	<b>6,045,613</b>	<b>848,684</b>
Net (decrease) increase in cash and cash equivalents	(1,045)	5,606	(479)
<b>Cash and cash equivalents, beginning of year</b>	<b>5,853</b>	<b>247</b>	<b>726</b>
<b>Cash and cash equivalents, end of year</b>	<b>\$4,808</b>	<b>\$5,853</b>	<b>\$ 247</b>
<b>Supplemental disclosure of cash flow information:</b>			
Interest paid	\$576,287	\$249,384	\$181,949
Taxes paid	\$11,740	\$3,462	—
<b>Noncash financing activities:</b>			
Net change in unrealized loss on available-for-sale securities and interest rate swaps net of reclassification adjustment	(\$86,317)	(\$73,539)	(\$122,772)
Dividends declared, not yet paid	\$12,368	\$60,632	\$45,155
<b>Noncash investing and financing activities:</b>			
Noncash acquisition of FIDAC	—	\$40,500	—

See notes to financial statements.

## 1. ORGANIZATION AND SIGNIFICANT ACCOUNTING POLICIES

Annaly Mortgage Management, Inc. (the "Company") was incorporated in Maryland on November 25, 1996. 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 acquired Fixed Income Discount Advisory Company ("FIDAC") on June 4, 2004 (See Note 2). FIDAC is a registered investment advisor and is a taxable Real Estate Investment Trust ("REIT") subsidiary of the Company.

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

**Basis of Presentation**—The consolidated financial statements as of and for the year ended December 31, 2005 include the accounts of the Company and FIDAC. All material intercompany balances have been eliminated.

**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 \$83.1 million during the year ended December 31, 2005. There were no impairment losses recognized in 2004 and 2003.

SFAS No. 107, *Disclosure About Fair Value of Financial Instruments*, requires disclosure of the fair value of financial instruments for which it is practicable 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 cash and cash equivalents, accrued interest receivable, receivable for securities sold, receivable for advisory and service fees, repurchase agreements, and payable for mortgage-backed securities purchased, dividends payable, accounts payable, and accrued interest payable, generally approximates cost as of December 31, 2005 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 or accreted 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," the change in the fair value of any such derivative is recorded in other comprehensive income or loss for hedges that qualify as effective. The ineffective amount of all Hedging Instruments, if any, is recognized in earnings each quarter. 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 Investment Securities by only purchasing securities issued by FHLMC, FNMA, GNMA or FHLB. 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.

**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.

**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 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.

**Recent Accounting Pronouncements**—In March 2004, the Emerging Issues Task Force, or EITF, reached a consensus on Issue No. 03-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments. This Issue provides clarification with respect to the meaning of other-than-temporary impairment and its application to investments classified as either available-for-sale or held-to-maturity under SFAS No. 115, and investments accounted for under the cost method or the equity method. On November 3, 2005 a FASB Staff Position ("FSP FAS 115-1") was released to address the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. The Company adopted the provisions of FSP 115-1 effective as of December 31, 2005 and recorded a loss on other-than-temporary impaired securities of \$83.1 million consistent with the applications of this guidance.

In May 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections* ("SFAS NO. 154"), which replaces APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statement*. SFAS No. 154 changes the requirements for accounting and reporting a change in accounting principle, and applies to all voluntary changes in accounting principles, as well as changes required by an accounting pronouncement in the unusual instance it does not include specific transition provision. Specifically, SFAS No. 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine the period-specific effects or the cumulative effect of the change. When it is impracticable to determine the effects of the change, the new accounting principle must be applied to the balances of assets and liabilities as of the beginning of the earliest period for which retrospective application

is practicable and a corresponding adjustment must be made to the opening balance of retained earnings for that period rather than being reported in an income statement. When it is impracticable to determine the cumulative effect of the change, the new principle must be applied as if it were adapted prospectively from the earliest date practicable, SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. SFAS No. 154 does not change the transition provisions of any existing pronouncements. The Company has evaluated the impact of SFAS No. 154 and does not expect the adoption of this Statement to have a significant impact on its consolidated statement of operations and comprehensive income or financial condition. The Company will apply SFAS No. 154 in future periods, when applicable.

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (Revised 2004) – *Share-Based Payment* ("SFAS No. 123R"). SFAS 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 recognized based on the fair value of the equity instruments issued. SFAS No. 123R is effective for the Company on January 1, 2006. The Company adopted SFAS No. 123(R), using the modified-prospective transition approach, effective January 1, 2006 with no cumulative effect on net income. The adoption of SFAS No. 123R is not expected to have a significant impact on the Company's financial position and results of operations.

The Company accounts for the share-based payments under the intrinsic value method in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation:

(dollars in thousands, except per share data)	For the year ended December 31, 2005	For the year ended December 31, 2004	For the year ended December 31, 2003
Net (loss) income related to common shareholders, as reported	(\$23,840)	\$240,847	\$180,103
Deduct: Total stock-based employee compensation expense determined under fair value based method	(357)	(149)	(48)
<b>Pro-forma net (loss) income related to common shareholders</b>	<b>(\$24,197)</b>	<b>\$240,698</b>	<b>\$180,055</b>
Net (loss) income per share related to common shareholders, as reported			
<b>Basic</b>	<b>(\$0.19)</b>	<b>\$2.04</b>	<b>\$1.95</b>
<b>Diluted</b>	<b>(\$0.19)</b>	<b>\$2.03</b>	<b>\$1.94</b>
Pro-forma net (loss) income per share related to common shareholders			
<b>Basic</b>	<b>(\$0.20)</b>	<b>\$2.03</b>	<b>\$1.95</b>
<b>Diluted</b>	<b>(\$0.20)</b>	<b>\$2.03</b>	<b>\$1.94</b>

The Emerging Issues Task Force of the FASB is considering placing an item on its agenda relating to the accounting treatment under SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a replacement of FASB Statement 125, 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 the interpretation of SFAS 140, which would require the seller to continue to carry such sold asset on their books based on their "continuing involvement" with such assets. Depending on the ultimate outcome of the EITF 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. If the Company were to change the current accounting treatment for these transactions, total assets and total liabilities would each be reduced by approximately \$1.9 billion.

## 2. FIXED INCOME DISCOUNT ADVISORY COMPANY

On December 31, 2003, the Company entered into a merger agreement with FIDAC. At the annual meeting of the Company's shareholders held on May 27, 2004, shareholders voted to approve the merger. The merger closed before the opening of business on June 4, 2004. The merger was accounted for using the purchase method of accounting in accordance with SFAS No. 141. Accordingly, the consolidated statements of financial condition as of December 31, 2005 and 2004 include the effects of the merger and the Company's application of the purchase method of accounting. Additionally, the consolidated statements of operations and of cash flows for the year ended December 31, 2004 include the consolidated results of the Company and FIDAC for the period from June 4, 2004 to December 31, 2004. The consolidated statements of operation and cash flows for the year ended December 31, 2005 include a full year of results of operations of the Company and FIDAC.

Upon completion of the merger and pursuant to the merger agreement, FDC Merger Sub, ("Merger Sub"), the Company's wholly owned subsidiary created solely for the purpose of effectuating the merger, merged with and into FIDAC. As a result of the merger, Merger Sub ceased to exist, and FIDAC is the surviving corporation and operates as the Company's wholly owned taxable REIT subsidiary. At the time of the merger, each FIDAC shareholder received approximately 2,935 shares of the Company's common stock for each share of FIDAC stock the shareholder owned and has the right to receive additional shares of the Company's common stock in the future, based on FIDAC achieving specific performance goals. FIDAC's shareholders may also receive additional shares of the Company's common stock as an earn-out in 2006 worth up to \$49,500,000 if FIDAC meets specific performance goals under the merger agreement. The Company cannot calculate how many shares the Company will issue under the earn-out provisions since that will vary depending upon whether and the extent to which FIDAC achieves specific performance goals. Even if FIDAC achieves specific performance goals for a fiscal year, the number of additional shares to be issued to the FIDAC shareholders will vary depending on the Company's average share price for the first 20 trading days of the following fiscal year.

The value of the shares of the Company's common stock issued to the FIDAC shareholders immediately upon the consummation of the acquisition was fixed at \$40,500,000 based upon the closing price of the Company's common stock on December 31, 2003, and was paid on June 4, 2004 by delivering 2,201,080 shares of the Company's common stock.

The total amount of goodwill represents the purchase price in excess of the fair value of the net assets acquired. Under SFAS No. 142, Goodwill and Other Intangible Assets, goodwill is not amortized, but tested at least annually for impairment. Certain customer relationships are deemed by the Company to have an indefinite life based on a lack of attrition history and management's expectation of continued service to FIDAC clients and,

accordingly, are not being amortized. Instead, they are required to be tested at least annually for impairment. FIDAC trademark and non-compete agreements are considered intangible assets subject to amortization over their estimated life of three years and one year, respectively. For the years ended December 31, 2005 and 2004, amortization expense related to these intangibles was \$571,000 and \$130,000, respectively. Over the next five years the amortization is expected to be \$2.4 million in total.

*A summary of the fair values of the net assets acquired is as follows:*

(dollars in thousands)

Cash and cash equivalents	\$2,526
Receivable for advisory fees and services	1,564
Other assets	591
Customer relationships	15,613
FIDAC trademark	250
Non-compete agreements	140
Goodwill	22,905
Accounts payable	(748)
<b>Total fair value of net assets, including acquisition cost</b>	<b>\$42,841</b>



**MORTGAGE-BACKED SECURITIES**

The following tables present the Company's available-for-sale Mortgage-Backed Securities portfolio as of December 31, 2005 and 2004:

<b>DECEMBER 31, 2005</b> (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)
<b>Estimated fair value</b>	<b>\$5,700,524</b>	<b>\$9,886,576</b>	<b>\$342,764</b>	<b>\$15,929,864</b>
(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
<b>Total</b>	<b>\$16,136,438</b>	<b>\$5,027</b>	<b>(\$211,601)</b>	<b>\$15,929,864</b>

<b>DECEMBER 31, 2004</b> (dollars in thousands)	Federal Home Loan Mortgage Corporation	Federal National Mortgage Association	Government National Mortgage Association	Total Mortgage-Backed Securities
Mortgage-Backed Securities, gross	\$6,063,131	\$12,061,462	\$604,310	\$18,728,903
Unamortized discount	(171)	(843)	(109)	(1,123)
Unamortized premium	130,211	288,217	8,528	426,956
Amortized cost	6,193,171	12,348,836	612,729	19,154,736
Gross unrealized gains	11,534	9,905	1,582	23,021
Gross unrealized losses	(39,429)	(97,890)	(2,052)	(139,371)
<b>Estimated fair value</b>	<b>\$6,165,276</b>	<b>\$12,260,851</b>	<b>\$612,259</b>	<b>\$19,038,386</b>
(dollars in thousands)	Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Estimated Fair Value
Adjustable rate	\$13,833,122	\$20,713	(\$93,796)	\$13,760,039
Fixed rate	5,321,614	2,308	(45,575)	5,278,347
<b>Total</b>	<b>\$19,154,736</b>	<b>\$23,021</b>	<b>(\$139,371)</b>	<b>\$19,038,386</b>

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, 2005 and 2004 according to their estimated weighted-average life classifications:

	December 31, 2005		December 31, 2004	
Weighted-Average Life (dollars in thousands)	Fair Value	Amortized Cost	Fair Value	Amortized Cost
Less than one year	\$508,851	\$514,560	\$357,135	\$359,433
Greater than one year and less than five years	12,648,106	12,824,736	14,623,143	14,705,212
Greater than or equal to five years	2,772,907	2,797,142	4,058,108	4,090,091
<b>Total</b>	<b>\$15,929,864</b>	<b>\$16,136,438</b>	<b>\$19,038,386</b>	<b>\$19,154,736</b>

The weighted-average lives of the Mortgage-Backed Securities at December 31, 2005 and 2004 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 \$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. Mortgage-Backed Securities with a carrying value of \$2.2 billion were in a continuous unrealized loss position over 12 months at December 31, 2004 in the amount of \$34.1 million. Mortgage-Backed Securities with a carrying value of \$13.1 billion were in a continuous unrealized loss position for less than 12 months at December 31, 2004 in the amount of \$105.3 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. At December 31, 2005, \$2.9 billion in Mortgage-Backed Securities were deemed to be other-than-temporarily impaired, which resulted in an impairment loss of \$83.1 million. At September 30, 2005, the Company's investments that were in a loss position were not considered other-than-temporarily impaired since at the time the Company had the intent 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. With the continued increase in the Federal Funds rate during the fourth quarter, however, management determined during the fourth quarter that it did not intend to hold some of its securities until maturity and would reposition a portion of its assets. 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 10.3% at December 31, 2005 and 10.1% at December 31, 2004.

During the year ended December 31, 2005, the Company realized \$53.2 million in net losses from sales of Investment Securities. During year ended December 31, 2004, the Company realized \$5.2 million in net gains from sales of Mortgage-Backed Securities.

#### 4. AGENCY DEBENTURES

At December 31, 2005, the Company did not own agency debentures. At December 31, 2004 the Company owned callable agency debentures totaling \$395.0 million par value, which were issued by FHLMC, FNMA, and FHLB. All of the Company's agency debentures were classified as available-for-sale. The agency debentures had carrying values of \$390.5 million at December 31, 2004. During the year ended December 31, 2005, the Company realized \$8.3 million in net losses from sales of agency debentures.

#### 5. REPURCHASE AGREEMENTS

The Company had outstanding \$13.6 billion and \$16.7 billion of repurchase agreements with weighted average borrowing rates of 4.16% and 2.46%, and weighted average remaining maturities of 79 days and 111 days as of December 31, 2005 and December 31, 2004, respectively. Investment Securities pledged as collateral under these repurchase agreements had an estimated fair value of \$14.3 billion at December 31, 2005 and \$17.4 billion at December 31, 2004.

At December 31, 2005 and December 31, 2004, the repurchase agreements had the following remaining maturities:

(dollars in thousands)	December 31, 2005	December 31, 2004
Within 30 days	\$10,575,945	\$13,059,810
30 to 59 days	1,250,356	1,598,069
60 to 89 days	-	-
90 to 119 days	-	-
Over 120 days	1,750,000	2,050,000
<b>Total</b>	<b>\$13,576,301</b>	<b>\$16,707,879</b>

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

(dollars in thousands)	Amount at risk <sup>(1)</sup>	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.

#### 6. OTHER LIABILITIES

In 2001, the Company entered into a repurchase agreement with an original maturity in July 2004. This repurchase agreement provided the buyer with the right to extend its maturity date, in whole or in part, in three-month increments up to July 2006. The buyer has continuously exercised its right to extend the maturity date, and the agreement is currently set to mature in July 2006. The repurchase agreement has a principal amount of \$100,000,000, and is included in repurchase agreements in the consolidated statements of financial condition. The Company accounts for the extension option as a separate interest rate floor liability carried at fair value. The initial fair value of \$1.2 million allocated to the extension option resulted in a similar discount on the repurchase agreement borrowings that was amortized over the initial term of three years using the effective yield method. At December 31, 2005 and December 31, 2004, the fair value of this interest rate floor was \$149,000 and \$2.7 million, respectively, and is included in other liabilities in the consolidated statements of financial condition. The amount of change in fair value of this interest rate floor has been recorded in the consolidated statement of operations and comprehensive (loss) income in the interest expense balance.

#### 7. PREFERRED STOCK AND COMMON STOCK

During the year ended December 31, 2005, the Company declared dividends to common shareholders totaling \$127.1 million or \$1.04 per share, of which \$12.4 million were paid on January 27, 2006. During the year ended December 31, 2005, 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, the Company declared dividends to common shareholders totaling \$237.9 million or \$1.98 per share, of which \$60.6 million were paid on January 27, 2005. During the year ended December 31, 2004, the Company declared and paid dividends to preferred shareholders totaling \$7.7 million or \$1.45 per share. 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.

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 April 1, 2003, the Company entered into an underwriting agreement pursuant to which the Company raised net proceeds of approximately \$151.3 million in equity in an offering of 9,300,700 shares of common stock. During the year ended December 31, 2003, 1,879,600 shares were issued through the Equity Shelf Program, totaling net proceeds of \$34.6 million. During the year ended December 31, 2003, 92,697 options were exercised under the long-term compensation plan at \$914,000. Also, 231,893 shares were purchased in the dividend reinvestment and direct purchase program at \$4.2 million.

## 8. NET (LOSS) INCOME PER COMMON SHARE

The following table presents a reconciliation of the net (loss) income and shares used in calculating basic and diluted earnings per share for the years ended December 31, 2005, 2004 and 2003.

For the years ended	December 31, 2005	December 31, 2004	December 31, 2003
Net (loss) income	(\$9,247)	\$248,592	\$180,103
Less: Preferred stock dividends	14,593	7,745	—
<b>Net (loss) income related to common Shareholders</b>	<b>(\$23,840)</b>	<b>\$240,847</b>	<b>\$180,103</b>
Weighted average shares of common stock outstanding-basic	122,475	118,223	92,215
Add: Effect of dilutive stock options	—	236	816
<b>Weighted average shares of common stock outstanding-diluted</b>	<b>122,475</b>	<b>118,459</b>	<b>93,031</b>

Because the Company had a net loss related to common shareholders, 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.

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, 2003.

## 9. 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.

The following table sets forth activity relating to the Company's stock options awards:

For the years ended	December 31, 2005		December 31, 2004		December 31, 2003	
	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	1,645,721	\$15.66	1,063,259	\$14.28	512,706	\$8.59
Granted	737,750	17.08	639,750	17.39	643,450	18.00
Exercised	(16,128)	12.21	(57,288)	9.40	(92,697)	8.54
Expired	(33,750)	17.87	-	-	(200)	17.97
<b>Options outstanding at the end of year</b>	<b>2,333,593</b>	<b>\$16.10</b>	<b>1,645,721</b>	<b>\$15.66</b>	<b>1,063,259</b>	<b>\$14.28</b>

The following table summarizes information about stock options outstanding at December 31, 2005:

Range of Exercise Prices	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
\$7.94—\$19.99	2,323,593	\$16.08	7.76
\$20.00—\$29.99	10,000	20.53	1.99
	<b>2,333,593</b>	<b>\$16.10</b>	<b>7.74</b>

## 10. 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, 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. The effective tax rate was 47% for the year ended December 31, 2005.

During the year ended December 31, 2004, the Company recorded \$4.5 million of income tax expense for income attributable to taxable REIT subsidiary and the portion of earnings retained based on Code Section 162(m) limitations. The Company's effective tax rate was 45% for the year ended December 31, 2004. Such rate differed from the federal statutory rate as a result of state and local taxes and permanent difference pertaining to employee remuneration as discussed above. During the years ended December 31, 2003, 100% of the taxable income of the Company was distributed and as a result, the Company was not subject to income taxes.

## 11. 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 \$573,000, \$591,000, and \$612,000 for the years ended December 31, 2005, 2004 and 2003, respectively. The expense was net of sub-lease payments received of \$84,000 and \$7,000 for the years ended December 31, 2005 and 2004, respectively.

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

(dollars in thousands)	Total per Year
2006	\$530
2007	532
2008	532
2009	532
<b>Total remaining lease payments</b>	<b>\$2,126</b>

## 12. 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, 2005, the Company entered into interest rate swaps to pay a fixed rate and receive a floating rate of interest, with total notion amount of \$479.0 million.

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.

## 13. CONTINGENCIES

From time to time, we are 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 our consolidated financial statements



**14. SUMMARIZED QUARTERLY RESULTS (UNAUDITED)**

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
<b>Net interest income</b>	<b>62,296</b>	<b>37,837</b>	<b>22,431</b>	<b>13,922</b>
<b>Other (loss) income</b>				
Investment advisory and service fees	6,309	9,669	10,945	8,702
Gain (loss) on sale of Mortgage-Backed Securities	580	11,435	32	(65,285)
Loss on other-than-temporarily impaired securities	—	—	—	(83,098)
<b>Total other (loss) income</b>	<b>6,889</b>	<b>21,104</b>	<b>10,977</b>	<b>(139,681)</b>
<b>Expenses:</b>				
Distribution fees	1,610	2,126	2,414	1,850
General and administrative expenses	6,664	6,800	6,455	6,359
<b>Total expenses</b>	<b>8,274</b>	<b>8,926</b>	<b>8,869</b>	<b>8,209</b>
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
<b>Net income (loss) related to common shareholders</b>	<b>\$55,685</b>	<b>\$43,345</b>	<b>\$17,538</b>	<b>(\$140,408)</b>
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 (loss) per average common share:				
<b>Basic</b>	<b>\$0.46</b>	<b>\$0.36</b>	<b>\$0.14</b>	<b>(\$1.14)</b>
<b>Diluted</b>	<b>\$0.46</b>	<b>\$0.36</b>	<b>\$0.14</b>	<b>(\$1.14)</b>

The following is a presentation of the quarterly results of operations for the year ended **December 31, 2004**.

(dollars in thousands, except per share data)

	March 31, 2004	June 30, 2004	September 30, 2004	December 31, 2004
Interest income	\$114,341	\$122,234	\$138,970	\$156,783
Interest expense	50,303	55,648	70,173	93,992
<b>Net interest income</b>	<b>64,038</b>	<b>66,586</b>	<b>68,797</b>	<b>62,791</b>
<b>Other income</b>				
Investment advisory and service fees	—	1,260	4,811	6,143
Gain on sale of Mortgage-Backed Securities	595	2,126	1,350	1,144
<b>Total other income</b>	<b>595</b>	<b>3,386</b>	<b>6,161</b>	<b>7,287</b>
<b>Expenses:</b>				
Distribution Fees	—	298	1,024	1,538
General and administrative expenses	5,790	5,643	6,159	6,862
<b>Total expenses</b>	<b>5,790</b>	<b>5,941</b>	<b>7,183</b>	<b>8,400</b>
Income before income taxes	58,843	64,031	67,775	61,678
Income taxes	—	494	1,155	2,384
<b>Net income</b>	<b>58,843</b>	<b>63,537</b>	<b>66,620</b>	<b>59,294</b>
Dividends on preferred stock	—	1,998	2,082	3,665
<b>Net income available to common shareholders</b>	<b>\$58,843</b>	<b>\$61,539</b>	<b>\$64,538</b>	<b>\$55,629</b>
Weighted average number of basic common shares outstanding	112,506,206	118,276,509	120,802,814	121,246,246
Weighted average number of diluted common shares outstanding	112,804,001	118,469,756	120,994,191	121,514,941
Net income per share available to common shareholders:				
<b>Basic</b>	<b>\$0.52</b>	<b>\$0.52</b>	<b>\$0.53</b>	<b>\$0.46</b>
<b>Diluted</b>	<b>\$0.52</b>	<b>\$0.52</b>	<b>\$0.53</b>	<b>\$0.46</b>

## COMMON STOCK AND MARKET INFORMATION

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, 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

	HIGH	LOW	CLOSE
First Quarter ended March 31, 2004	\$21.22	\$18.15	\$18.02
Second Quarter ended June 30, 2004	\$19.63	\$15.94	\$16.09
Third Quarter ended September 30, 2004	\$18.44	\$15.95	\$16.71
Fourth Quarter ended December 31, 2004	\$20.53	\$16.33	\$19.62

	Common Dividends Declared Per Share
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

	Common Dividends Declared Per Share
First Quarter ended March 31, 2004	\$0.50
Second Quarter ended June 30, 2004	\$0.48
Third Quarter ended September 30, 2004	\$0.50
Fourth Quarter ended December 31, 2004	\$0.50

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" in our 2005 Form 10-K. 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, 2005, 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*

**Jeremy Diamond**

*Managing Director*

**Ronald D. Kazel**

*Managing Director*

**James P. Fortescue**

*Senior Vice President*

**Kristopher Konrad**

*Senior Vice President*

**Rose-Marie Lyght**

*Senior Vice President*

**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*

**Donald A. Segalas**

*President  
Pinnacle Asset  
Management, L.P.*

**CORPORATE HEADQUARTERS****Annaly Mortgage Management, Inc.**

1211 Avenue of the Americas, Suite 2902  
New York, New York 10036

**LEGAL COUNSEL****McKee Nelson LLP**

1919 M. Street, NW  
Suite 800  
Washington, D.C. 20036

**AUDITORS****Deloitte & Touche LLP**

Two World Financial Center  
New York, New York 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, New Jersey  
07606-1163

[www.melloninvestor.com/isd](http://www.melloninvestor.com/isd)

**STOCK EXCHANGE LISTING**

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

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

**ANNUAL MEETING**

The Annual Meeting of the Stockholders will be  
held Thursday, May 25, 2006 at 9:30 a.m. at:

**New York Marriott Marquis**

1535 Broadway  
New York, New York 10036

**SHAREHOLDER COMMUNICATIONS**

Copies of the Company's Annual Report and  
2005 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](http://www.annaly.com)**.



# 2005 Annual Report

**Annaly Mortgage Management, Inc.**  
1211 Avenue of the Americas, Suite 2902  
New York, New York 10036

1-888-8ANNALY  
[WWW.ANNALY.COM](http://WWW.ANNALY.COM)