ANWORTH MORTGAGE ASSET CORP
Form 10-K
March 16, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

OR

¨ **TRANSACTION REPORT PURSUANT TO SECTION 13 OR 15 OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER 001-13709

ANWORTH MORTGAGE ASSET CORPORATION

(Exact Name of Registrant as Specified in Its Charter)

MARYLAND	**52-2059785**
(State or Other Jurisdiction of Incorporation Organization)	**(I.R.S. Employer Identification No.)**
1299 OCEAN AVENUE, 2ND FLOOR, SANTA MONICA, CALIFORNIA	**90401**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s telephone number, including area code: (310) 255-4493

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Exchange on Which Registered
Series A Cumulative Preferred Stock, $0.01 Par Value	**New York Stock Exchange**
Series B Cumulative Convertible Preferred Stock, $0.01 Par Value	**New York Stock Exchange**
Common Stock, $0.01 Par Value	**New York Stock Exchange**

Securities registered pursuant to Section 12(g) of the Act: NONE

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 of Section 15(d) of the Act. Yes ¨ No x

Indicate by check mark whether the registrant is a well-known seasoned issuer as defined in Rule 405 of the Act. Yes ¨ No x

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

Indicate by check mark that disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (check one):

Large Accelerated Filer ¨ Accelerated Filer x Non-Accelerated Filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes ¨ No x

The aggregate market value of the voting stock held by non-affiliates of the registrant, computed by reference to the average closing bid and asked prices of such stock as of June 30, 2006 was approximately $425,933,049 (All officers and directors of the registrant are considered affiliates).

At March 9, 2007, the registrant had 1,875,500 shares of Series A Cumulative Preferred Stock issued and outstanding; 1,150,000 shares of Series B Cumulative Convertible Preferred Stock issued and outstanding; and 45,615,669 shares of Common Stock issued and outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III of the Form 10-K incorporates by reference certain portions of the registrant s proxy statement for its 2007 annual meeting of stockholders to be filed with the Commission not later than 120 days after the end of the fiscal year covered by this report.

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ANWORTH MORTGAGE ASSET CORPORATION

FORM 10-K ANNUAL REPORT

FISCAL YEAR ENDED DECEMBER 31, 2006

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CAUTIONARY STATEMENT

This Annual Report on Form 10-K contains or incorporates by reference certain forward-looking statements. Forward-looking statements are those that predict or describe future events or trends and that do not relate solely to historical matters. You can generally identify forward-looking statements as statements containing the words will, believe, expect, anticipate, intend, estimate, assume or other simil expressions. You should not rely on our forward-looking statements because the matters they describe are subject to known and unknown risks, uncertainties and other unpredictable factors, many of which are beyond our control. These forward-looking statements are subject to assumptions that are difficult to predict and to various risks and uncertainties. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors, some of which are listed under the section Risk Factors at the end of Item 1A of this Annual Report on Form 10-K. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

As used in this Annual Report on Form 10-K, company, we, us, our and Anworth refer to Anworth Mortgage Asset Corporation.

PART I

Item 1. BUSINESS

Overview

We were incorporated in Maryland on October 20, 1997 and commenced our operations on March 17, 1998. We are in the business of investing primarily in United States agency and other highly rated single-family adjustable-rate and fixed-rate mortgage-backed securities, or MBS, and residential mortgage loans that we acquire in the secondary market. United States agency securities are securities that are obligations guaranteed by the United States government or its sponsored enterprises such as Fannie Mae (FNM), Freddie Mac (FHLMC) or Ginnie Mae (GNMA). We seek attractive long-term investment returns by investing our equity capital and borrowed funds in such securities and other mortgage-related assets. Our returns are principally earned on the spread between the yield on our interest-earning assets and the interest cost of the funds we borrow.

On November 3, 2003, we formed our wholly-owned subsidiary, Belvedere Trust Mortgage Corporation, or Belvedere Trust. Belvedere Trust acquires high credit-quality jumbo adjustable-rate and hybrid first-lien mortgage loans and other mortgage-related assets, securitizes a substantial amount of those mortgage loans and then retains a portion of the MBS while selling the balance to third parties in the secondary market. Belvedere Trust is externally managed by BT Management Company, L.L.C., or BT Management, a Delaware limited liability company that is owned 50% by Anworth, 45% by the executive officers of Belvedere Trust and 5% by Lloyd McAdams, our Chairman, President and Chief Executive Officer. BT Management manages Belvedere Trust through a management agreement with Belvedere Trust pursuant to which BT Management manages the day-to-day operations of Belvedere Trust in exchange for an annual base management fee and a quarterly incentive fee.

Our investments consist of the following portfolios: Agency mortgage-backed securities, or Agency MBS; Non-Agency mortgage-backed securities, or Non-Agency MBS; Belvedere Trust s residential real estate loans, or BT Residential Loans; and Belvedere Trust s Other mortgage-backed securities, or BT Other MBS.

At December 31, 2006, we had total assets of $6.7 billion. Agency MBS portfolio, consisting of $4.7 billion, was distributed as follows: 26% agency adjustable-rate MBS; 58% agency hybrid adjustable-rate MBS; 16% agency fixed-rate MBS; and less than 1% agency floating-rate collateralized mortgage obligations, or CMOs. Non-Agency MBS portfolio consisted of $107 million of floating-rate CMOs. BT Other MBS held at December 31, 2006 were approximately $163 million. Belvedere Trust had no mortgage loans held for

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securitization at December 31, 2006. Securitized mortgage loans were $1.7 billion. At December 31, 2006, Belvedere Trust s assets comprised 28% of our overall assets, or approximately $1.9 billion in mortgage-related assets. Total equity at December 31, 2006 was $491 million. Common stockholders equity was approximately $444 million, or $9.74 per share. For the year ended December 31, 2006, we reported a net loss of $14.2 million. Net loss to common stockholders was $18.2 million, or a net loss of $(0.40) per diluted share. This includes a net loss of $7.6 million on the sale of securities during 2006 and a net loss of $2.7 million for Belvedere Trust.

We have elected to be taxed as a real estate investment trust, or REIT, under the United States Internal Revenue Code of 1986, as amended, or the Code. As a REIT, we routinely distribute substantially all of the income generated from our operations to our stockholders. As long as we retain our REIT status, we generally will not be subject to federal or state taxes on our income to the extent that we distribute our net income to our stockholders. Certain direct and indirect subsidiaries of Belvedere Trust are taxable REIT subsidiaries and, as such, are liable for corporate income tax expenses.

Our Strategy

Investment Strategy

Our strategy is to invest primarily in United States agency and other highly rated single-family adjustable-rate and fixed-rate MBS, high quality residential real estate loans and other mortgage-related assets. We seek to acquire assets that will produce competitive returns after considering the amount and nature of the investment s anticipated returns, our ability to pledge the investment to secure collateralized borrowings and the costs associated with financing, managing, securitizing and reserving for these investments. We do not currently originate mortgage loans or provide other types of financing to the owners of real estate. Mortgage loans may be purchased directly from originators or from various suppliers of mortgage-related assets throughout the United States including savings and loans associations, banks, mortgage bankers and other mortgage lenders.

Financing Strategy

We primarily finance the acquisition of MBS with short-term borrowings and, to a lesser extent, equity capital. We employ short-term borrowing to attempt to increase potential returns to our stockholders. Pursuant to our Capital and Leverage Policy, we seek to strike a balance between the under-utilization of leverage, which reduces potential returns to stockholders, and the over-utilization of leverage, which could reduce our ability to meet our obligations during adverse market conditions.

We usually borrow at short-term rates using repurchase agreements. Repurchase agreements are generally short-term in nature with a maximum term of typically two years. We actively manage the adjustment periods and the selection of the interest rate indices of our borrowings against the adjustment periods and the selection of indices on our mortgage-related assets in order to lessen the liquidity and interest rate-related risks. We generally seek to diversify our exposure by entering into repurchase agreements with multiple lenders which we believe are financially sound and are approved by our board of directors.

Belvedere Trust primarily finances its acquisition of residential real estate loans by issuing pass-through long-term debt through securitizations. The interest rates on the long-term debt are variable and are based either upon the interest rates on the underlying loan collateral or upon the London Interbank Offered Rate, or LIBOR. The maturities on the long-term debt are also based upon the maturities of the underlying mortgages. In addition, Belvedere Trust enters into whole loan financing facilities to finance its residential real estate loan acquisitions prior to securitization. The whole loan financing facilities are short-term borrowings that are secured by the loans.

Growth Strategy

It is our long-term objective to further grow our earnings and our dividends per common share using various strategies which may include the following:

- decreasing the ratio of operating expenses to stockholder equity by increasing the amount of our stockholder equity at a rate faster than the rate of increase in our operating expenses;
- issuing additional common shares when the net proceeds will materially increase the paid-in capital per share and the book value per share;
- repurchasing outstanding common shares when the net cost will materially increase the paid-in capital per share and the book value per share; and
- lowering our effective borrowing costs over time by seeking direct funding with collateralized lenders rather than using financial intermediaries and possibly using commercial paper, medium-term note programs, preferred stock and other forms of capital.

Our Operating Policies and Programs

We have established the following four primary operating policies to implement our business strategies:

- our Asset Acquisition Policy;
- our Capital and Leverage Policy;
- our Credit Risk Management Policy; and
- our Asset/Liability Management Policy.

Asset Acquisition Policy

Our Asset Acquisition Policy provides guidelines for acquiring investments and contemplates that we will acquire a portfolio of investments that can be grouped into specific categories. Each category and our respective investment guidelines are as follows:

- *Category I* At least 60% of our total assets will generally be adjustable- or fixed-rate MBS and short-term investments. Assets in this category will be rated within one of the two highest rating categories by at least one nationally recognized statistical rating organization or, if not rated, will be obligations guaranteed by the United States government or its agencies, such as Fannie Mae or Freddie Mac. Also included in Category I are the portion of real estate mortgage loans that have been deposited into a trust and have received a rating within one of the two highest rating categories by at least one nationally recognized statistical rating organization.
- *Category II* At least 90% of our total assets will generally consist of Category I investments plus unsecuritized mortgage loans, mortgage securities rated at least investment grade by at least one nationally recognized statistical rating organization, or shares of

other REITs or mortgage-related companies and the portion of real estate mortgage loans that have been deposited into a trust and have received an investment grade rating by at least one nationally recognized statistical rating organization.

Category III No more than 10% of our total assets may be of a type not meeting any of the above criteria. Among the types of assets generally assigned to this category are mortgage securities rated below investment grade and leveraged mortgage derivative securities. Under our Category III investment criteria, we may acquire other types of mortgage derivative securities including, but not limited to, interest-only, principal-only or other types of MBS that receive a disproportionate share of interest income or principal.

Capital and Leverage Policy

We employ a leverage strategy to increase our investment assets by borrowing against existing mortgage-related assets and using the proceeds to acquire additional mortgage-related assets. Relative to our investment in investment grade Agency and Non-Agency MBS, we generally borrow, on a short-term basis, between eight to twelve times the amount of our equity allocated to these investments. Our borrowings may vary from time to time depending on market conditions and other factors deemed relevant by our management and our board of directors. We believe that this will leave an adequate capital base to protect against interest rate environments in which our borrowing costs might exceed our interest income from mortgage-related assets. We enter into collateralized borrowings with major lending institutions which we believe are financially sound and are approved by our board of directors.

Depending on the different costs of borrowing funds at different maturities, we may vary the maturities of our borrowed funds in an attempt to produce lower borrowing costs. Our borrowings are short-term and we manage actively, on an aggregate basis, both the interest rate indices and interest rate adjustment periods of our borrowings against the interest rate indices and interest rate adjustment periods on our mortgage-related assets.

Our mortgage-related assets are financed primarily at short-term borrowing rates through repurchase agreements and dollar-roll agreements. In the future, we may also employ borrowings under lines of credit and other collateralized financings that we may establish with approved institutional lenders.

Belvedere Trust principally employs securitization to finance its ownership of residential real estate loans.

Credit Risk Management Policy

We review credit risk and other risks of loss associated with each of our potential investments. In addition, we may diversify our portfolio of mortgage-related assets to avoid undue geographic, insurer, industry and certain other types of concentrations. We may reduce certain risks from sellers and servicers through representations and warranties. Our board of directors monitors the overall portfolio risk and determines appropriate levels of provision for losses.

Compliance with our Credit Risk Management Policy guidelines is determined at the time of purchase of mortgage assets based upon the most recent valuation utilized by us. Such compliance is not affected by events subsequent to such purchase including, without limitation, changes in characterization, value or rating of any specific mortgage assets or economic conditions or events generally affecting any mortgage-related assets of the type held by us or Belvedere Trust.

Asset/Liability Management Policy

Interest Rate Risk Management. To the extent consistent with our election to qualify as a REIT, we follow an interest rate risk management program intended to protect our portfolio of mortgage-related assets and related debt against the effects of major interest rate changes. Specifically, our interest rate management program is formulated with the intent to offset, to some extent, the potential adverse effects resulting from rate adjustment limitations on our mortgage-related assets and the differences between interest rate adjustment indices and interest rate adjustment periods of our adjustable-rate mortgage-related assets and related borrowings.

Our interest rate risk management program encompasses a number of procedures including the following:

- monitoring and adjusting, if necessary, the interest rate sensitivity of our mortgage-related assets compared with the interest rate sensitivities of our borrowings;

- attempting to structure our borrowing agreements relating to adjustable-rate mortgage-related assets to have a range of different maturities and interest rate adjustment periods (although substantially all will be less than one year); and

actively managing, on an aggregate basis, the interest rate indices and interest rate adjustment periods of our mortgage-related assets compared to the interest rate indices and adjustment periods of our borrowings.

We expect to be able to adjust the average maturity/adjustment period of our borrowings on an ongoing basis by changing the mix of maturities and interest rate adjustment periods as borrowings come due or are renewed. Through the use of these procedures, we attempt to reduce the risk of differences between interest rate adjustment periods of our adjustable-rate mortgage-related assets and our related borrowings.

Depending on market conditions and the cost of the transactions, we may conduct certain hedging activities in connection with the management of our portfolio. To the extent consistent with our election to qualify as a REIT, we may adopt a hedging strategy intended to lessen the effects of interest rate changes and to enable us to earn net interest income in periods of generally rising, as well as declining or static, interest rates. Specifically, hedging programs are formulated with the intent to offset some of the potential adverse effects of changes in interest rate levels relative to the interest rates on the mortgage-related assets held in our investment portfolio and differences between the interest rate adjustment indices and periods of our mortgage-related assets and our borrowings. We monitor carefully, and may have to limit, our asset/liability management program to assure that we do not realize excessive hedging income or hold hedges having excess value in relation to mortgage-related assets, which could result in our disqualification as a REIT or, in the case of excess hedging income, if the excess is due to reasonable cause and not willful neglect, the payment of a penalty tax for failure to satisfy certain REIT income tests under the Code. In addition, asset/liability management involves transaction costs that increase dramatically as the period covered by hedging protection increases and that may increase during periods of fluctuating interest rates.

Prepayment Risk Management.   We also seek to lessen the effects of prepayment of mortgage loans underlying our securities at a faster or slower rate than anticipated. We accomplish this by structuring a diversified portfolio with a variety of prepayment characteristics, investing in mortgage-related assets with prepayment prohibitions and penalties, investing in certain mortgage security structures that have prepayment protections and purchasing mortgage-related assets at a premium or at a discount. We invest in mortgage-related assets that, on a portfolio basis, do not have significant purchase price premiums. Under normal market conditions, we seek to maintain the aggregate capitalized purchase premium of the portfolio at 3% or less. In addition, we can purchase principal-only derivatives to a limited extent as a hedge against prepayment risks. We monitor prepayment risk through periodic review of the impact of a variety of prepayment scenarios on our revenues, net earnings, dividends, cash flow and net consolidated balance sheets market value.

We believe that we have developed cost-effective asset/liability management policies to mitigate prepayment risks. However, no strategy can completely insulate us from prepayment risks. Further, as noted above, certain of the federal income tax requirements that we must satisfy to qualify as a REIT limit our ability to fully hedge our prepayment risks. Therefore, we could be prevented from effectively hedging our interest rate and prepayment risks.

Our Investments

Mortgage-Backed Securities (MBS)

Pass-Through Certificates.   We principally invest in pass-through certificates, which are securities representing interests in pools of mortgage loans secured by residential real property in which payments of both interest and principal on the securities are generally made monthly, in effect, passing through monthly payments made by the individual borrowers on the mortgage loans which underlie the securities, net of fees paid to the issuer or guarantor of the securities. Early repayment of principal on some MBS, arising from prepayments of principal due to sale of the underlying property, refinancing or foreclosure, net of fees and costs which may be incurred, may expose us to a lower rate of return upon reinvestment of principal. This is generally referred to as

prepayment risk. Additionally, if a security subject to prepayment has been purchased at a premium, the unamortized value of the premium would be lost in the event of prepayment.

Like other fixed-income securities, when interest rates rise, the value of a mortgage-backed security generally will decline. When interest rates are declining, however, the value of MBS with prepayment features may not increase as much as other fixed-income securities. The rate of prepayments on underlying mortgages will affect the price and volatility of MBS and may have the effect of shortening or extending the effective maturity of the security beyond what was anticipated at the time of purchase. When interest rates rise, our holdings of MBS may experience reduced returns if the owners of the underlying mortgages pay off their mortgages later than anticipated. This is generally referred to as extension risk.

Payment of principal and interest on some mortgage pass-through securities, though not the market value of the securities themselves, may be guaranteed by the full faith and credit of the federal government, including securities backed by Ginnie Mae, or by agencies or instrumentalities of the federal government, including Fannie Mae and Freddie Mac. MBS created by non-governmental issuers, including commercial banks, savings and loan institutions, private mortgage insurance companies, mortgage bankers and other secondary market issuers, may be supported by various forms of insurance or guarantees including individual loan, title, pool and hazard insurance and letters of credit which may be issued by governmental entities, private insurers or the mortgage poolers.

Collateralized Mortgage Obligations. CMOs are MBS. Interest and principal on a CMO are paid, in most cases, on a monthly basis. CMOs may be collateralized by whole mortgage loans, but are more typically collateralized by portfolios of mortgage pass-through securities. CMOs are structured into multiple classes with each class bearing a different stated maturity. Monthly payments of principal, including prepayments, are first returned to investors holding the shortest maturity class; investors holding the longer maturity classes receive principal only after the first class has been retired. We will typically consider CMOs that are issued or guaranteed by the federal government, or by any of its agencies or instrumentalities, to be United States government securities.

Other Types of MBS

Mortgage Derivative Securities. We may acquire mortgage derivative securities in an amount not to exceed 10% of our total assets. Mortgage derivative securities provide for the holder to receive interest-only, principal-only or interest and principal in amounts that are disproportionate to those payable on the underlying mortgage loans. Payments on mortgage derivative securities are highly sensitive to the rate of prepayments on the underlying mortgage loans. In the event of faster or slower than anticipated prepayments on these mortgage loans, the rates of return on interests in mortgage derivative securities, representing the right to receive interest-only or a disproportionately large amount of interest or interest-only derivatives, would be likely to decline or increase, respectively. Conversely, the rates of return on mortgage derivative securities, representing the right to receive principal-only or a disproportionate amount of principal or principal-only derivatives, would be likely to increase or decrease in the event of faster or slower prepayments, respectively.

We may invest in inverse floaters, a class of CMOs with a coupon rate that resets in the opposite direction from the market rate of interest to which it is indexed, including LIBOR or the 11th District Cost of Funds Index, or COFI. Any rise in the index rate, which can be caused by an increase in interest rates, causes a drop in the coupon rate of an inverse floater, while any drop in the index rate causes an increase in the coupon of an inverse floater. An inverse floater may behave like a leveraged security since its interest rate usually varies by a magnitude much greater than the magnitude of the index rate of interest. The leverage-like characteristics inherent in inverse floaters result in a greater volatility of their market prices.

We may invest in other mortgage derivative securities that may be developed in the future.

Subordinated Interests. We may acquire subordinated interests, which are classes of MBS that are junior to other classes of the same series of MBS in the right to receive payments from the underlying mortgage loans. The subordination may be for all payment failures on the mortgage loans securing or underlying such series of mortgage securities. The subordination will not be limited to those resulting from particular types of risks, including those resulting from war, earthquake or flood, or the bankruptcy of a borrower. The subordination may be for the entire amount of the series of mortgage-related securities or may be limited in amount.

Mortgage Warehouse Participations. We may occasionally acquire mortgage warehouse participations as an additional means of diversifying our sources of income. We anticipate that these investments, together with our investments in other Category III assets, will not in the aggregate exceed 10% of our total mortgage-related assets. These investments are participations in lines of credit to mortgage loan originators secured by recently originated mortgage loans that are in the process of being sold to investors. Our investments in mortgage warehouse participations are limited because they are not qualified REIT assets under the Code.

Other Mortgage-Related Assets

Mortgage Loans. We also acquire and accumulate mortgage loans through Belvedere Trust as part of our investment strategy until a sufficient quantity has been accumulated for securitization into high-quality MBS in order to enhance their value and liquidity. We anticipate that any mortgage loans that Belvedere Trust acquires and does not immediately securitize, together with Belvedere Trust s investments in BT Other MBS that are not Category I assets, will not constitute more than 40% of our total mortgage-related assets at any time. Mortgage loans are acquired with the intention of securitizing them into high-credit quality mortgage securities. Despite our intentions, however, Belvedere Trust may not be successful in securitizing these mortgage loans. To meet our investment criteria, mortgage loans acquired by us and Belvedere Trust will generally conform to the underwriting guidelines established by Fannie Mae, Freddie Mac or to secondary market standards for high quality mortgage loans. Applicable banking laws generally require that an appraisal be obtained in connection with the original issuance of mortgage loans by the lending institution and we do not intend to obtain additional appraisals at the time of acquiring mortgage loans.

Mortgage loans and other mortgage-related assets are purchased from various suppliers of mortgage-related assets throughout the United States including savings and loans associations, banks, mortgage bankers and other mortgage lenders. We acquire mortgage loans directly from originators and from entities holding mortgage loans originated by others. Our board of directors has not established any limits upon the geographic concentration or the credit quality of suppliers of the mortgage-related assets that we acquire.

Other Investments. We may acquire other investments that include equity and debt securities issued by other primarily mortgage-related finance companies, interests in mortgage-related collateralized bond obligations, other subordinated interests in pools of mortgage-related assets, commercial mortgage loans and securities and residential mortgage loans other than high-credit quality mortgage loans. Although we expect that our other investments will be limited to less than 10% of total assets, we have no limit on how much of our stockholders equity will be allocated to other investments. There may be periods in which other investments represent a large portion of our stockholders equity.

Belvedere Trust Mortgage Corporation

Belvedere Trust s Business

Belvedere Trust is in the business of acquiring, owning and securitizing residential real estate loans with a focus on high credit-quality jumbo adjustable-rate and hybrid first-lien mortgages. Belvedere Trust also acquires and owns other mortgage-related assets including subordinated securities from other issuers. Belvedere Trust, through taxable REIT subsidiaries and qualified REIT subsidiaries, acquires mortgage loans and other mortgage-related assets from various originators and suppliers of mortgage-related assets throughout the United States. Belvedere Trust has built relationships with a diversified network of mortgage loan originators including savings

and loan associations, banks and mortgage bankers. Belvedere Trust s sourcing and analytical efforts determine the quality, consistency and volume of loans and other mortgage-related assets that it purchases. Belvedere Trust targets the types and attributes of the mortgage loans it seeks to acquire and holds these mortgage loans until a sufficient quantity has been accumulated for securitization into high-quality MBS.

Our Strategy for Belvedere Trust

Operating Strategy. Our operating strategies for Belvedere Trust include:

- targeting mortgages and other mortgage-related assets from the high credit-quality niche segment of the first-lien jumbo, adjustable-rate and hybrid mortgage markets and first-lien mortgage markets where superior risk-adjusted returns may be available;
- continuing to develop comprehensive mortgage investment tools and discipline to support our asset acquisition, portfolio management and risk management activities; and
- further developing the infrastructure to implement our business plan and obtaining the scaling benefits of managing a large portfolio of residential real estate loan assets.

We believe our strategy for Belvedere Trust currently provides it with certain competitive advantages including the fact that:

- by not originating or servicing mortgages itself, Belvedere Trust limits its fixed expenses and reduces overhead costs;
- Belvedere Trust has agreements in place with a number of mortgage originators which we believe provide Belvedere Trust with stable product sourcing while simultaneously allowing Belvedere Trust to maintain consistent quality controls;
- Belvedere Trust securitizes large pools of mortgages and, out of the larger pools of collateral, retains securities which have features that specifically benefit our investment strategy; and
- Belvedere Trust has included in its portfolio securities from its own securitizations. We believe that the ability to select the mortgages that constitute collateral for the securitizations promotes a consistent quality profile and provides Belvedere Trust with greater certainty regarding expected performance.

Financing Strategy. Belvedere Trust leverages its capital allocated to residential real estate loan investment by borrowing funds through short-term and long-term secured debt facilities. Our goal for Belvedere Trust is to use leverage prudently as dictated by our integrated risk management strategy to enhance spread income and returns to stockholders. The cornerstone of our long-term residential real estate loan finance strategy is securitization of our residential real estate loans. Securitization materially limits liquidity risks and potentially maximizes risk-adjusted returns on capital.

To facilitate the financing of some of the mortgage-related assets which Belvedere Trust owns, it had in place, at December 31, 2006, a variety of short-term borrowing arrangements including repurchase agreements with 10 dealers. At December 31, 2006, Belvedere Trust also had one whole loan financing facility with a credit limit of $400 million. When it purchases residential real estate loans, Belvedere Trust typically funds them through a whole loan financing facility where it earns a spread until the loans are securitized. To mitigate the impact of rising interest rates on the consummation of forward loan purchase commitments in connection with planned securitization funding, Belvedere Trust may enter into Eurodollar futures contracts.

Securitization Activities

Belvedere Trust is a qualified REIT subsidiary, but structures securitization transactions primarily through taxable REIT subsidiaries (which generally are taxed as C corporations subject to full corporation taxation) which, in turn, establish special purpose entities, or SPEs, that issue securities through real estate mortgage

investment conduit, or REMIC, trusts. The principal business activity involves issuing various series of long-term debt (in the form of pass-through certificates or bonds collateralized by residential real estate loans). The collateral specific to each long-term debt series is the sole source of repayment of the debt and, therefore, Belvedere Trust s exposure to loss is limited to its net investment in the collateral.

Belvedere Trust sells a portion of the MBS to third parties in the secondary market while retaining the balance. The MBS retained by Belvedere Trust are purchased by one of its qualified REIT subsidiaries to maximize tax efficiency on the interest income on those securities. Belvedere Trust has, to date, retained the majority of the subordinate securities and certain of the senior securities from its securitizations. From its formation through December 31, 2006, Belvedere Trust had securitized a total of $3.8 billion of mortgage loans. Through December 31, 2006, MBS with an initial balance of approximately $3.4 billion had been sold to third parties. The balance, $337 million of original principal, has been retained by a qualified REIT subsidiary of Belvedere Trust. Some of the securities retained by Belvedere Trust have been financed with short-term repurchase agreements.

Belvedere Trust acquires residential mortgage loans and other mortgage-related assets from third party originators including banks and other mortgage lenders. During the year ended December 31, 2006, Belvedere Trust did not transfer any residential real estate loans to securitization trusts. During the year ended December 31, 2005, Belvedere Trust transferred approximately $1.4 billion of residential real estate loans to securitization trusts pursuant to pooling and third party servicing agreements. These transactions utilized non-qualified SPEs requiring consolidation, which effectively resulted in these transactions being accounted for as financings. The residential real estate loans remain as assets on our Consolidated Balance Sheets subsequent to securitization, and the financing resulting from these securitizations is shown on our Consolidated Balance Sheets as Mortgage-backed securities issued. The servicing of the mortgage loans is performed by third parties under servicing arrangements that resulted in no servicing asset or liability.

In accordance with our investment guidelines, Belvedere Trust has the opportunity to invest in asset classes other than mortgage loans intended for securitization. Such investments may be attractive, among other times, when the cost of acquiring residential real estate loans has increased to a point where it becomes un-economical to securitize these loans. This situation may happen at various points of the business and credit cycle, especially when loan production decreases. Belvedere Trust has not securitized loans since May 25, 2005 because of such circumstances. Investments have instead been made in senior and subordinated tranches from various issuers securitizations. The analyses and investment decisions have been based on a similar approach to what Belvedere Trust typically has done for the acquisition of whole loans intended for its own securitizations. It is Belvedere Trust s intent to securitize whole loans again under its shelf registration statement when the price of residential real estate loans relative to securitization execution makes it feasible again.

Management Agreement

Belvedere Trust has entered into a management agreement with BT Management. Pursuant to the management agreement, BT Management manages the day-to-day operations of Belvedere Trust in exchange for an annual base management fee and a quarterly incentive fee. The annual base management fee is equal to 1.15% of the first $300.0 million of average net invested assets, plus 0.85% of the portion above $300.0 million. The incentive fee for each fiscal quarter is equal to 20% of the amount of net income of Belvedere Trust, before incentive compensation, for such quarter in excess of the amount that would produce an annualized return on equity equal to the Ten-Year U.S. Treasury Rate for such fiscal quarter plus 1%.

The management agreement requires that Belvedere Trust pay all amounts earned thereunder each quarter, subject to offset for accrued negative incentive compensation. For the years ended December 31, 2006, 2005 and 2004, Belvedere Trust paid BT Management incentive compensation of $0, $792 thousand and $714 thousand, respectively. At December 31, 2006, there was a negative compensation accrual carried forward of $2.2 million.

Competition

When we invest in MBS, mortgage loans and other investment assets, we compete with a variety of institutional investors including other REITs, insurance companies, mutual funds, pension funds, investment banking firms, banks and other financial institutions that invest in the same types of assets. Many of these investors have greater financial resources and access to lower costs of capital than we do.

Employees

As of December 31, 2006, Anworth had twelve employees, seven of whom were part-time, and BT Management had six full-time employees who performed substantially all of their duties for Belvedere Trust.

Company Information

We were incorporated in Maryland on October 20, 1997 and commenced our operations on March 17, 1998. Our principal executive offices are located at 1299 Ocean Avenue, 2nd Floor, Santa Monica, California, 90401. Our telephone number is (310) 255-4493 and our fax number is (310) 434-0070.

Information on our Company Web Site

Our web site address is *www.anworth.com*. We make our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports available, free of charge, on our web site as soon as reasonably practicable after we file these reports with the Securities and Exchange Commission, or the SEC. In addition, we post the following information on our web site:

- our corporate code of conduct, which qualifies as a code of ethics as defined by Item 406 of Regulation S-K of the Securities Exchange Act of 1934;
- our corporate governance guidelines; and
- charters for our Audit Committee, Nominating and Corporate Governance Committee and Compensation Committee.

All of the above information is also available in print upon request to our secretary at the address listed under the heading Company Information above.

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CERTAIN FEDERAL INCOME TAX CONSIDERATIONS

The following discussion summarizes particular United States federal income tax considerations regarding our qualification and taxation as a REIT and particular United States federal income tax consequences resulting from the acquisition, ownership and disposition of our capital stock. This discussion is based on current law and assumes that we have qualified at all times throughout our existence, and will continue to qualify, as a REIT for United States federal income tax purposes. The tax law upon which this discussion is based could be changed and any such change could have a retroactive effect. The following discussion is not exhaustive of all possible tax considerations. This summary neither gives a detailed discussion of any state, local or foreign tax considerations nor discusses all of the aspects of United States federal income taxation that may be relevant to you in light of your particular circumstances or to particular types of stockholders which are subject to special tax rules, such as insurance companies, tax-exempt entities, financial institutions or broker-dealers, foreign corporations or partnerships and persons who are not citizens or residents of the United States, stockholders that hold our stock as a hedge, part of a straddle, conversion transaction or other arrangement involving more than one position, or stockholders whose functional currency is not the United States dollar. This discussion assumes that you will hold our capital stock as a capital asset, generally property held for investment, under the Code.

In reading the federal income tax disclosure below, it should be noted that although Anworth is combined with all of its wholly-owned subsidiaries for financial accounting and reporting purposes, for federal income tax purposes, only Anworth and its wholly-owned subsidiaries, Belvedere Trust, BT Management Holding Corporation, Belvedere Trust Secured Assets Corporation and BellaVista Finance Corporation, constitute the REIT. Anworth s remaining wholly-owned subsidiaries, Belvedere Trust Finance Corporation, or BT Finance, BT Residential Funding Corporation and BellaVista Funding Corporation, constitute a separate consolidated group subject to regular income taxes.

We urge you to consult with your own tax advisor regarding the specific consequences to you of the acquisition, ownership and disposition of stock in an entity electing to be taxed as a REIT, including the federal, state, local, foreign and other tax considerations of such acquisition, ownership, disposition and election and the potential changes in applicable tax laws.

General

Our qualification and taxation as a REIT depends upon our ability to continue to meet the various qualification tests, imposed under the Code and discussed below, relating to our actual annual operating results, asset diversification, distribution levels and diversity of stock ownership. Accordingly, the actual results of our operations for any particular taxable year may not satisfy these requirements.

We have made an election to be taxed as a REIT under the Code commencing with our taxable year ended December 31, 1998. We currently expect to continue operating in a manner that will permit us to maintain our qualification as a REIT. All qualification requirements for maintaining our REIT status, however, may not have been, or will not continue to be, met.

So long as we qualify for taxation as a REIT, we generally will be permitted a deduction for dividends we pay to our stockholders. As a result, we generally will not be required to pay federal corporate income taxes on our net income that is currently distributed to our stockholders. This treatment substantially eliminates the double taxation that ordinarily results from investment in a corporation. Double taxation means taxation once at the corporate level when income is earned and once again at the stockholder level when this income is distributed. We will be required to pay federal income tax, however, as follows:

- we will be required to pay tax at regular corporate rates on any undistributed real estate investment trust taxable income, including undistributed net capital gains;
- we may be required to pay the alternative minimum tax on our items of tax preference; and

if we have (a) net income from the sale or other disposition of foreclosure property which is held primarily for sale to customers in the ordinary course of business, or (b) other non-qualifying income from foreclosure property, we will be required to pay tax at the highest corporate rate on this income. Foreclosure property is generally defined as property acquired through foreclosure or after a default on a loan secured by the property or on a lease of the property.

To the extent that distributions exceed current and accumulated earnings and profits, they will constitute a return of capital, rather than dividend or capital gain income, and will reduce the basis for the stockholder s stock with respect to which the distributions are paid or, to the extent that they exceed such basis, will be taxed in the same manner as gain from the sale of that stock. For purposes of determining whether distributions are out of current or accumulated earnings and profits, our earnings and profits will be allocated first to our preferred stock and then to our common stock. Therefore, depending on our earnings and profits, distributions with respect to our 8.625% Series A Cumulative Preferred Stock, or our Series A Preferred Stock, (as compared to distributions with respect to our common stock) are more likely to be treated as dividends than as return of capital or a distribution in excess of basis.

Dividends paid by regular C corporations to stockholders other than corporations now are generally taxed at the rate applicable to long-term capital gains, which is a maximum of 15%, subject to certain limitations. Because we are a REIT, however, our dividends, including dividends paid on our Series A Preferred Stock, generally will continue to be taxed at regular ordinary income tax rates, except in limited circumstances that we do not contemplate.

We will be required to pay a 100% tax on any net income from prohibited transactions. Prohibited transactions are, in general, sales or other taxable dispositions of property other than foreclosure property held primarily for sale to customers in the ordinary course of business. Under existing law, whether property is held as inventory or primarily for sale to customers in the ordinary course of a trade or business depends on all the facts and circumstances surrounding the particular transaction.

If we fail to satisfy the 75% gross income test or the 95% gross income test discussed below but nonetheless maintain our qualification as a REIT because certain other requirements are met, we will be subject to a tax equal to:

the greater of (i) the amount by which 75% of our gross income exceeds the amount qualifying under the 75% gross income test described below, and (ii) the amount by which 95% of our gross income exceeds the amount qualifying under the 95% gross income test described below, multiplied by a fraction intended to reflect our profitability.

In the event of more than de minimis failure of any of the asset tests occurs in a taxable year, as long as the failure was due to reasonable cause and not to willful neglect and we dispose of the assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure, we will pay a tax equal to the greater of $50 thousand or 35% of the net income from the non-qualifying assets during the period in which we failed to satisfy any of the asset tests.

In the event of a failure to satisfy one or more requirements for REIT qualification occurring in a taxable year, other than the gross income tests and the asset tests, as long as such failure was due to reasonable cause and not to willful neglect, we will be required to pay a penalty of $50 thousand for each such failure.

We will be required to pay a nondeductible 4% excise tax on the excess of the required distribution over the amounts actually distributed if we fail to distribute during each calendar year at least the sum of:

85% of our real estate investment trust ordinary income for the year;

95% of our real estate investment trust capital gain net income for the year; and

any undistributed taxable income from prior periods.

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This distribution requirement is in addition to, and different from, the distribution requirements discussed below in the section entitled Annual Distribution Requirements.

We may elect to retain and pay income tax on our net long-term capital gain. In that case, a United States stockholder would be taxed on its proportionate share of our undistributed long-term capital gain (to the extent that we make a timely designation of such gain to the stockholder) and would receive a credit or refund of its proportionate share of the tax we paid.

If we own a residual interest in a REMIC, we will be taxable at the highest corporate rate on the portion of any excess inclusion income that we derive from the REMIC residual interests equal to the percentage of our stock that is held by disqualified organizations. Although the law is unclear, similar rules may apply if we own an equity interest in a taxable mortgage pool. To the extent that we own a REMIC residual interest in a taxable mortgage pool through a taxable REIT subsidiary, we will not be subject to tax. A disqualified organization includes:

- the United States;
- any state or political subdivision of the United States;
- any foreign government;
- any international organization;
- any agency or instrumentality of any of the foregoing;
- any other tax-exempt organization other than a farmers cooperative described in Section 521 of the Code that is exempt both from income taxation and from taxation under the unrelated business taxable income provisions of the Code; and
- any rural electrical or telephone cooperative.

If we acquire any asset from a corporation which is or has been taxed as a C corporation under the Code in a transaction in which the basis of the asset in our hands is determined by reference to the basis of the asset in the hands of the C corporation and we subsequently recognize gain on the disposition of the asset during the ten-year period beginning on the date on which we acquired the asset, then we will be required to pay tax at the highest regular corporate tax rate on this gain to the extent of the excess of:

- the fair market value of the asset, over
- our adjusted basis in the asset,
- in each case determined as of the date on which we acquired the asset.

A C corporation is generally defined as a corporation required to pay full corporate-level tax. The results described in the preceding paragraph with respect to the recognition of gain will apply unless we make an election under Treasury Regulation Section 1.337(d)-7(c). If such an election were made, the C corporation would recognize taxable gain or loss as if it had sold the assets we acquired from the C corporation to an unrelated third party at fair market value on the acquisition date.

We will be subject to a 100% excise tax if our dealings with any taxable REIT subsidiaries (defined below) are not at arm s length.

In addition, not withstanding our REIT status, we may also have to pay certain state and local income taxes, because not all states and localities treat REITs in the same manner as they are treated for federal income tax purposes.

Requirements for Qualification as a REIT

The Code defines a REIT as a corporation, trust or association:

1. that is managed by one or more trustees or directors;
2. that issues transferable shares or transferable certificates to evidence beneficial ownership;
3. that would be taxable as a domestic corporation but for tax code Sections 856 through 859;
4. that is not a financial institution or an insurance company within the meaning of the Code;
5. that is beneficially owned by 100 or more persons;
6. that not more than 50% in value of the outstanding stock of which is owned, actually or constructively, by five or fewer individuals, including specified entities, during the last half of each taxable year;
7. that meets other tests, described below, regarding the nature of its income and assets and the amount of its distributions; and
8. that elects to be a REIT or has made such election for a previous taxable year and satisfies all relevant filing and other administrative requirements established by the Internal Revenue Service, or the IRS, that must be met to elect and retain REIT status.

The Code provides that all of the first four conditions stated above must be met during the entire taxable year and that the fifth condition must be met during at least 335 days of a taxable year of twelve months, or during a proportionate part of a taxable year of less than twelve months. The fifth and sixth conditions do not apply until after the first taxable year for which an election is made to be taxed as a REIT.

For purposes of the sixth condition, pension trusts and other specified tax-exempt entities generally are treated as individuals, except that a look-through exception generally applies with respect to pension funds.

Stock Ownership Tests

Our stock must be beneficially held by at least 100 persons, the 100 Stockholder Rule, and no more than 50% of the value of our stock may be owned, directly or indirectly, by five or fewer individuals at any time during the last half of the taxable year, the 5/50 Rule. For purposes of the 100 Stockholder Rule only, trusts described in Section 401(a) of the Code and exempt under Section 501(a) of the Code are generally treated as persons. These stock ownership requirements must be satisfied in each taxable year other than the first taxable year for which an election is made to be taxed as a REIT. We are required to solicit information from certain of our record stockholders to verify actual stock ownership levels and our charter provides for restrictions regarding the transfer of our stock in order to aid in meeting the stock ownership requirements. If we were to fail either of the stock ownership tests, we would generally be disqualified from our REIT status. However, if we comply with regulatory rules pursuant to which we are required to send annual letters to holders of our stock requesting information regarding the actual ownership of our stock, and we do not know, or exercising reasonable diligence would not have known, whether we failed to meet the 5/50 Rule, we will be treated as having met the 5/50 Rule.

Income Tests

We must satisfy two gross income requirements annually to maintain our qualification as a REIT:

We must derive, directly or indirectly, at least 75% of our gross income, excluding gross income from prohibited transactions, from specified real estate sources, including rental income, interest on obligations secured by mortgages on real property or on interests in real property, gain from the disposition of qualified real estate assets, i.e., interests in real property, mortgages secured by real property or interests in real property, and some other assets, income from certain types of temporary investments, amounts, such as commitment fees, received in consideration for entering into an

agreement to make a loan secured by real property, unless such amounts are determined by income and profits, and income derived from a REMIC in proportion to the real estate assets held by the REMIC, unless at least 95% of the REMIC s assets are real estate assets (in which case, all of the income derived from the REMIC), or the 75% gross income test; and

We must derive at least 95% of our gross income, excluding gross income from prohibited transactions, from (a) the sources of income that satisfy the 75% gross income test, (b) dividends, interest and gain from the sale or disposition of stock or securities, or (c) any combination of the foregoing, or the 95% gross income test.

Gross income from servicing loans for third parties and loan origination fees is not qualifying income for purposes of either gross income test. Gross income from our sale of property that we hold primarily for sale to customers in the ordinary course of business is excluded from both the numerator and the denominator in both income tests. Income and gain from certain transactions that we enter into to hedge indebtedness incurred or to be incurred to acquire or carry real estate assets and that are clearly and timely identified as such are excluded from both the numerator and denominator for purposes of the 95% gross income test (but not the 75% gross income test).

For purposes of the 75% and 95% gross income tests, a REIT is deemed to have earned a proportionate share of the income earned by any partnership, or any limited liability company treated as a partnership for federal income tax purposes, in which it owns an interest, which share is determined by reference to its capital interest in such entity, and is deemed to have earned the income earned by any qualified REIT subsidiary (in general, a 100%-owned corporate subsidiary of a REIT). Our qualified REIT subsidiary, BT Management Holding Corporation, a Delaware corporation, owns a 50% interest in the profits, losses and capital of BT Management which is taxed as a partnership for federal income tax purposes. Belvedere Trust has entered into a management agreement with BT Management which manages Belvedere Trust s investments and performs administrative services for Belvedere Trust. So long as BT Management Holding Corporation is a qualified REIT subsidiary of ours and it owns an interest in BT Management, we will be treated, for federal income tax purposes, as directly owning BT Management Holding Corporation s proportionate share of the assets, liabilities and income of BT Management for purposes of determining our compliance with the REIT qualification tests. Certain of BT Management s gross income (for example, management fee income under the management agreement with Belvedere Trust) will not be qualifying income under the 75% or 95% tests described above. Accordingly, we may decide to make a taxable REIT subsidiary election for BT Management Holding Corporation in the future if we believe that such non-qualifying income will jeopardize our ability to satisfy the 75% or 95% income tests. If we make a taxable REIT subsidiary election for BT Management Holding Corporation, its proportionate share of BT Management s gross income will not be treated as our gross income for purposes of our REIT qualification tests, but BT Management Holding Corporation s taxable income will be subject to corporate level income tax. Any dividends paid to us by BT Management Holding Corporation, while it is a taxable REIT subsidiary, will be qualifying income for purposes of our satisfaction of the 95% income test, but not the 75% test. Interest earned by a REIT ordinarily does not qualify as income meeting the 75% or 95% gross income tests if the determination of all or some of the amount of interest depends in any way on the income or profits of any person. Interest will not be disqualified from meeting such tests, however, solely by reason of being based on a fixed percentage or percentages of receipts or sales.

The following paragraphs discuss in more detail the specific application of the gross income tests to us.

Interest. The term interest, as defined for purposes of both gross income tests, generally excludes any amount that is based in whole or in part on the income or profits of any person. However, interest generally includes the following:

an amount that is based on a fixed percentage or percentages of receipts or sales; and

an amount that is based on the income or profits of a debtor as long as the debtor derives substantially all of its income from the real property securing the debt from leasing substantially all of its interest in

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the property and only to the extent that the amounts received by the debtor would be qualifying rents from real property if received directly by a REIT.

If a loan contains a provision that entitles a REIT to a percentage of the borrower s gain upon the sale of the real property securing the loan or a percentage of the appreciation in the property s value as of a specific date, income attributable to that loan provision will be treated as gain from the sale of the property securing the loan, which generally is qualifying income for purposes of both gross income tests.

Interest on debt secured by a mortgage on real property or on interests in real property, including, for this purpose, discount points, prepayment penalties, loan assumption fees and late payment charges that are not compensation for services, generally is qualifying income for purposes of the 75% gross income test. However, if the highest principal amount of a loan outstanding during a taxable year exceeds the fair market value of the real property securing the loan as of the date the REIT agreed to originate or acquire the loan, a portion of the interest income from such loan will not be qualifying income for purposes of the 75% gross income test but will be qualifying income for purposes of the 95% gross income test. The portion of the interest income that will not be qualifying income for purposes of the 75% gross income test will be equal to the portion of the principal amount of the loan that is not secured by real property that is, the amount by which the loan exceeds the value of the real estate that is security for the loan.

The interest, original issue discount and market discount income that we receive from our mortgage loans and MBS generally will be qualifying income for purposes of both gross income tests. However, as discussed above, if the fair market value of the real estate securing any of our loans is less than the principal amount of the loan, a portion of the income from that loan will be qualifying income for purposes of the 95% gross income test but not the 75% gross income test.

Fee Income. We may receive various fees in connection with originating mortgage loans. The fees will be qualifying income for purposes of both the 75% and 95% income tests if they are received in consideration for entering into an agreement to make a loan secured by real property and the fees are not determined based on the borrower s income or profits. Therefore, commitment fees will generally be qualifying income for purposes of the income tests. Other fees, such as fees received for servicing loans for third parties and origination fees, are not qualifying income for purposes of either income test.

Dividends. Our share of any dividends received from any corporation (including any of our taxable REIT subsidiaries, but excluding any REIT) in which we own an equity interest will qualify for purposes of the 95% gross income test but not for purposes of the 75% gross income test. Our share of any dividends received from any other REIT in which we own an equity interest will be qualifying income for purposes of both gross income tests.

Rents from Real Property. We do not intend to acquire any real property, but we may acquire real property or an interest therein in the future. To the extent that we acquire real property or an interest therein, rents we receive will qualify as rents from real property in satisfying the gross income requirements for a REIT described above only if the following conditions are met:

First, the amount of rent must not be based, in whole or in part, on the income or profits of any person. However, an amount received or accrued generally will not be excluded from rents from real property solely by reason of being based on fixed percentages of receipts or sales.

Second, rents we receive from a related party tenant will not qualify as rents from real property in satisfying the gross income tests unless the tenant is a taxable REIT subsidiary, at least 90% of the property is leased to unrelated tenants and the rent paid by the taxable REIT subsidiary is substantially comparable to the rent paid by the unrelated tenants for comparable space. A tenant is a related party tenant if the REIT, or an actual or constructive owner of 10% or more of the REIT, actually or constructively owns 10% or more of the tenant.

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Third, if rent attributable to personal property leased in connection with a lease of real property is greater than 15% of the total rent received under the lease, then the portion of rent attributable to the personal property will not qualify as rents from real property.

Fourth, we generally must not operate or manage our real property or furnish or render services to our tenants, other than through an independent contractor who is adequately compensated and from whom we do not derive revenue. However, we may provide services directly to tenants if the services are usually or customarily rendered in connection with the rental of space for occupancy only and are not considered to be provided for the tenants convenience. In addition, we may provide a minimal amount of non-customary services to the tenants of a property, other than through an independent contractor, as long as our income from the services does not exceed 1% of our income from the related property. Furthermore, we may own up to 100% of the stock of a taxable REIT subsidiary, which may provide customary and non-customary services to tenants without tainting its rental income from the related properties.

Hedging Transactions. From time to time, we enter into hedging transactions with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps and floors, options to purchase these items and futures and forward contracts. Income and gain from hedging transactions will be excluded from gross income for purposes of the 95% gross income test (but not the 75% gross income test). A hedging transaction includes any transaction entered into in the normal course of our trade or business primarily to manage the risk of interest rate, price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, to acquire or carry real estate assets. We will be required to clearly identify any such hedging transaction before the close of the day on which it was acquired, originated or entered into. To the extent that we hedge for other purposes, or to the extent that a portion of our mortgage loans is not secured by real estate assets (as described below under Asset Tests), or in other situations, the income from those transactions is not likely to be treated as qualifying income for purposes of the 95% gross income test. All of our hedging income and gain likely will be non-qualifying income for purposes of the 75% gross income test. We intend to structure any hedging transactions in a manner that does not jeopardize our status as a REIT.

Prohibited Transactions. A REIT will incur a 100% tax on the net income derived from any sale or other disposition of property other than foreclosure property that the REIT holds primarily for sale to customers in the ordinary course of a trade or business. We believe that none of our assets will be held primarily for sale to customers and that a sale of any of our assets will not be in the ordinary course of our business. Whether a REIT holds an asset primarily for sale to customers in the ordinary course of a trade or business depends, however, on the facts and circumstances in effect from time to time, including those related to a particular asset. Nevertheless, we will attempt to comply with the terms of safe-harbor provisions in the federal income tax laws prescribing when an asset sale will not be characterized as a prohibited transaction.

It is our current intention that our securitizations of our residential real estate loans through our qualified REIT subsidiaries will not be treated as sales for tax purposes. If we were to transfer residential real estate loans to a REMIC, this transfer would be treated as a sale for tax purposes and the sale may be subject to the prohibited transactions tax. As a result, we intend to securitize our residential real estate loans through our qualified REIT subsidiaries only in non-REMIC transactions.

Foreclosure Property. We will be subject to tax at the maximum corporate rate on any income from foreclosure property other than income that otherwise would be qualifying income for purposes of the 75% gross income test, less expenses directly connected with the production of that income. However, gross income from foreclosure property will qualify under the 75% and 95% gross income tests. Foreclosure property is any real property, including interests in real property, and any personal property incident to such real property:

that is acquired by a REIT as the result of the REIT having bid on such property at foreclosure, or having otherwise reduced such property to ownership or possession by agreement or process of law,

- after there was a default or default was imminent on a lease of such property or on indebtedness that such property secured;
- for which the related loan or lease was acquired by the REIT at a time when the default was not imminent or anticipated; and
- for which the REIT makes a proper election to treat the property as foreclosure property.

However, a REIT will not be considered to have foreclosed on a property where the REIT takes control of the property as a mortgagee-in-possession and cannot receive any profit or sustain any loss except as a creditor of the mortgagor. Property generally ceases to be foreclosure property at the end of the third taxable year following the taxable year in which the REIT acquired the property or longer if an extension is granted by the Secretary of the Treasury. This grace period terminates and foreclosure property ceases to be foreclosure property on the first day:

- on which a lease is entered into for the property that, by its terms, will give rise to income that does not qualify for purposes of the 75% gross income test or any amount is received or accrued, directly or indirectly, pursuant to a lease entered into on or after such day that will give rise to income that does not qualify for purposes of the 75% gross income test;
- on which any construction takes place on the property, other than completion of a building or any other improvement, where more than 10% of the construction was completed before default became imminent; or
- which is more than 90 days after the day on which the REIT acquired the property and the property is used in a trade or business which is conducted by the REIT other than through an independent contractor from whom the REIT itself does not derive or receive any income.

Failure to Satisfy Gross Income Tests. If we fail to satisfy one or both of the gross income tests for any taxable year, we nevertheless may qualify as a REIT for that year if we qualify for relief under certain provisions of the federal income tax laws. Those relief provisions will be available if:

- our failure to meet those tests is due to reasonable cause and not to willful neglect, and
- following such failure for any taxable year, a schedule of the sources of our income is filed in accordance with regulations prescribed by the Secretary of the Treasury.

We cannot predict, however, whether in all circumstances we would qualify for the relief provisions. In addition, as discussed above, even if the relief provisions apply, we would incur a 100% tax on the gross income attributable to the greater of (i) the amount by which we fail the 75% gross income test or (ii) the amount by which 95% of our gross income exceeds the amount of our income qualifying under the 95% gross income test, multiplied, in either case, by a fraction intended to reflect our profitability.

Asset Tests

To qualify as a REIT, we also must satisfy the following asset tests at the end of each quarter of each taxable year: First, at least 75% of the value of our total assets must consist of:

- cash or cash items, including certain receivables;

government securities;

interests in real property, including leaseholds and options to acquire real property and leaseholds;

interests in mortgage loans secured by real property;

stock in other REITs;

investments in stock or debt instruments during the one-year period following our receipt of new capital that we raise through equity offerings or public offerings of debt with at least a five-year term; and

regular or residual interests in a REMIC. However, if less than 95% of the assets of a REMIC consists of assets that are qualifying real estate-related assets under the federal income tax laws, determined as if we held such assets, we will be treated as holding directly our proportionate share of the assets of such REMIC.

Second, of our investments not included in the 75% asset class, the value of our interest in any one issuer s securities may not exceed 5% of the value of our total assets.

Third, we may not own more than 10% of the voting power or value of any one issuer s outstanding securities.

Fourth, no more than 20% of the value of our total assets may consist of the securities of one or more taxable REIT subsidiaries.

Fifth, no more than 25% of the value of our total assets may consist of the securities of taxable REIT subsidiaries and other taxable subsidiaries that are not taxable REIT subsidiaries and other assets that are not qualifying assets for purposes of the 75% asset test.

For purposes of the second and third asset tests, the term securities does not include stock in another REIT, equity or debt securities of a qualified REIT subsidiary or taxable REIT subsidiary, mortgage loans that constitute real estate assets, or equity interests in a partnership. For purposes of the 10% value test, the term securities does not include:

Straight debt securities, which is defined as a written unconditional promise to pay on demand or on a specified date a sum certain in money if (i) the debt is not convertible, directly or indirectly, into stock, and (ii) the interest rate and interest payment dates are not contingent on profits, the borrower s discretion, or similar factors. Straight debt securities do not include any securities issued by a partnership or a corporation in which we or any controlled taxable REIT subsidiary (i.e., a taxable REIT subsidiary in which we own directly or indirectly more than 50% of the voting power or value of the stock) hold non- straight debt securities that have aggregate value of more than 1% of the issuer s outstanding securities. However, straight debt securities include debt subject to the following contingencies:

a contingency relating to the time of payment of interest or principal, as long as either (i) there is no change to the effective yield of the debt obligation other than a change to the annual yield that does not exceed the greater of 0.25% or 5% of the annual yield, or (ii) neither the aggregate issue price nor the aggregate face amount of the issuer s debt obligations held by us exceeds $1 million and no more than 12 months of unaccrued interest on the debt obligations can be required to be prepaid; and

a contingency relating to the time or amount of payment upon a default or prepayment of a debt obligation, as long as the contingency is consistent with customary commercial practice.

Any loan to an individual or an estate.

Any section 467 rental agreement other than an agreement with a related party tenant.

Any obligation to pay rents from real property.

Certain securities issued by governmental entities.

Any security issued by a REIT.

Any debt instrument of an entity treated as a partnership for federal income tax purposes to the extent of our interest as a partner in the partnership.

Any debt instrument of an entity treated as a partnership for federal income tax purposes not described in the preceding bullet points if at least 75% of the partnership s gross income, excluding income from prohibited transaction, is qualifying income for purposes of the 75% gross income test described above in Income Tests.

The asset tests described above are based on our gross assets. For federal income tax purposes, we will be treated as owning both the loans we hold directly and the loans that we have securitized through non-REMIC debt securitizations. Although we will have a partially offsetting obligation with respect to the securities issued pursuant to the securitizations, these offsetting obligations will not reduce the gross assets we are considered to own for purposes of the asset tests.

We believe that all or substantially all of the mortgage loans and MBS that we will own will be qualifying assets for purposes of the 75% asset test. For purposes of these rules, however, if the outstanding principal balance of a mortgage loan exceeds the fair market value of the real property securing the loan, a portion of such loan likely will not be a qualifying real estate asset under the federal income tax laws. Although the law on the matter is not entirely clear, it appears that the non-qualifying portion of that mortgage loan will be equal to the portion of the loan amount that exceeds the value of the associated real property that is security for that loan. To the extent that we own debt securities issued by other REITs or C corporations that are not secured by a mortgage on real property, those debt securities will not be qualifying assets for purposes of the 75% asset test. Instead, we would be subject to the second, third and fifth asset tests with respect to those debt securities.

We will monitor the status of our assets for purposes of the various asset tests and will seek to manage our investment portfolio to comply at all times with such tests. There can be no assurance, however, that we will be successful in this effort. In this regard, to determine our compliance with these requirements, we will need to estimate the value of the real estate securing our mortgage loans at various times. Although we will seek to be prudent in making these estimates, there can be no assurances that the IRS might not disagree with these determinations and assert that a lower value is applicable. If we fail to satisfy the asset tests at the end of a calendar quarter, we will not lose our REIT status if:

we satisfied the asset tests at the end of the preceding calendar quarter; and

the discrepancy between the value of our assets and the asset test requirements arose from changes in the market values of our assets and was not wholly or partly caused by the acquisition of one or more non-qualifying assets.

If we did not satisfy the condition described in the second item, above, we still could avoid disqualification by eliminating any discrepancy within 30 days after the close of the calendar quarter in which it arose.

In the event that, at the end of any calendar quarter, we violate the second or third asset tests described above, we will not lose our REIT status if (i) the failure is de minimis (up to the lesser of 1% of our assets or $10 million) and (ii) we dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure. In the event of a more than de minimis failure of any of the asset tests, as long as the failure was due to reasonable cause and not to willful neglect, we will not lose our REIT status if (i) we dispose of assets or otherwise comply with the asset tests within six months after the last day of the quarter in which we identify such failure and (ii) pay a tax equal to the greater of $50 thousand or 35% of the net income from the non-qualifying assets during the period in which we failed to satisfy the asset tests.

We currently believe that the loans, securities and other assets that we expect to hold will satisfy the foregoing asset test requirements. However, no independent appraisals will be obtained to support our conclusions as to the value of our assets and securities, or in many cases, the real estate collateral for the mortgage loans that we hold. Moreover, the values of some assets may not be susceptible to a precise determination. As a result, there can be no assurance that the IRS will not contend that our ownership of securities and other assets violates one or more of the asset tests applicable to REITs.

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Distribution Requirements

Each taxable year, we must distribute dividends, other than capital gain dividends and deemed distributions of retained capital gain, to our stockholders in an aggregate amount at least equal to:

the sum of:

90% of our REIT taxable income, computed without regard to the dividends paid deduction and our net capital gain or loss, and

90% of our after-tax net income, if any, from foreclosure property, minus

the sum of certain items of non-cash income.

We must pay such distributions in the taxable year to which they relate or in the following taxable year if we declare the distribution before we timely file our federal income tax return for the year and pay the distribution on or before the first regular dividend payment date after such declaration.

We will pay the federal income tax on taxable income, including net capital gain, which we do not distribute to stockholders. Furthermore, if we fail to distribute during a calendar year, or by the end of January following the calendar year in the case of distributions with declaration and record dates falling in the last three months of the calendar year, at least the sum of:

85% of our REIT ordinary income for such year,

95% of our REIT capital gain income for such year, and

any undistributed taxable income from prior periods,

we will incur a 4% nondeductible excise tax on the excess of such required distribution over the amounts we actually distribute. We may elect to retain and pay income tax on the net long-term capital gain we receive in a taxable year. See Taxation of Taxable United States Stockholders. If we so elect, we will be treated as having distributed any such retained amount for purposes of the 4% nondeductible excise tax described above. We intend to make timely distributions sufficient to satisfy the annual distribution requirements and to avoid corporate income tax and the 4% nondeductible excise tax.

It is possible that, from time to time, we may experience timing differences between the actual receipt of income and actual payment of deductible expenses and the inclusion of that income and deduction of such expenses in arriving at our REIT taxable income. Possible examples of those timing differences include the following:

Because we may deduct capital losses only to the extent of our capital gains, we may have taxable income that exceeds our economic income.

We will recognize taxable income in advance of the related cash flow if any of our mortgage loans or MBS are deemed to have original issue discount. We generally must accrue original issue discount based on a constant yield method that takes into account projected prepayments but that defers taking into account credit losses until they are actually incurred.

We may recognize taxable market discount income when we receive the proceeds from the disposition of, or principal payments on, loans that have a stated redemption price at maturity that is greater than our tax basis in those loans, although such proceeds often will be used to make non-deductible principal payments on related borrowings.

We may recognize taxable income without receiving a corresponding cash distribution if we foreclose on or make a significant modification to a loan to the extent that the fair market value of the underlying property or the principal amount of the modified loan, as applicable, exceeds our basis in the original loan.

We may recognize phantom taxable income from any residual interests in REMICs or retained ownership interests in mortgage loans subject to collateralized mortgage obligation debt.

Although several types of non-cash income are excluded in determining the annual distribution requirement, we will incur corporate income tax and the 4% nondeductible excise tax with respect to those non-cash income items if we do not distribute those items on a current basis. As a result of the foregoing, we may have less cash than is necessary to distribute all of our taxable income and thereby avoid corporate income tax and the excise tax imposed on certain undistributed income. In such a situation, we may need to borrow funds or issue additional common stock or preferred stock.

Under certain circumstances, we may be able to correct a failure to meet the distribution requirement for a year by paying deficiency dividends to our stockholders in a later year. We may include such deficiency dividends in our deduction for dividends paid for the earlier year. Although we may be able to avoid income tax on amounts distributed as deficiency dividends, we will be required to pay interest to the IRS based upon the amount of any deduction we take for deficiency dividends.

Recordkeeping Requirements

We must maintain certain records in order to qualify as a REIT. In addition, to avoid a monetary penalty, we must request, on an annual basis, information from our stockholders designed to disclose the actual ownership of our outstanding stock. We intend to comply with these requirements.

Failure to Qualify

If we fail to satisfy one or more requirements for REIT qualification, other than the gross income tests and the asset tests, we could avoid disqualification if our failure is due to reasonable cause and not to willful neglect and we pay a penalty of $50 thousand for each such failure. In addition, there are relief provisions for a failure of the gross income tests and asset tests as described in Income Tests and Asset Tests.

If we fail to qualify as a REIT in any taxable year and no relief provision applies, we would be subject to federal income tax and any applicable alternative minimum tax on our taxable income at regular corporate rates. In calculating our taxable income in a year in which we fail to qualify as a REIT, we would not be able to deduct amounts paid out to stockholders. In fact, we would not be required to distribute any amounts to stockholders in that year. In such event, to the extent of our current and accumulated earnings and profits, all distributions to stockholders would be taxable as ordinary income. Subject to certain limitations of the federal income tax laws, corporate stockholders might be eligible for the dividends received deduction and domestic non-corporate stockholders may be eligible for the reduced federal income tax rate of 15% on such dividends. Unless we qualified for relief under specific statutory provisions, we also would be disqualified from taxation as a REIT for the four taxable years following the year during which we ceased to qualify as a REIT. We cannot predict whether, in all circumstances, we would qualify for such statutory relief.

Qualified REIT Subsidiaries

A qualified REIT subsidiary is any corporation in which we own 100% of such corporation s outstanding stock and for which no election has been made to classify it as a taxable REIT subsidiary. Belvedere Trust, BT Management Holding Corporation, Belvedere Trust Secured Assets Corporation and BellaVista Finance Corporation are currently treated as qualified REIT subsidiaries. As such, their assets, liabilities and income are generally treated as our assets, liabilities and income for purposes of each of the above REIT qualification tests. Belvedere Trust may elect to be taxed as a REIT in the future, possibly as early as its taxable year ending December 31, 2007. As discussed above, we may decide to make an election to treat BT Management Holding Corporation as a taxable REIT subsidiary at a future date.

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Taxable REIT Subsidiaries

A taxable REIT subsidiary is any corporation in which we own stock (directly or indirectly) and which we and such corporation elect to classify as a taxable REIT subsidiary. A taxable REIT subsidiary is not subject to the REIT asset, income and distribution requirements, nor are its assets, liabilities or income treated as our assets, liabilities or income for purposes of each of the above REIT qualification tests. Effective January 1, 2004, we elected to treat BT Finance as a taxable REIT subsidiary. BT Finance s wholly-owned subsidiaries, BT Residential Funding Corporation and BellaVista Funding Corporation, are also taxable REIT subsidiaries. Except for Belvedere Trust, we generally intend to make a taxable REIT subsidiary election with respect to any other corporation in which we acquire securities constituting more than 10% by vote or value of such corporation and that is not a qualified REIT subsidiary. However, the aggregate value of all of our taxable REIT subsidiaries must be limited to 20% of the total value of our assets.

We will be subject to a 100% penalty tax on any rent, interest or other charges that we impose on any taxable REIT subsidiary in excess of an arm s length price for comparable services. We expect that any rents, interest or other charges imposed on any taxable REIT subsidiary will be at arm s length prices.

We generally expect to derive income from our taxable REIT subsidiaries by way of dividends. Such dividends are not real estate source income for purposes of the 75% income test. Therefore, when aggregated with our non-real estate source income, such dividends must be limited to 25% of our gross income each year. We will monitor the value of our investment in, and the distributions from, our taxable REIT subsidiaries to ensure compliance with all applicable REIT income and asset tests.

Taxable REIT subsidiaries are generally subject to corporate level tax on their net income and will generally be able to distribute only net after-tax earnings to its stockholders, including us, as dividend distributions.

Taxation of Taxable United States Stockholders

For purposes of the discussion in this Form 10-K, the term United States stockholder means a holder of our stock that is, for United States federal income tax purposes:

- a citizen or resident of the United States;
- a corporation (including an entity treated as a corporation for federal income tax purposes), partnership or other entity created or organized in or under the laws of the United States or of any state thereof or in the District of Columbia, unless Treasury regulations provide otherwise;
- an estate the income of which is subject to United States federal income taxation regardless of its source; or
- a trust (i) whose administration is subject to the primary supervision of a United States court and which has one or more United States persons who have the authority to control all substantial decisions of the trust or (ii) that has a valid election in place to be treated as a United States person.

Distributions Generally

Distributions out of our current or accumulated earnings and profits, other than capital gain dividends, will generally be taxable to United States stockholders as ordinary income. Provided that we continue to qualify as a REIT, dividends paid by us will not be eligible for the dividends received deduction generally available to United States stockholders that are corporations. To the extent that we make distributions in excess of current and accumulated earnings and profits, the distributions will be treated as a tax-free return of capital to each United States stockholder and will reduce the adjusted tax basis which each United States stockholder has in our stock by the amount of the distribution, but not below zero. Distributions in excess of a United States stockholder s

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adjusted tax basis in its stock will be taxable as capital gain and will be taxable as long-term capital gain if the stock has been held for more than one year. If we declare a dividend in October, November, or December of any calendar year which is payable to stockholders of record on a specified date in such a month and actually pay the dividend during January of the following calendar year, the dividend is deemed to be paid by us and received by the stockholder on December 31st of the previous year, but only to the extent we have any remaining undistributed earnings and profits (as computed under the Code) as of December 31st. Any portion of this distribution in excess of our previously undistributed earnings and profits as of December 31st should be treated as a distribution to our stockholders in the following calendar year for United States federal income tax purposes. Stockholders may not include in their own income tax returns any of our net operating losses or capital losses. Ordinary dividends to a United States stockholder generally will not qualify for the 15% tax rate for qualified dividend income. However, the 15% tax rate for qualified dividend income will apply to our ordinary REIT dividends (i) attributable to dividends received by us from non-REIT corporations such as a taxable REIT subsidiary, and (ii) any income on which we have paid a corporate income tax.

Capital Gain Distributions

Distributions designated by us as capital gain dividends will be taxable to United States stockholders as capital gain income. We can designate distributions as capital gain dividends to the extent of our net capital gain for the taxable year of the distribution. This capital gain income will generally be taxable to non-corporate United States stockholders at a 15% or 25% rate based on the characteristics of the asset we sold that produced the gain. United States stockholders that are corporations may be required to treat up to 20% of certain capital gain dividends as ordinary income.

Retention of Net Capital Gains

We may elect to retain, rather than distribute as a capital gain dividend, our net capital gains. If we were to make this election, we would pay tax on such retained capital gains. In such a case, our stockholders would generally:

- include their proportionate share of our undistributed net capital gains in their taxable income;
- receive a credit for their proportionate share of the tax paid by us in respect of such net capital gain; and
- increase the adjusted basis of their stock by the difference between the amount of their share of our undistributed net capital gain and their share of the tax paid by us.

Passive Activity Losses, Investment Interest Limitations and Other Considerations of Holding Our Stock

Distributions we make and gains arising from the sale or exchange of our stock by a United States stockholder will not be treated as passive activity income. As a result, United States stockholders will not be able to apply any passive losses against income or gains relating to our stock. Distributions by us, to the extent they do not constitute a return of capital, generally will be treated as investment income for purposes of computing the investment interest limitation under the Code. Further, if we, or a portion of our assets, were to be treated as a taxable mortgage pool, any excess inclusion income that is allocated to you could not be offset by any losses or other deductions you may have.

Dispositions of Stock

A United States stockholder that sells or disposes of our stock will recognize gain or loss for federal income tax purposes in an amount equal to the difference between the amount of cash or the fair market value of any property the stockholder receives on the sale or other disposition and the stockholder s adjusted tax basis in the stock. This gain or loss will be capital gain or loss and will be long-term capital gain or loss if the stockholder has held the stock for more than one year. In general, any loss recognized by a United States stockholder upon

the sale or other disposition of our stock that the stockholder has held for six months or less will be treated as long-term capital loss to the extent the stockholder received distributions from us which were required to be treated as long-term capital gains. All or a portion of any loss that a United States stockholder realizes upon a taxable disposition of our common stock may be disallowed if the stockholder purchases other stock within 30 days before or after the disposition.

Information Reporting and Backup Withholding

We report to our United States stockholders and the IRS the amount of dividends paid during each calendar year and the amount of any tax withheld. Under the backup withholding rules, a stockholder may be subject to backup withholding with respect to dividends paid and redemption proceeds unless the holder is a corporation or comes within other exempt categories and, when required, demonstrates this fact or provides a taxpayer identification number or social security number certifying as to no loss of exemption from backup withholding and otherwise complies with applicable requirements of the backup withholding rules. A United States stockholder that does not provide us with its correct taxpayer identification number or social security number may also be subject to penalties imposed by the IRS. A United States stockholder can meet this requirement by providing us with a correct, properly completed and executed copy of IRS Form W-9 or a substantially similar form. Backup withholding is not an additional tax. Any amount paid as backup withholding will be creditable against the stockholder s income tax liability, if any, and otherwise be refundable. In addition, we may be required to withhold a portion of capital gain distributions made to any stockholders who fail to certify their non-foreign status.

Taxation of Tax-Exempt Stockholders

The IRS has ruled that amounts distributed as a dividend by a REIT will be treated as a dividend by the recipient and excluded from the calculation of unrelated business taxable income, or UBTI, when received by a tax-exempt entity. Based on that ruling, provided that a tax-exempt stockholder has not held our stock as debt financed property within the meaning of the Code, i.e., property, the acquisition, or holding of which is financed through a borrowing by the tax-exempt United States stockholder, the stock is not otherwise used in an unrelated trade or business, and we or Belvedere Trust do not hold a residual interest in a REMIC that gives rise to excess inclusion income, as defined in Section 860E of the Code, dividend income on our stock and income from the sale of our stock should not be unrelated business taxable income to a tax-exempt stockholder. However, if we or Belvedere Trust were to hold residual interests in a REMIC, or if we or a pool of our assets or Belvedere Trust s assets were to be treated as a taxable mortgage pool, a portion of the dividends paid to a tax-exempt stockholder may be subject to tax as unrelated business taxable income. Although we do not believe that we, or any portion of our assets or Belvedere Trust s assets, will be treated as a taxable mortgage pool, no assurance can be given that the IRS might not successfully maintain that such a taxable mortgage pool exists.

For tax-exempt stockholders that are social clubs, voluntary employee benefit associations, supplemental unemployment benefit trusts, and qualified group legal services plans exempt from federal income taxation under Sections 501(c)(7), (c)(9), (c)(17) and (c)(20) of the Code, respectively, income from an investment in our stock will constitute unrelated business taxable income unless the organization is able to properly claim a deduction for amounts set aside or placed in reserve for certain purposes so as to offset the income generated by its investment in our stock. Any prospective and current investors should consult their tax advisors concerning these set aside and reserve requirements.

Notwithstanding the above, however, a substantial portion of the dividends you receive may constitute UBTI if we are treated as a pension-held REIT and you are a pension trust which:

- is described in Section 401(a) of the Code; and

- holds more than 10%, by value, of the interests in the REIT.

Tax-exempt pension funds that are described in Section 401(a) of the Code and exempt from tax under Section 501(a) of the Code are referred to below as qualified trusts.

A REIT is a pension-held REIT if:

- it would not have qualified as a REIT but for the fact that Section 856(h)(3) of the Code provides that stock owned by a qualified trust shall be treated, for purposes of the 5/50 Rule, described above, as owned by the beneficiaries of the trust, rather than by the trust itself; and
- either at least one qualified trust holds more than 25%, by value, of the interests in the REIT, or one or more qualified trusts, each of which owns more than 10%, by value, of the interests in the REIT, holds in the aggregate more than 50%, by value, of the interests in the REIT.

The percentage of any REIT dividend treated as unrelated business taxable income is equal to the ratio of:

- the unrelated business taxable income earned by the REIT, less directly related expenses, treating the REIT as if it were a qualified trust and therefore subject to tax on unrelated business taxable income, to
- the total gross income, less directly related expenses, of the REIT.

A de minimis exception applies where the percentage is less than 5% for any year. As a result of the limitations on the transfer and ownership of stock contained in our charter, we do not expect to be classified as a pension-held REIT.

Taxation of Non-United States Stockholders

The rules governing federal income taxation of non-United States stockholders are complex and no attempt will be made herein to provide more than a summary of these rules. Non-United States stockholders means beneficial owners of shares of our stock that are not United States stockholders (as such term is defined in the discussion above under the heading entitled Taxation of Taxable United States Stockholders).

PROSPECTIVE AND CURRENT NON-UNITED STATES STOCKHOLDERS SHOULD CONSULT THEIR TAX ADVISORS TO DETERMINE THE IMPACT OF FOREIGN, FEDERAL, STATE AND LOCAL INCOME TAX LAWS WITH REGARD TO AN INVESTMENT IN OUR STOCK AND OF OUR ELECTION TO BE TAXED AS A REAL ESTATE INVESTMENT TRUST, INCLUDING ANY REPORTING REQUIREMENTS.

Distributions to non-United States stockholders that are not attributable to gain from our sale or exchange of United States real property interests, and that are not designated by us as capital gain dividends or retained capital gains, will be treated as dividends of ordinary income to the extent that they are made out of our current or accumulated earnings and profits. These distributions will generally be subject to a withholding tax equal to 30% of the distribution unless an applicable tax treaty reduces or eliminates that tax. However, if income from an investment in our stock is treated as effectively connected with the non-United States stockholder s conduct of a United States trade or business, the non-United States stockholder generally will be subject to federal income tax at graduated rates in the same manner as United States stockholders are taxed with respect to those distributions and also may be subject to the 30% branch profits tax in the case of a non-United States stockholder that is a corporation. We expect to withhold tax at the rate of 30% on the gross amount of any distributions made to a non-United States stockholder unless:

- a lower treaty rate applies and any required form, for example IRS Form W-8BEN, evidencing eligibility for that reduced rate is filed by the non-United States stockholder with us; or

the non-United States stockholder files an IRS Form W-8ECI with us claiming that the distribution is effectively connected income.

Any portion of the dividends paid to non-United States stockholders that is treated as excess inclusion income will not be eligible for exemption from the 30% withholding tax or a reduced treaty rate.

Distributions in excess of our current and accumulated earnings and profits will not be taxable to non-United States stockholders to the extent that these distributions do not exceed the adjusted basis of the stockholder s stock, but rather will reduce the adjusted basis of that stock. To the extent that distributions in excess of current and accumulated earnings and profits exceed the adjusted basis of a non-United States stockholder s stock, these distributions will give rise to tax liability if the non-United States stockholder would otherwise be subject to tax on any gain from the sale or disposition of its stock, as described below. Because it generally cannot be determined at the time a distribution is made whether or not such distribution may be in excess of current and accumulated earnings and profits, the entire amount of any distribution normally will be subject to withholding at the same rate as a dividend. However, amounts so withheld are creditable against United States tax liability, if any, or refundable by the IRS to the extent the distribution is subsequently determined to be in excess of our current and accumulated earnings and profits. We are also required to withhold 10% of any distribution in excess of our current and accumulated earnings and profits if our stock is a United States real property interest because we are not a domestically controlled REIT, as discussed below. Consequently, although we intend to withhold at a rate of 30% on the entire amount of any distribution, to the extent that we do not do so, any portion of a distribution not subject to withholding at a rate of 30% may be subject to withholding at a rate of 10%.

Distributions attributable to our capital gains which are not attributable to gain from the sale or exchange of a United States real property interest generally will not be subject to income taxation unless (1) investment in our stock is effectively connected with the non-United States stockholder s U.S. trade or business (or, if an income tax treaty applies, is attributable to a U.S. permanent establishment of the non-United States stockholder), in which case the non-United States stockholder will be subject to the same treatment as United States stockholders with respect to such gain (except that a corporate non-United States stockholder may also be subject to the 30% branch profits tax), or (2) the non-United States stockholder is a non-resident alien individual who is present in the United States for 183 days or more during the taxable year and certain other conditions are satisfied, in which case the non-resident alien individual will be subject to a 30% tax on the individual s capital gains.

For any year in which we qualify as a REIT, distributions that are attributable to gain from the sale or exchange of a United States real property interest, which includes some interests in real property, but generally does not include an interest solely as a creditor in mortgage loans or MBS, will be taxed to a non-United States stockholder under the provisions of the Foreign Investment in Real Property Tax Act of 1980, or FIRPTA. Under FIRPTA, distributions attributable to gain from sales of United States real property interests are taxed to a non-United States stockholder as if that gain were effectively connected with the stockholder s conduct of a United States trade or business. Non-United States stockholders thus would be taxed at the normal capital gain rates applicable to stockholders, subject to applicable alternative minimum tax and a special alternative minimum tax in the case of nonresident alien individuals. Distributions subject to FIRPTA also may be subject to the 30% branch profits tax in the hands of a non-United States corporate stockholder. We are required to withhold 35% of any distribution that we designate (or, if greater, the amount that we could designate) as a capital gains dividend. The amount withheld is creditable against the non-United States stockholder s FIRPTA tax liability.

A capital gain distribution from a REIT to a foreign investor has been removed from the category of effectively connected income, provided that (i) the distribution is received with respect to a class of stock that is regularly traded on an established securities market located in the United States (our stock currently is so traded) and (ii) the foreign investor does not own more than 5% of the class of stock at any time during the taxable year within which the distribution is received. In that case, the foreign investor is not required to file a U.S. federal income tax return by reason of receiving such a distribution. The distribution is to be treated as a REIT dividend to that investor, taxed as a REIT dividend that is not a capital gain. Also, the branch profits tax does not apply to such a distribution.

Gains recognized by a non-United States stockholder upon a sale of our stock generally will not be taxed under FIRPTA if we are a domestically-controlled REIT, which is a REIT in which at all times during a specified testing period less than 50% in value of the stock was held directly or indirectly by non-United States stockholders. Because our stock is publicly traded, we cannot assure our investors that we are or will remain a domestically-controlled REIT. Even if we are not a domestically-controlled REIT, however, a non-United States stockholder that owns, actually or constructively, 5% or less of our stock throughout a specified testing period will not recognize taxable gain on the sale of our stock under FIRPTA if the shares are traded on an established securities market.

If gain from the sale of the stock were subject to taxation under FIRPTA, the non-United States stockholder would be subject to the same treatment as United States stockholders with respect to that gain, subject to applicable alternative minimum tax, a special alternative minimum tax in the case of nonresident alien individuals, and the possible application of the 30% branch profits tax in the case of non-United States corporations. In addition, the purchaser of the stock could be required to withhold 10% of the purchase price and remit such amount to the IRS.

Gains not subject to FIRPTA will be taxable to a non-United States stockholder if:

- the non-United States stockholder s investment in the stock is effectively connected with a trade or business in the United States, in which case the non-United States stockholder will be subject to the same treatment as United States stockholders with respect to that gain; or

- the non-United States stockholder is a nonresident alien individual who was present in the United States for 183 days or more during the taxable year and other conditions are met, in which case the nonresident alien individual will be subject to a 30% tax on the individual s capital gains.

Information Reporting and Backup Withholding

If the proceeds of a disposition of our stock are paid by or through a U.S. office of a broker-dealer, the payment is generally subject to information reporting and to backup withholding (currently at a rate of 28%) unless the disposing non-United States stockholder certifies as to his name, address and non-U.S. status or otherwise establishes an exemption. Generally, U.S. information reporting and backup withholding will not apply to a payment of disposition proceeds if the payment is made outside the U.S. through a foreign office of a foreign broker-dealer. If the proceeds from a disposition of our stock are paid to or through a foreign office of a U.S. broker-dealer or a non-U.S. office of a foreign broker-dealer that is (i) a controlled foreign corporation for federal income tax purposes, (ii) a foreign person 50% or more of whose gross income from all sources for a three-year period was effectively connected with a U.S. trade or business, (iii) a foreign partnership with one or more partners who are U.S. persons and who in the aggregate hold more than 50% of the income or capital interest in the partnership, or (iv) a foreign partnership engaged in the conduct of a trade or business in the United States, then (i) backup withholding will not apply unless the broker-dealer has actual knowledge that the owner is not a foreign stockholder, and (ii) information reporting will not apply if the non-United States stockholder satisfies certification requirements regarding its status as a foreign stockholder.

State, Local and Foreign Taxation

We may be required to pay state, local and foreign taxes in various state, local and foreign jurisdictions, including those in which we transact business or make investments, and our stockholders may be required to pay state, local and foreign taxes in various state, local and foreign jurisdictions, including those in which they reside. Our state, local and foreign tax treatment may not conform to the federal income tax consequences summarized above. In addition, a stockholder s state, local and foreign tax treatment may not conform to the federal income tax consequences summarized above. Consequently, prospective investors should consult their tax advisors regarding the effect of state, local and foreign tax laws on an investment in our stock.

Possible Legislative or Other Actions Affecting Tax Considerations

Prospective investors and stockholders should recognize that the present U.S. federal income tax treatment of an investment in our stock may be modified by legislative, judicial or administrative action at any time and that any such action may affect investments and commitments previously made. The rules dealing with U.S. federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Treasury Department, resulting in revisions of regulations and revised interpretations of established concepts as well as statutory changes. Revisions in U.S. federal tax laws and interpretations thereof could adversely affect the tax consequences of an investment in our stock.

Item 1A. RISK FACTORS

An investment in our stock involves a number of risks. Before making a decision to purchase our securities, you should carefully consider all of the risks described in this annual report. If any of the risks discussed in this annual report actually occur, our business, financial condition and results of operations could be materially adversely affected. If this were to occur, the trading price of our securities could decline significantly and you may lose all or part of your investment.

General Risks Related to Our Business

Our leveraging strategy increases the risks of our operations.

Relative to our investment grade Agency and Non-Agency MBS, we generally borrow, on a short-term basis, between eight to twelve times the amount of our equity, although our borrowings may at times be above or below this amount. We incur this leverage by borrowing against a substantial portion of the market value of our mortgage-related assets. Use of leverage can enhance our investment returns. Leverage, however, also increases risks. In the following ways, the use of leverage increases our risk of loss and may reduce our net income by increasing the risks associated with other risk factors including a decline in the market value of our MBS or a default of a mortgage-related asset:

- The use of leverage increases our risk of loss resulting from various factors including rising interest rates, increased interest rate volatility, downturns in the economy and reductions in the availability of financing or deterioration in the conditions of any of our mortgage-related assets.

- A majority of our borrowings are secured by our mortgage-related assets, generally under repurchase agreements. A decline in the market value of the mortgage-related assets used to secure these debt obligations could limit our ability to borrow or result in lenders requiring us to pledge additional collateral to secure our borrowings. In that situation, we could be required to sell mortgage-related assets under adverse market conditions in order to obtain the additional collateral required by the lender. If these sales are made at prices lower than the carrying value of the MBS, we would experience losses.

- A default of a mortgage-related asset that constitutes collateral for a repurchase agreement or whole loan financing facility could also result in an involuntary liquidation of the mortgage-related asset. This would result in a loss to us of the difference between the value of the mortgage-related asset upon liquidation and the amount borrowed against the mortgage-related asset.

- To the extent we are compelled to liquidate qualified REIT assets to repay debts, our compliance with the REIT rules regarding our assets and our sources of income could be affected, which could jeopardize our status as a REIT. Losing our REIT status would cause us to lose tax advantages applicable to REITs and may decrease our overall profitability and distributions to our stockholders.

Our officers devote a portion of their time to other companies in capacities that could create conflicts of interest that may harm our investment opportunities; this lack of a full-time commitment could also harm our operating results.

Lloyd McAdams, Joseph E. McAdams, Thad M. Brown, Bistra Pashamova and other of our officers and employees are officers and employees of Pacific Income Advisers, or PIA, where they devote a portion of their time. These officers and employees are under no contractual obligations mandating minimum amounts of time to be devoted to our company. In addition, a trust controlled by Lloyd McAdams is the principal stockholder of PIA.

These officers and employees are involved in investing both our assets and approximately $4.1 billion in MBS and other fixed income assets for institutional clients and individual investors through PIA. These multiple responsibilities and ownerships may create conflicts of interest if these officers and employees of our company are presented with opportunities that may benefit both us and the clients of PIA. These officers allocate investments among our portfolio and the clients of PIA by determining the entity or account for which the investment is most suitable. In making this determination, these officers consider the investment strategy and guidelines of each entity or account with respect to acquisition of assets, leverage, liquidity and other factors that our officers determine appropriate. These officers, however, have no obligation to make any specific investment opportunities available to us and the above-mentioned conflicts of interest may result in decisions or allocations of securities that are not in our best interests.

Several of our officers and employees are also directors, officers and managers of BT Management, the company that manages the day-to-day operations of Belvedere Trust, and Lloyd McAdams is also an owner and Chairman of Syndicated Capital, Inc., a registered broker-dealer. Our officers service to PIA, BT Management and Syndicated Capital, Inc. allow them to spend only part of their time and effort managing our company, as they are required to devote a portion of their time and effort to the management of other companies, and this may harm our overall management and operating results.

We may incur increased borrowing costs related to repurchase agreements and that would harm our profitability.

Currently, all of our borrowings are collateralized borrowings in the form of repurchase and whole loan financing agreements. If the interest rates on these agreements increase, that would harm our profitability.

Our borrowing costs under repurchase agreements generally correspond to short-term interest rates such as LIBOR or a short-term Treasury index, plus or minus a margin. The margins on these borrowings over or under short-term interest rates may vary depending upon:

- the movement of interest rates;
- the availability of financing in the market; and
- the value and liquidity of our mortgage-related assets.

An increase in interest rates may harm our book value and cause a decrease in the demand for mortgage loans, which could harm the cash available for distribution to you.

Increases in interest rates may harm the market value of our mortgage-related assets. Our hybrid adjustable-rate mortgage-related assets (during the fixed-rate component of the mortgages underlying such assets) and our fixed-rate securities are generally more harmed by these increases. In accordance with generally accepted accounting principles (or GAAP), we reduce our book value by the amount of any decrease in the market value of our mortgage-related assets. Losses on securities classified as available-for-sale, which are determined by management to be other-than-temporary in nature, are reclassified from Accumulated other comprehensive income to current operations.

Furthermore, rising interest rates generally reduce the demand for consumer credit, including mortgage loans. Interest rates had been at record low levels in recent years. The Mortgage Bankers Association of America has projected that residential mortgage loan originations will decrease for a period after 2006, primarily due to an anticipated decrease in refinancings caused by rising interest rates. In a period of rising interest rates, we expect to acquire and securitize fewer loans, which would harm parts of our business, revenues and results of operations, which could adversely affect the amount of cash available for distribution to you.

A flat or inverted yield curve may negatively affect our operations, book value and profitability due to its potential impact on investment yields and the supply of adjustable-rate mortgage, or ARM, products.

A flat yield curve occurs when there is little difference between short-term and long-term interest rates. An inverted yield curve occurs when short-term interest rates are higher than long-term interest rates. A flat or inverted yield curve may be an adverse environment for ARM product volume, as there may be little incentive for borrowers to choose an ARM product over a longer-term fixed-rate loan. If the supply of ARM product decreases, yields may decline due to market forces.

Our borrowing costs under repurchase agreements generally correspond to short-term interest rates such as LIBOR. A flat or inverted yield curve will likely result in lower profits.

Additionally, a flat or inverted yield curve may negatively impact the pricing of our securities. According to GAAP, if the values of our securities decrease, we reduce our book value by the amount of any decrease in the market value of our mortgage-related assets.

We depend on borrowings to purchase mortgage-related assets and reach our desired amount of leverage. If we fail to obtain or renew sufficient funding on favorable terms, we will be limited in our ability to acquire mortgage-related assets and our earnings and profitability would decline.

We depend on short-term borrowings to fund acquisitions of mortgage-related assets and reach our desired amount of leverage. Accordingly, our ability to achieve our investment and leverage objectives depends on our ability to borrow money in sufficient amounts and on favorable terms. In addition, we must be able to renew or replace our maturing short-term borrowings on a continuous basis. Moreover, we depend on a limited number of lenders to provide the primary credit facilities for our purchases of mortgage-related assets.

If we cannot renew or replace maturing borrowings, we may have to sell our mortgage-related assets under adverse market conditions and may incur permanent capital losses as a result. Any number of these factors in combination may cause difficulties for us, including a possible liquidation of a major portion of our portfolio at disadvantageous prices with consequent losses, which may render us insolvent.

Possible market developments could cause our lenders to require us to pledge additional assets as collateral. If our assets are insufficient to meet the collateral requirements, then we may be compelled to liquidate particular assets at an inopportune time.

Possible market developments, including a sharp rise in interest rates, a change in prepayment rates or increasing market concern about the value or liquidity of one or more types of mortgage-related assets in which our portfolio is concentrated may reduce the market value of our portfolio, which may cause our lenders to require additional collateral. This requirement for additional collateral may compel us to liquidate our assets at a disadvantageous time, thus harming our operating results and net profitability.

Our use of repurchase agreements to borrow funds may give our lenders greater rights in the event that either we or a lender files for bankruptcy.

Our borrowings under repurchase agreements may qualify for special treatment under the bankruptcy code, giving our lenders the ability to avoid the automatic stay provisions of the bankruptcy code and to take

possession of and liquidate our collateral under the repurchase agreements without delay in the event that we file for bankruptcy. Furthermore, the special treatment of repurchase agreements under the bankruptcy code may make it difficult for us to recover our pledged assets in the event that a lender files for bankruptcy. Thus, the use of repurchase agreements exposes our pledged assets to risk in the event of a bankruptcy filing by either a lender or us.

Because assets we acquire may experience periods of illiquidity, we may lose profits or be prevented from earning capital gains if we cannot sell mortgage-related assets at an opportune time.

We bear the risk of being unable to dispose of our mortgage-related assets at advantageous times or in a timely manner because mortgage-related assets generally experience periods of illiquidity. The lack of liquidity may result from the absence of a willing buyer or an established market for these assets, as well as legal or contractual restrictions on resale. As a result, the illiquidity of mortgage-related assets may cause us to lose profits and the ability to earn capital gains.

Our hedging strategies may not be successful in mitigating our risks associated with interest rates.

We engage in hedging activity. As such, we use various derivative financial instruments to provide a level of protection against interest rate risks, but no hedging strategy can protect us completely. When interest rates change, we expect to record a gain or loss on derivatives, which would be offset by an inverse change in the value of loans or residual interests. Additionally, from time to time, we may enter into hedging transactions in connection with our holdings of MBS and government securities with respect to one or more of our assets or liabilities. Our hedging activities may include entering into interest rate swaps, caps and floors, options to purchase these items and futures and forward contracts. Our actual hedging decisions will be determined in light of the facts and circumstances existing at the time and may differ from our currently anticipated hedging strategy. We cannot assure you that our use of derivatives will offset the risks related to changes in interest rates. It is likely that there will be periods in the future during which we will incur losses after accounting for our derivative financial instruments. The derivative financial instruments we select may not have the effect of reducing our interest rate risk. In addition, the nature and timing of hedging transactions may influence the effectiveness of these strategies. Poorly designed strategies or improperly executed transactions could actually increase our risk and losses. In addition, hedging strategies involve transaction and other costs. We cannot assure you that our hedging strategy and the derivatives that we use will adequately offset the risk of interest rate volatility or that our hedging transactions will not result in losses.

Competition may prevent us from acquiring mortgage-related assets at favorable yields and that would negatively impact our profitability.

Our net income largely depends on our ability to acquire mortgage-related assets at favorable spreads over our borrowing costs. In acquiring mortgage-related assets, we compete with other REITs, investment banking firms, savings and loan associations, banks, insurance companies, mutual funds, other lenders and other entities that purchase mortgage-related assets, many of which have greater financial resources than us. As a result, we may not in the future be able to acquire sufficient mortgage-related assets at favorable spreads over our borrowing costs. If that occurs, our profitability will be harmed.

Our board of directors may change our operating policies and strategies without prior notice or stockholder approval and such changes could harm our business, results of operation and stock price.

Our board of directors can modify or waive our current operating policies and our strategies without prior notice and without stockholder approval. We cannot predict the effect any changes to our current operating policies and strategies may have on our business, operating results and stock price, however, the effects may be adverse.

We depend on our key personnel and the loss of any of our key personnel could harm our operations.

We depend on the diligence, experience and skill of our officers and other employees for the selection, structuring and monitoring of our mortgage-related assets and associated borrowings. Our key officers include Lloyd McAdams, Chairman, President and Chief Executive Officer (Principal Executive Officer); Joseph E. McAdams, Chief Investment Officer, Executive Vice President and Director; Thad M. Brown, Chief Financial Officer (Principal Financial Officer), Treasurer and Secretary; Charles J. Siegel, Senior Vice President-Finance and Assistant Secretary; Evangelos Karagiannis, Vice President; and Bistra Pashamova, Vice President. Belvedere Trust s key officers are Claus Lund, Belvedere Trust s President and Chief Executive Officer, and Russell Thompson, Belvedere Trust s Chief Financial Officer and Treasurer. Our dependence on our key personnel is heightened by the fact that we have a relatively small number of employees and the loss of any key person could harm our entire business, financial condition, cash flow and results of operations. In particular, the loss of the services of Lloyd McAdams or Joseph E. McAdams could seriously harm our business.

Our incentive compensation plan may create an incentive to increase the risk of our mortgage portfolio in an attempt to increase compensation.

In addition to their base salaries, some management and key employees are eligible to earn incentive compensation for each fiscal year pursuant to our 2002 Incentive Plan. Under the 2002 Incentive Plan, the aggregate amount of compensation that may be earned by these employees equals a percentage of taxable net income, before incentive compensation, in excess of the amount that would produce an annualized return on average net worth equal to the ten-year U.S. Treasury Rate plus 1%. In any fiscal quarter in which our taxable net income is an amount less than the amount necessary to earn this threshold return, we calculate negative incentive compensation for that fiscal quarter which will be carried forward and will offset future incentive compensation earned under the 2002 Incentive Plan, but only with respect to those participants who were participants during the fiscal quarter(s) in which negative incentive compensation was generated. Although negative incentive compensation is used to offset future incentive compensation, as our management evaluates different mortgage-related assets for our investment, there is a risk that management will cause us to assume more risk than is prudent.

Risk Related Primarily to Anworth s Business

Interest rate mismatches between our adjustable-rate MBS and our borrowings used to fund our purchases of these assets may reduce our income during periods of changing interest rates.

We fund most of our acquisitions of adjustable-rate MBS with borrowings that have interest rates based on indices and repricing terms similar to, but of shorter maturities than, the interest rate indices and repricing terms of our MBS. Accordingly, if short-term interest rates increase, this may harm our profitability.

Most of the MBS we acquire are adjustable-rate securities. This means that their interest rates may vary over time based upon changes in a short-term interest rate index. Therefore, in most cases, the interest rate indices and repricing terms of the MBS that we acquire and their funding sources will not be identical, thereby creating an interest rate mismatch between our assets and liabilities. While the historical spread between relevant short-term interest rate indices has been relatively stable, there have been periods when the spread between these indices was volatile. During periods of changing interest rates, these mismatches could reduce our net income, dividend yield and the market price of our stock.

The interest rates on our borrowings generally adjust more frequently than the interest rates on our adjustable-rate MBS. For example, at December 31, 2006, our agency and Non-Agency adjustable-rate MBS had a weighted average term to next rate adjustment of approximately 28 months, while our borrowings had a weighted average term to next rate adjustment of 90 days. After adjusting for interest rate swap transactions, the weighted average term to next rate adjustment was 301 days. Accordingly, in a period of rising interest rates, we

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could experience a decrease in net income or a net loss because the interest rates on our borrowings adjust faster than the interest rates on our adjustable-rate MBS.

Increased levels of prepayments from MBS may decrease our net interest income.

Pools of mortgage loans underlie the MBS that we acquire. We generally receive payments from principal payments that are made on these underlying mortgage loans. When borrowers prepay their mortgage loans faster than expected, this results in prepayments that are faster than expected on the MBS. Faster than expected prepayments could harm our profitability as follows:

- We usually purchase MBS that have a higher interest rate than the market interest rate at the time. In exchange for this higher interest rate, we pay a premium over the par value to acquire the security. In accordance with accounting rules, we amortize this premium over the term of the mortgage-backed security. If the mortgage-backed security is prepaid in whole or in part prior to its maturity date, however, we expense the premium that was prepaid at the time of the prepayment. At December 31, 2006, substantially all of our MBS had been acquired at a premium.

- We anticipate that a substantial portion of our adjustable-rate MBS may bear interest rates that are lower than their fully indexed rates, which are equivalent to the applicable index rate plus a margin. If an adjustable-rate mortgage-backed security is prepaid prior to or soon after the time of adjustment to a fully indexed rate, we will have held that mortgage-backed security while it was less profitable and lost the opportunity to receive interest at the fully indexed rate over the remainder of its expected life.

- If we are unable to acquire new MBS similar to the prepaid MBS, our financial condition, results of operation and cash flow would suffer.

Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. Prepayment rates also may be affected by conditions in the housing and financial markets, general economic conditions and the relative interest rates on fixed-rate and adjustable-rate mortgage loans.

While we seek to minimize prepayment risk to the extent practical, in selecting investments, we must balance prepayment risk against other risks and the potential returns of each investment. No strategy can completely insulate us from prepayment risk.

We may experience reduced net interest income from holding fixed-rate investments during periods of rising interest rates.

We generally fund our acquisition of fixed-rate MBS with short-term borrowings. During periods of rising interest rates, our costs associated with borrowings used to fund acquisition of fixed-rate assets are subject to increases while the income we earn from these assets remains substantially fixed. This reduces or could eliminate the net interest spread between the fixed-rate MBS that we purchase and our borrowings used to purchase them, which could lower our net interest income or cause us to suffer a loss. At December 31, 2006, 16% of our Agency MBS were fixed-rate securities.

Interest rate caps on our adjustable-rate MBS may reduce our income or cause us to suffer a loss during periods of rising interest rates.

Our adjustable-rate MBS are subject to periodic and lifetime interest rate caps. Periodic interest rate caps limit the amount an interest rate can increase during any given period. Lifetime interest rate caps limit the amount an interest rate can increase through maturity of a mortgage-backed security. Our borrowings are not subject to similar restrictions. Accordingly, in a period of rapidly increasing interest rates, the interest rates paid on our borrowings could increase without limitation while interest rate caps would limit the interest rates on our

adjustable-rate MBS. This problem is magnified for our adjustable-rate MBS that are not fully indexed. Further, some adjustable-rate MBS may be subject to periodic payment caps that result in a portion of the interest being deferred and added to the principal outstanding. As a result, we could receive less cash income on adjustable-rate MBS than we need to pay interest on our related borrowings. These factors could lower our net interest income or cause us to suffer a loss during periods of rising interest rates. At December 31, 2006, approximately 84% of our Agency MBS were adjustable-rate securities.

We may invest in leveraged mortgage derivative securities that generally experience greater volatility in market prices, thus exposing us to greater risk with respect to their rate of return.

We may acquire leveraged mortgage derivative securities that may expose us to a high level of interest rate risk. The characteristics of leveraged mortgage derivative securities result in greater volatility in their market prices. Thus, acquisition of leveraged mortgage derivative securities would expose us to the risk of greater price volatility in our portfolio and that could harm our net income and overall profitability.

New assets we acquire may not generate yields as attractive or be as accretive to book value as have been experienced historically.

We may acquire new assets as we receive principal and interest payments and prepayments from our existing assets. We also sell assets from time to time as part of our portfolio and asset/liability management programs. We may invest these proceeds into new earning assets.

New assets may not generate yields as attractive as we have experienced historically. Business conditions, including credit results, prepayment patterns and interest rate trends in the future, are unlikely to be as favorable as they have been for the last few years.

New assets may not be as accretive to book value as existing assets. The market value of our assets is sensitive to interest rate fluctuations. In the past few years as short-term interest rates have increased, the market value of our existing assets has declined. As we classify our Agency MBS, Non-Agency MBS and BT Other MBS as available-for-sale, accounting regulations require that any unrealized losses from the decline in market value be carried as Accumulated other comprehensive loss in the Stockholders equity section of the Consolidated Balance Sheets. When short-term interest rates stop increasing, or start declining, or when the interest rates on these securities reset, the market value of these assets will increase. This may be more accretive to book value than the new assets that we acquire to replace any existing assets.

Our investment policy involves risks associated with the credit quality of our investments. If the credit quality of our investments declines or if there are defaults on the investments we make, our profitability may decline and we may suffer losses.

Our MBS have primarily been agency certificates that, although not rated, carry an implied AAA rating. Agency certificates are MBS where either Freddie Mac or Fannie Mae guarantees payments of principal or interest on the certificates. Freddie Mac and Fannie Mae are government-sponsored enterprises and securities guaranteed by these entities are not guaranteed by the United States government. Our capital investment policy, however, provides us with the ability to acquire a material amount of lower credit quality MBS. If we acquire MBS of lower credit quality, our profitability may decline and we may incur losses if there are defaults on the mortgages backing those securities or if the rating agencies downgrade the credit quality of those securities or the securities of Fannie Mae and Freddie Mac.

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Risk Related Primarily to Belvedere Trust s Business

Increased levels of prepayments from loans and MBS may decrease Belvedere Trust s net interest income.

When borrowers prepay their mortgage loans faster than expected, this results in an early return of principal and, generally, a shorter average life for the related mortgage assets. Faster than expected prepayments could harm Belvedere Trust s profitability as follows:

- Belvedere Trust may purchase mortgage loans and MBS that have a higher interest rate than the market interest rate at the time. In exchange for this higher interest rate, Belvedere Trust may pay a premium over the par value to acquire the asset. In accordance with accounting rules, Belvedere Trust amortizes this premium over the term of the mortgage-related asset. Belvedere Trust estimates prepayment speeds for the purposes of amortizing the premium or discount for each mortgage-related asset that it acquires. If the prepayment speeds for the mortgage-related asset are faster than expected, the interest income related to that asset may be reduced and the amortization of the premium may be accelerated.

- Belvedere Trust anticipates that a substantial portion of its adjustable-rate mortgage loans and MBS may bear interest rates that are lower than their fully indexed rates, which are equivalent to the applicable index rate plus a margin. If an adjustable-rate mortgage-related asset is prepaid prior to or soon after the time of adjustment to a fully indexed rate, Belvedere Trust will have held that mortgage-related asset while it was less profitable and lost the opportunity to receive interest at the fully indexed rate over the remainder of its expected life.

- If Belvedere Trust is unable to acquire new mortgage-related assets similar to the prepaid assets, its financial condition, results of operation and cash flow would suffer.

- Certain mortgage-related assets, such as interest-only securities, bear a concentrated level of prepayment risk. Faster than expected prepayments could result in a reduction of interest income and an increase in premium amortization expense, resulting in lower net income, and may result in an impairment of the value of the asset.

Prepayment rates generally increase when interest rates fall and decrease when interest rates rise, but changes in prepayment rates are difficult to predict. Prepayment rates also may be affected by conditions in the housing and financial markets, general economic conditions and the relative interest rates on fixed-rate and adjustable-rate mortgage loans.

While Belvedere Trust seeks to minimize prepayment risk to the extent practical, in selecting investments, it must balance prepayment risk against other risks and the potential returns of each investment. No strategy can completely insulate Belvedere Trust from prepayment risk.

Belvedere Trust s inability to complete an initial public offering or to secure alternate sources of equity could materially harm its business and results.

On May 17, 2005, Belvedere Trust filed a registration statement with the SEC for the purpose of registering up to $100 million of its common stock in connection with a contemplated IPO. In December 2005, after discussions with the underwriters, Anworth and Belvedere Trust determined that the IPO would be delayed due to current market conditions. Should Belvedere Trust be unable to complete an IPO or obtain alternate sources of equity, its ability to acquire mortgage-related assets would be materially harmed and, as a result, its business and results from operations could be materially negatively affected.

Belvedere Trust s use of short-term debt exposes us to liquidity, market value and securitization execution risks that could result in harm to our financial condition.

In order to continue its securitization operations, Belvedere Trust requires access to short-term debt to finance loan inventory accumulation prior to sale to securitization entities. In times of market dislocation, this

type of short-term debt might become unavailable from time to time. During such periods, Belvedere Trust would have to reduce the volume of its holdings and the number of securitizations that it undertakes. Belvedere Trust uses the inventory of assets it acquires to collateralize the debt. The debt is recourse to Belvedere Trust and if the market value of the collateral declines, Belvedere Trust may need to use its liquidity to increase the amount of collateral pledged to secure the debt or to reduce the debt amount.

Belvedere Trust s payment of commitment fees and other expenses to secure borrowing lines may not protect it from liquidity issues or losses. Variations in lenders ability to access funds, lender confidence in Belvedere Trust, lender collateral requirements, available borrowing rates, the acceptability and market values of Belvedere Trust s collateral and other factors could force Belvedere Trust to utilize its liquidity reserves or to sell assets and thus could harm its liquidity, financial soundness and earnings.

If Belvedere Trust is unable to complete securitizations or experiences delayed mortgage loan sales or securitization closings, it could face a liquidity shortage, which would harm our operating results.

Belvedere Trust relies significantly upon securitizations to generate cash proceeds to repay borrowings and replenish its borrowing capacity. If there is a delay in a securitization closing or any reduction in its ability to complete securitizations, Belvedere Trust may be required to utilize other sources of financing which, if available at all, may not be on similar terms. In addition, delays in closing mortgage sales or securitizations of our mortgage loans increase its risk by exposing it to credit and interest rate risks for this extended period of time. Several factors could harm Belvedere Trust s ability to complete securitizations of its mortgage loans including, among others, the following:

- conditions in the securities and secondary markets;
- the credit quality of the mortgage loans acquired;
- the volume of its mortgage loan acquisitions;
- its ability to obtain credit enhancements;
- downgrades by rating agencies of its previous securitizations; and
- lack of investor demand for purchasing components of the securities.

Belvedere Trust s business may be significantly harmed by a slowdown in the economy of California, resulting in potentially higher delinquencies and increased loan losses.

At December 31, 2006, approximately 52% of the residential real estate loans that Belvedere Trust owns are secured by property in California. An overall decline in the economy or the residential real estate market, or the occurrence of a natural disaster that is not covered by standard homeowners insurance policies, such as an earthquake or hurricane, could decrease the value of mortgaged properties in California. This, in turn, would increase the risk of delinquency, default or foreclosure on mortgage loans underlying Belvedere Trust s MBS. This could harm Belvedere Trust s credit loss experience and may harm other aspects of Belvedere Trust s business including Belvedere Trust s ability to securitize mortgage loans.

Belvedere Trust has had only limited operating history in the business of acquiring and securitizing whole mortgage loans and it may not be successful.

Belvedere Trust was formed in November 2003 to engage in the business of acquiring and securitizing mortgage loans and other mortgage-related assets and it has a limited operating history. The acquisition of residential real estate loans and the securitization process are inherently complex and involve risks related to the types of mortgage loans Belvedere Trust seeks to acquire, interest rate changes, funding sources, delinquency rates, prepayment rates, borrower bankruptcies and other factors that Belvedere Trust may not be able to manage. Incorrect

management of these risks may take years to become apparent. If it fails to manage these and other risks, this could harm our business and the results of our operations.

Belvedere Trust s investment strategy of acquiring, accumulating and securitizing loans involves credit risk that could result in loan losses and could harm our operating results.

While Belvedere Trust securitizes the loans it acquires in order to improve its access to financing, it bears the risk of loss on any loans that it acquires and which it subsequently securitizes. Belvedere Trust has risk of loss for all loans and other mortgage-related assets it holds on its balance sheet. Belvedere Trust acquires loans and other mortgage-related assets that are typically not credit enhanced and that do not have the backing of Fannie Mae or Freddie Mac. Accordingly, Belvedere Trust is subject to risks of borrower default, bankruptcy and special hazard losses (such as those occurring from earthquakes and hurricanes) with respect to those loans to the extent that there is any deficiency between the value of the mortgage collateral and insurance and the principal amount of the loan and any premium paid for the loan. In the event of a default on any such loans that Belvedere Trust holds, Belvedere Trust would bear the loss of principal between the realized value of the mortgaged property and the principal amount of the loan as well as foreclosure costs and the loss of interest. We have not established any limits upon the geographic concentration or the credit quality of suppliers of the mortgage loans that Belvedere Trust acquires.

Belvedere Trust s efforts to manage credit risk may not be successful in limiting delinquencies and defaults in underlying loans or losses on its investments.

At December 31, 2006, approximately 2.98% of the loans in Belvedere Trust s portfolio, including Belvedere Trust s first securitization (HYB1), were 30 days or more delinquent by outstanding principal balance. Belvedere Trust has incurred losses to date of $261 thousand. Based on current analysis, Belvedere Trust projects loan losses to approximate 0.215% of the original loan balances. This analysis is based on factors related to borrower credit, such as Fair, Isaac and Company (FICO) score, as well as the value of the underlying properties relative to the loan balances.

Loan losses may be greater than Belvedere Trust anticipates. Despite its efforts to manage credit risk, there are many aspects of credit that it cannot control and there can be no assurance that Belvedere Trust s quality control and loss mitigation operations will be successful in limiting future delinquencies, defaults and losses. Belvedere Trust s underwriting reviews or third-party reviews may not be effective. The securitizations in which Belvedere Trust has invested may not receive funds that Belvedere Trust believes are due from mortgage insurance companies. Loan servicing companies may not cooperate with Belvedere Trust s loss mitigation efforts, or such efforts may otherwise be ineffective. Various service providers to securitizations, such as trustees, bond insurance providers and custodians, may not perform in a manner that promotes Belvedere Trust s interests. The value of the homes collateralizing residential loans may decline. Belvedere Trust acquires loans that allow for negative amortization; if the borrowers make payments that are less than the amount required to pay the interest due on these loans, the principal balance of the loans will increase. At December 31, 2006, 38% of Belvedere Trust s loans allowed for negative amortization. If loans become real estate owned, servicing companies will have to manage these properties and may not be able to sell them. Changes in consumer behavior, bankruptcy laws and other laws may increase loan losses. In most cases, the value of the underlying property will be the sole source of funds for any recoveries. Expanded loss mitigation efforts in the event that defaults increase could increase Belvedere Trust s operating costs.

Belvedere Trust requires a significant amount of capital and if it is not available, its business and financial performance could be significantly harmed.

Belvedere Trust requires substantial capital to fund its loan acquisitions, to pay its loan acquisition expenses and to hold its loans prior to securitization. Pending sale or securitization of a pool of mortgage loans, Belvedere Trust acquires mortgage-related assets that it expects to finance through borrowings from whole loan financing

facilities and repurchase agreements. It is possible that its lenders could experience changes in their ability to advance funds to us, independent of Belvedere Trust s performance or the performance of its loans. Belvedere Trust anticipates that its repurchase agreements will be dependent on the ability of counterparties to re-sell Belvedere Trust s obligations to third parties. If there is a disruption of the repurchase market generally, or if one of Belvedere Trust s counterparties is itself unable to access the repurchase market, Belvedere Trust s access to this source of liquidity could be harmed. Capital could also be required to meet margin calls under the terms of Belvedere Trust s borrowings in the event that there is a decline in the market value of the loans that collateralize its debt, the terms of short-term debt become less attractive, or for other reasons. Any of these events would harm Belvedere Trust s operating results, liquidity, financial condition and earnings.

To date, we have invested $100 million in Belvedere Trust to capitalize its mortgage operations. At December 31, 2006, Belvedere Trust had fully invested all of the proceeds of our investment. New investments are made by Belvedere Trust as capital is freed up from scheduled and unscheduled principal payments of its mortgage assets. Belvedere Trust monitors its portfolio on an ongoing basis and, to the extent it is deemed appropriate, securities may be sold and other investments made. If it is unable to sell additional securities on reasonable terms or at all, or it is not able to access external sources of capital, it will need to either reduce its acquisition business or sell a higher portion of its loans. In the event that Belvedere Trust s liquidity needs exceed its access to liquidity, Belvedere Trust may need to sell assets at an inopportune time, thus reducing its earnings. Adverse cash flow could threaten Belvedere Trust s ability to maintain solvency or to satisfy the income and asset tests necessary to elect and maintain REIT status.

To the extent that Belvedere Trust has a large number of loans in an area affected by a natural disaster, it may suffer losses.

Standard homeowner insurance policies generally do not provide coverage for natural disasters, such as hurricanes and the ensuing flooding. Furthermore, nonconforming borrowers are not likely to have special hazard insurance. To the extent that borrowers do not have insurance coverage for natural disasters, they may not be able to repair the property or may stop paying their mortgages if the property is damaged. A natural disaster that results in a significant number of delinquencies could cause increased foreclosures and decrease Belvedere Trust s ability to recover losses on properties affected by such disasters and could harm Belvedere Trust s retained residual interests in securitizations and thus Belvedere Trust s financial condition and results of operations.

Second-lien mortgage loans expose Belvedere Trust to greater credit risks.

To the extent Belvedere Trust invests in second-lien mortgage loans, its security interests in the property securing the second-lien mortgage loans is subordinated to the interests of the first mortgage holder and the second mortgages have a higher loan-to-value ratio than does the first mortgage. If the value of the property is equal to or less than the amount needed to repay the borrower s obligation to the first mortgage holder upon foreclosure, the second-lien mortgage loan will not be repaid. To date, Belvedere Trust has not invested in second-lien mortgage loans.

Residential mortgage loan delinquencies, defaults and credit losses could reduce Belvedere Trust s ability to complete securitizations, which could expose Belvedere Trust to risk from holding loans longer than expected.

Credit losses from any of the mortgage loans in the securitized loan pools reduce the principal value of and economic returns from residential MBS. Credit losses could reduce Belvedere Trust s ability to sponsor new securitizations of residential loans. Therefore, Belvedere Trust may have to hold loans longer on its balance sheet, which may change its risk profile with regard to credit and interest rate risk. At December 31, 2006, by outstanding principal balances, approximately 1.59% of the residential mortgage loans in Belvedere Trust s portfolio, including Belvedere Trust s first securitization, were 30 days delinquent, approximately 0.41% were 60 days delinquent and approximately 0.98% were 90 days delinquent.

The use of securitizations with over-collateralization requirements may have a negative impact on Belvedere Trust s cash flow.

Belvedere Trust does not currently use securitizations with over-collateralization requirements but may do so in the future. If Belvedere Trust utilizes over-collateralization as a credit enhancement to its securitizations, Belvedere Trust expects that such over-collateralization will restrict its cash flow if loan delinquencies exceed certain levels. The terms of Belvedere Trust s securitizations will generally provide that, if certain delinquencies and/or losses exceed the specified levels based on rating agencies (or the financial guaranty insurer s, if applicable) analysis of the characteristics of the loans pledged to collateralize the securities, the required level of over-collateralization may be increased or may be prevented from decreasing as would otherwise be permitted if losses and/or delinquencies did not exceed those levels. Other tests (based on delinquency levels or other criteria) may restrict Belvedere Trust s ability to receive net interest income from a securitization transaction. We cannot assure you that the performance tests will be satisfied. Failure to satisfy performance tests may harm our results of operations.

Representations and warranties made by Belvedere Trust in loan sales and securitizations may subject Belvedere Trust to liability that could result in loan losses and could harm our operating results.

In connection with securitizations, Belvedere Trust makes representations and warranties regarding the mortgage-related assets transferred into securitization trusts. The trustee in the securitizations has recourse to Belvedere Trust with respect to the breach of the standard representations and warranties regarding the loans made at the time such mortgage-related assets are transferred. While Belvedere Trust generally has recourse to its loan originators for any such breaches, there can be no assurance of the originators abilities to honor their respective obligations. Belvedere Trust attempts to generally limit the potential remedies of the trustee to the potential remedies Belvedere Trust receives from the originators from whom Belvedere Trust acquired the mortgage loans. However, in some cases, the remedies available to the trustee may be broader than those available to Belvedere Trust against the originators of the mortgage-related assets and, should the trustee enforce its remedies against Belvedere Trust, it may not always be able to enforce whatever remedies it has against its loan originators. Furthermore, if Belvedere Trust discovers, prior to the securitization of a loan, that there is any fraud or misrepresentation with respect to the mortgage and the originator fails to repurchase the mortgage, then Belvedere Trust may not be able to sell the mortgage or may have to sell the mortgage at a discount.

The mortgage-related assets Belvedere Trust owns expose it to concentrated risks and thus are likely to lead to variable returns.

Belvedere Trust s permanent asset portfolio produces a significant amount of its revenue. It consists principally of mortgage loans that have been securitized by Belvedere Trust and, to a lesser extent, securities acquired from securitizations sponsored by others. The mortgage-related assets Belvedere Trust owns employ a high degree of internal structural leverage that concentrates risk into the assets that Belvedere Trust acquires. No amount of risk management or mitigation can change the variable nature of cash flows, market values and financial results generated by concentrated risks in Belvedere Trust s mortgage-related investments which, in turn, can result in variable returns to Belvedere Trust. Due to the concentration of risks, the assets Belvedere Trust holds may be exposed to greater credit, interest rate and prepayment risk.

The success of Belvedere Trust s business will depend upon its ability to determine that mortgage loans are serviced effectively.

The success of Belvedere Trust s mortgage loan business will depend to a great degree upon its ability to determine that its mortgage loans are serviced effectively. In general, it is Belvedere Trust s intention to acquire loans servicing retained, where the loans will be serviced by the originating or selling institution. Belvedere Trust has no experience servicing a portfolio of loans. In those instances where Belvedere Trust is required to purchase the servicing of a loan portfolio in order to acquire a portfolio with desirable attributes, Belvedere Trust

will be required to sell the servicing rights, implement a servicing function or transfer the servicing of the loans to a third party with whom Belvedere Trust has established a sub-servicing relationship. We cannot assure you that Belvedere Trust will be able to service the loans or effectively supervise a sub-servicing relationship according to industry standards. Failure to service the loans properly will harm Belvedere Trust s business and operating results. Prior to either building the servicing capabilities that Belvedere Trust may require or acquiring an existing servicing operation that has such capabilities, if ever, Belvedere Trust has contracted with an experienced servicer of the type of loans it acquires to sub-service its loans. The fees paid to such subservicer will reduce, to a certain extent, the revenue Belvedere Trust is able to retain from its mortgage loans and Belvedere Trust s net interest income will be reduced and at risk, depending on the effectiveness of the servicing company.

Belvedere Trust acquires and owns interest-only loans which expose it to increased risk of default.

A portion of the loans Belvedere Trust acquires have interest-only features during the initial term of the loan. At December 31, 2006, 41% of the loans Belvedere Trust owned had interest-only features as measured by outstanding principal balance. These loans permit borrowers not to begin repayment of the principal balance of the loans until after the interest-only period expires. After the expiration of the interest-only period, the borrowers payments increase to amortize the entire principal balance owed over the remaining life of the loan. Variable-rate interest-only products, especially when coupled with an amortization feature that begins at a time in the future, can significantly increase the payment obligation. Consequently, there is a risk that these mortgagors may be unable to make the increased payments and could default under these loans. In the event the performance of Belvedere Trust s interest-only loans is below expectations, its operating results, financial condition and business prospects could be harmed.

Belvedere Trust has acquired most of its mortgage-related assets from a limited number of originators and the failure to properly manage these relationships, or if these originators experience origination problems, Belvedere Trust s ability to acquire loans from them could be harmed, which would negatively affect its operations.

Belvedere Trust has acquired most of its mortgage-related assets from a limited number of originators. At December 31, 2006, approximately 60% of the loans acquired by Belvedere Trust had been originated by Countrywide Home Loans, Inc. and 18% had been originated by Washington Mutual Bank, N.A. and its affiliates, as measured by outstanding principal balance as of that date. If Belvedere Trust is unable to properly manage these relationships, or if these originators experience significant problems with their origination capabilities, Belvedere Trust s ability to acquire loans from them may be harmed and its results from operations may be negatively affected.

Belvedere Trust has acquired non-investment grade securities which bear a greater risk of credit losses.

Belvedere Trust has acquired non-investment grade securities which include first loss, second loss and third loss securities. Credit losses are generally allocated to securities in order, beginning with the first loss security up to a maximum of the principal amount of the first loss security. Losses are then allocated in order to the second loss, third loss and more senior securities. Since these securities include the first loss security, we bear primary credit risk associated with mortgages with a face value of $1.5 billion as of December 31,2006. Additionally, when Belvedere Trust acquires these securities, the purchase price generally includes a discount associated with this credit risk. Belvedere Trust evaluates the discount against any probable losses. If, subsequent to the acquisition of the securities, the estimated losses exceed the discount, this would cause a reduction in earnings.

Belvedere Trust is externally managed and this may diminish or eliminate the return on our investment in this line of business.

Belvedere Trust is externally managed pursuant to a management agreement between Belvedere Trust and BT Management. Although we own 50% of BT Management, 45% is also owned by the executive officers of Belvedere Trust and 5% by Lloyd McAdams. Our ability to generate profits from our ownership of Belvedere Trust, if any, could be greatly diminished due to the fact that we will be required to pay a base management fee to BT Management and we may also be required to pay an incentive fee. An externally managed structure may not optimize our interest in Belvedere Trust and, if we are unable to properly manage fixed costs at Belvedere Trust could, when combined with the base management fee, result in losses at Belvedere Trust.

Our Chairman has an ownership interest in BT Management that creates potential conflicts of interest.

Lloyd McAdams, our Chairman and Principal Executive Officer, has a direct ownership interest in BT Management that creates potential conflicts of interest. Mr. McAdams is Chairman of the Board and Principal Executive Officer and a member of the Board of Managers of BT Management and owns an equity interest in BT Management. Under the management agreement between Belvedere Trust and BT Management, BT Management is entitled to earn certain incentive compensation based on the level of Belvedere Trust s annualized net income. In evaluating mortgage assets for investment and with respect to other management strategies, an undue emphasis on the maximization of income at the expense of other criteria could result in increased risk to the value of our portfolio.

Risks Related to REIT Compliance and Other Matters

If we are disqualified as a REIT, we will be subject to tax as a regular corporation and face substantial tax liability.

We believe that, since our IPO in 1998, we have operated so as to qualify as a REIT under the Code and we intend to continue to meet the requirements for taxation as a REIT. Nevertheless, we may not remain qualified as a REIT in the future. Qualification as a REIT involves the application of highly technical and complex Code provisions for which only a limited number of judicial or administrative interpretations exist. Even a technical or inadvertent mistake could require us to pay a penalty or jeopardize our REIT status. Furthermore, Congress or the Internal Revenue Service, or IRS, might change tax laws or regulations and the courts might issue new rulings, in each case potentially having retroactive effects that could make it more difficult or impossible for us to qualify as a REIT. If we fail to qualify as a REIT in any tax year, then:

- we would be taxed as a regular domestic corporation, which, among other things, means being unable to deduct distributions to stockholders in computing taxable income and being subject to federal income tax on our taxable income at regular corporate rates;
- any resulting tax liability could be substantial and would reduce the amount of cash available for distribution to stockholders; and
- unless we were entitled to relief under applicable statutory provisions, we could be disqualified from treatment as a REIT for the subsequent four taxable years following the year during which we lost our qualification and thus our cash available for distribution to stockholders would be reduced for each of the years during which we do not qualify as a REIT.

Complying with REIT requirements may cause us to forego otherwise attractive opportunities.

In order to qualify as a REIT for federal income tax purposes, we must continually satisfy tests concerning, among other things, our sources of income, the nature and diversification of our MBS and other assets including our stock in Belvedere Trust, the amounts we distribute to our stockholders and the ownership of our stock. We

may also be required to make distributions to stockholders at disadvantageous times or when we do not have funds readily available for distribution. Thus, compliance with REIT requirements may hinder our ability to operate solely on the basis of maximizing profits.

Complying with REIT requirements may limit our ability to hedge effectively.

The REIT provisions of the Code may substantially limit our ability to hedge MBS and related borrowings by requiring us to limit our income in each year from qualifying and non-qualifying hedges, together with any other income not generated from qualified sources, to less than 25% of our gross income. In addition, we must limit our aggregate income from non-qualifying hedging, fees and certain other non-qualifying sources, other than from qualified REIT real estate assets or qualified hedges, to less than 5% of our annual gross income. As a result, we may in the future have to limit our use of advantageous hedging techniques or implement those hedges through a taxable REIT subsidiary. This could result in greater risks associated with changes in interest rates than we would otherwise want to incur. If we were to violate the 25% or 5% limitations, we may have to pay a penalty tax equal to the amount of income in excess of those limitations, multiplied by a fraction intended to reflect our profitability. If we fail to satisfy the 25% and 5% limitations, unless our failure was due to reasonable cause and not due to willful neglect, we could lose our REIT status for federal income tax purposes.

Complying with REIT requirements may force us to liquidate otherwise attractive investments or to make investments inconsistent with our business plan.

In order to qualify as a REIT, we must also determine that at the end of each calendar quarter at least 75% of the value of our assets consists of cash, cash items, government securities and qualified REIT real estate assets. The remainder of our investment in securities generally cannot include more than 10% of the outstanding voting securities of any one issuer or more than 10% of the total value of the outstanding securities of any one issuer. In addition, in general, no more than 5% of the value of our assets can consist of the securities of any one issuer. The 5% and 10% limitations described above will apply to our investment in Belvedere Trust unless Belvedere Trust is a qualified REIT subsidiary of ours (i.e., we own 100% of Belvedere Trust s outstanding stock), Belvedere Trust is a qualified REIT or Belvedere Trust is a taxable REIT subsidiary of ours. If we fail to comply with these requirements, we must dispose of a portion of our assets within 30 days after the end of the calendar quarter in order to avoid losing our REIT status and suffering adverse tax consequences. The need to comply with these gross income and asset tests may cause us to acquire other assets that are qualifying real estate assets for purposes of the REIT requirements that are not part of our overall business strategy and might not otherwise be the best investment alternative for us.

Complying with REIT requirements may force us to borrow to make distributions to stockholders.

As a REIT, we must distribute 90% of our annual taxable income (subject to certain adjustments) to our stockholders. From time to time, we may generate taxable income greater than our net income for financial reporting purposes from, among other things, amortization of capitalized purchase premiums, or our taxable income may be greater than our cash flow available for distribution to stockholders. For example, our taxable income would exceed our net income for financial reporting purposes to the extent that compensation paid to our Principal Executive Officer and our other four highest paid officers exceeds $1 million for any such officer for any calendar year under Section 162(m) of the Code. Since payments under our 2002 Incentive Plan do not qualify as performance-based compensation under Section 162(m), a portion of the payments made under the 2002 Incentive Plan to certain of our officers would not be deductible for federal income tax purposes under such circumstances. If we do not have other funds available in these situations, we may be unable to distribute substantially all of our taxable income as required by the REIT provisions of the Code. Thus, we could be required to borrow funds, sell a portion of our MBS at disadvantageous prices or find another alternative source of funds. These alternatives could increase our costs or reduce our equity.

Dividends payable by REITs do not qualify for the reduced tax rates.

Tax legislation enacted in 2003 reduced the maximum United States federal tax rate on certain corporate dividends paid to individuals and other non-corporate taxpayers to 15% (through 2010). Dividends paid by REITs to these stockholders are generally not eligible for these reduced rates. Although this legislation does not adversely affect the taxation of REITs or dividends paid by REITs, the more favorable rates applicable to non-REIT corporate dividends could cause investors who are individuals, trusts and estates to perceive investments in REITs to be relatively less attractive than investments in the stocks of non-REIT corporations that pay dividends, which could adversely affect the value of the stock of REITs, including our common stock.

If Belvedere Trust fails to qualify as a REIT, a qualified REIT subsidiary or a taxable REIT subsidiary, we may lose our REIT status.

As long as we own 100% of Belvedere Trust s outstanding stock, Belvedere Trust will be treated as a qualified REIT subsidiary for federal income tax purposes. As such, for federal income tax purposes, we will not be treated as owning stock in Belvedere Trust and Belvedere Trust s assets, liabilities and income will generally be treated as our assets, liabilities and income for purposes of the REIT qualification tests described above under Certain Federal Income Tax Considerations. If, however, we do not own 100% of Belvedere Trust s outstanding stock and Belvedere Trust does not qualify as a REIT, a qualified REIT subsidiary or a taxable REIT subsidiary, we will lose our REIT status if, at the end of any calendar quarter, the value of our Belvedere Trust securities exceeds 5% of the value of our total assets or we own more than 10% of the value or voting power of Belvedere Trust s outstanding securities. If we fail to satisfy the 5% test or the 10% test at the end of any calendar quarter, a 30-day cure period may apply following the close of the quarter. If we make an election to treat Belvedere Trust as a taxable REIT subsidiary, the total value of any securities we own in Belvedere Trust and all of our other taxable REIT subsidiaries, if any, may not exceed 20% of the value of our total assets at the end of any calendar quarter. Since Belvedere Trust may elect to be taxed as a REIT in the future, however, we do not intend to make a taxable REIT subsidiary election for Belvedere Trust. In the event of a more than de minimis failure of the 20% asset test, we will not lose our REIT status as long as (i) the failure was due to reasonable cause and not to willful neglect, (ii) we dispose of the assets causing the failure or otherwise comply with the 20% asset test within six months after the last day of the applicable quarter in which we identify such failure, and (iii) we pay a tax equal to the greater of $50 thousand or 35% of the net income from the non-qualifying assets during the period in which we failed the 20% asset test. If there is more than a de minimis failure of the 20% asset test and we do not satisfy the requirements described in the preceding sentence, we would lose our REIT status.

If Belvedere Trust fails to qualify as a REIT, Belvedere Trust will be subject to corporate income taxes on its taxable income, which will reduce the amount available for distribution to us.

Though Belvedere Trust was formed as a qualified REIT subsidiary, it may elect to be taxed as a REIT in the future, possibly as early as its taxable year ending December 31, 2007. Although Belvedere Trust expects to operate in a manner to permit it to qualify as a REIT, if and when it makes a REIT election, and to continue to maintain such qualification, the actual results of Belvedere Trust s operations for any particular taxable year may not satisfy these requirements. If Belvedere Trust fails to qualify for taxation as a REIT in any taxable year after it makes a REIT election, and the relief provisions of the Code do not apply, Belvedere Trust will be required to pay tax on Belvedere Trust s taxable income in that taxable year and all subsequent taxable years at regular corporate rates. Distributions to us in any year in which Belvedere Trust fails to qualify as a REIT will not be deductible by Belvedere Trust. As a result, we anticipate that if Belvedere Trust failed to qualify as a REIT after it makes a REIT election, this would reduce the cash available for distribution to us. Unless entitled to relief under specific statutory provisions, if Belvedere Trust fails to maintain its REIT status after it makes a REIT election, Belvedere Trust will also be disqualified from taxation as a REIT for the four taxable years following the year in which it loses its qualification.

We conduct a portion of our business through taxable REIT subsidiaries, which could have adverse tax consequences.

We conduct a portion of our business, including securitizations, through taxable REIT subsidiaries, such as BT Finance. Despite our qualification as a REIT, our taxable REIT subsidiaries must pay federal income tax on their taxable income. In addition, we must comply with various tests to continue to qualify as a REIT for federal income tax purposes and our income from, and investments in, our taxable REIT subsidiaries generally does not constitute permissible income and investments for these tests. While we attempt to determine that our dealings with our taxable REIT subsidiaries will not adversely affect our REIT qualification, no assurance can be given that we will successfully achieve that result. Furthermore, we may be subject to a 100% penalty tax, or our taxable REIT subsidiaries may be denied deductions, to the extent our dealings with our taxable REIT subsidiaries are not deemed to be arm s length in nature.

The tax imposed on REITs engaging in prohibited transactions will limit our ability to engage in transactions, including certain methods of securitizing loans, which would be treated as sales for federal income tax purposes.

A REIT s net income from prohibited transactions is subject to a 100% tax. In general, prohibited transactions are sales or other dispositions of property, other than foreclosure property but including any mortgage loans, held in inventory primarily for sale to customers in the ordinary course of business. We might be subject to this tax if we were to sell a loan or securitize loans in a manner that was treated as a sale of such inventory for federal income tax purposes. Therefore, in order to avoid the prohibited transactions tax, we may choose not to engage in certain sales of loans other than through a taxable REIT subsidiary and may limit the structures we utilize for our securitization transactions even though such sales or structures might otherwise be beneficial for us. In addition, this prohibition may limit our ability to restructure our investment portfolio of mortgage loans from time to time, even if we believe that it would be in our best interest to do so.

Failure to maintain an exemption from the Investment Company Act would harm our results of operations.

We believe that we conduct our business in a manner that allows us to avoid being regulated as an investment company under the Investment Company Act of 1940, as amended. If we fail to continue to qualify for an exemption from registration as an investment company, our ability to use leverage would be substantially reduced and we would be unable to conduct our business as planned. 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. Under the SEC s current interpretation, qualification for this exemption generally requires us to maintain at least 55% of our assets directly in qualifying real estate interests. MBS that do not represent all the certificates issued with respect to an underlying pool of mortgages may be treated as securities separate from the underlying mortgage loans and thus may not qualify for purposes of the 55% requirement. Therefore, our ownership of these MBS is limited by the Investment Company Act. In meeting the 55% requirement under the Investment Company Act, we treat as qualifying interests MBS issued with respect to an underlying pool for which we hold all issued certificates. If the SEC or its staff adopts a contrary interpretation, we could be required to sell a substantial amount of our MBS under potentially adverse market conditions. Further, in order to maintain our exemption from registration as an investment company, we may be precluded from acquiring MBS whose yield is somewhat higher than the yield on MBS that could be purchased in a manner consistent with the exemption.

We may incur excess inclusion income that would increase the tax liability of our stockholders.

In general, dividend income that a tax-exempt entity receives from us should not constitute unrelated business taxable income as defined in Section 512 of the Code. If we realize excess inclusion income and allocate it to stockholders, however, then this income would be fully taxable as unrelated business taxable income under Section 512 of the Code. If the stockholder is foreign, it would generally be subject to United States federal

income tax withholding on this income without reduction pursuant to any otherwise applicable income tax treaty. United States stockholders would not be able to offset such income with their operating losses.

We generally structure our borrowing arrangements in a manner designed to avoid generating significant amounts of excess inclusion income. However, excess inclusion income could result if we held a residual interest in a REMIC. Excess inclusion income also may be generated if we were to issue debt obligations with two or more maturities and the terms of the payments on these obligations bore a relationship to the payments that we received on our mortgage loans or MBS securing those debt obligations. For example, we may engage in non-REMIC CMO securitizations. We also enter into various repurchase agreements that have differing maturity dates and afford the lender the right to sell any pledged mortgage securities if we default on our obligations. The IRS may determine that these transactions give rise to excess inclusion income that should be allocated among our stockholders. We may invest in equity securities of other REITs and it is possible that we might receive excess inclusion income from those investments. Some types of entities, including, without limitation, voluntarily employee benefit associations and entities that have borrowed funds to acquire their shares of our stock, may be required to treat a portion of or all of the dividends they receive from us as unrelated business taxable income.

Misplaced reliance on legal opinions or statements by issuers of MBS and government securities could result in a failure to comply with REIT gross income or asset tests.

When purchasing MBS and government securities, we may rely on opinions of counsel for the issuer or sponsor of such securities, or statements made in related offering documents, for purposes of determining whether and to what extent those securities constitute REIT real estate assets for purposes of the REIT asset tests and produce income that qualifies under the REIT income tests. The inaccuracy of any such opinions or statements may harm our REIT qualification and result in significant corporate level tax.

Additional Risk Factors

We may not be able to use the money we raise to acquire investments at favorable prices.

We intend to seek to raise additional capital from time to time if we determine that it is in our best interests and the best interests of our stockholders, including through public offerings of our stock. The net proceeds of any offering could represent a significant increase in our equity. Depending on the amount of leverage that we use, the full investment of the net proceeds of any offering might result in a substantial increase in our total assets. There can be no assurance that we will be able to invest all of such additional funds in mortgage-related assets at favorable prices. We may not be able to acquire enough mortgage-related assets to become fully invested after an offering, or we may have to pay more for MBS than we have historically. In either case, the return that we earn on stockholders equity may be reduced.

We have not established a minimum dividend payment level for our common stockholders and there are no assurances of our ability to pay dividends to them in the future.

We intend to pay quarterly dividends and to make distributions to our common stockholders in amounts such that all or substantially all of our taxable income in each year, subject to certain adjustments, is distributed. This, along with other factors, should enable us to qualify for the tax benefits accorded to a REIT under the Code. We have not established a minimum dividend payment level for our common stockholders and our ability to pay dividends may be harmed by the risk factors described in this annual report on Form 10-K. All distributions to our common stockholders 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. There are no assurances of our ability to pay dividends in the future.

If we raise additional capital, our earnings per share and dividends per share may decline since we may not be able to invest all of the new capital during the quarter in which additional shares are sold and possibly the entire following calendar quarter.

Our future offerings of debt or preferred equity securities may harm the value of our Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock.

Our charter provides that we may issue up to 20 million shares of preferred stock in one or more series. In addition to our outstanding shares of Series A Cumulative Preferred Stock and Series B Cumulative Convertible Preferred Stock, we currently have an agreement with Cantor pursuant to which we may issue up to 2.0 million shares of our Series A Cumulative Preferred Stock. The issuance of additional preferred stock on parity with or senior to our Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock could have the effect of diluting the amounts we may have available for distribution to holders of our Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock. In addition, our Series A Cumulative Preferred Stock and Series B Cumulative Convertible Preferred Stock will be subordinated to all our existing and future debt. None of the provisions relating to our Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock contain any provisions affording the holders of our Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock protection in the event of a highly leveraged or other transaction, including a merger or the sale, lease or conveyance of all or substantially all our assets or business, that might harm the holders of our Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock.

Our charter does not permit ownership of over 9.8% of our common or preferred stock and attempts to acquire our common or preferred stock in excess of the 9.8% limit are void without prior approval from our board of directors.

For the purpose of preserving our REIT qualification and for other reasons, our charter prohibits direct or constructive ownership by any person of more than 9.8% of the lesser of the total number or value of the outstanding shares of our common stock or more than 9.8% of the outstanding shares of our preferred stock. Our charter s constructive ownership rules are complex and may cause the outstanding stock owned by a group of related individuals or entities to be deemed to be constructively owned by one individual or entity. As a result, the acquisition of less than 9.8% of the outstanding stock by an individual or entity could cause that individual or entity to own constructively in excess of 9.8% of the outstanding stock and thus be subject to our charter s ownership limit. Any attempt to own or transfer shares of our common or preferred stock in excess of the ownership limit without the consent of the board of directors shall be void and will result in the shares being transferred by operation of law to a charitable trust. Our board of directors has granted four unrelated third party institutional investors exemptions from the 9.8% ownership limitation as set forth in our charter documents. These exemptions permit these entities to hold up to 20.00%, 20.00% and 17.04% of our Series A Cumulative Preferred Stock, respectively.

Because provisions contained in Maryland law, our charter and our bylaws may have an anti-takeover effect, investors may be prevented from receiving a control premium for their shares.

Provisions contained in our charter and bylaws, as well as Maryland corporate law, may have anti-takeover effects that delay, defer or prevent a takeover attempt, which may prevent stockholders from receiving a control premium for their shares. For example, these provisions may defer or prevent tender offers for our common stock or purchases of large blocks of our common stock, thereby limiting the opportunities for our stockholders to receive a premium for their common stock over then-prevailing market prices. These provisions include the following:

Ownership limit. The ownership limit in our charter limits related investors including, among other things, any voting group, from acquiring over 9.8% of our common stock or more than 9.8% of our preferred stock without our permission.

Preferred Stock. Our charter authorizes our board of directors to issue preferred stock in one or more classes and to establish the preferences and rights of any class of preferred stock issued. These actions can be taken without soliciting stockholder approval.

Maryland business combination statute. Maryland law restricts the ability of holders of more than 10% of the voting power of a corporation s shares to engage in a business combination with the corporation.

Maryland control share acquisition statute. Maryland law limits the voting rights of control shares of a corporation in the event of a control share acquisition.

Issuances of large amounts of our stock could cause the price of our stock to decline.

We may issue additional shares of common stock or shares of preferred stock that are convertible into common stock. If we issue a significant number of shares of common stock or convertible preferred stock in a short period of time, there could be a dilution of the existing common stock and a decrease in the market price of the common stock.

Future offerings of debt securities, which would be senior to our common stock, Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock upon liquidation, or equity securities, which would dilute our existing stockholders and may be senior to our common stock, Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock for the purposes of dividend distributions, may harm the market price of our common stock, Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock.

In the future, we may attempt to increase our capital resources by making additional offerings of debt or equity securities, including commercial paper, medium-term notes, senior or subordinated notes and classes of preferred stock or common stock. Upon liquidation, holders of our debt securities and shares of preferred stock and lenders with respect to other borrowings will receive a distribution of our available assets prior to the holders of our common stock. Our preferred stock may have a preference on dividend payments that could limit our ability to make a dividend distribution to the holders of our common stock. Because our decision to issue securities in any future offering will depend on market conditions and other factors beyond our control, we cannot predict or estimate the amount, timing or nature of our future offerings. Thus, our common stockholders bear the risk of our future offerings reducing the market price of our common stock.

Our charter provides that we may issue up to 20 million shares of preferred stock in one or more series. The issuance of additional preferred stock on parity with or senior to the Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock could have the effect of diluting the amounts we may have available for distribution to holders of the Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock. The Series A Cumulative Preferred Stock and Series B Cumulative Convertible Preferred Stock will be subordinated to all our existing and future debt. Thus, our Series A Cumulative Preferred Stockholders and our Series B Cumulative Convertible Preferred Stockholders bear the risk of our future offerings reducing the market price of our Series A Cumulative Preferred Stock or Series B Cumulative Convertible Preferred Stock.

Item 1B. UNRESOLVED STAFF COMMENTS

None.

Item 2. PROPERTIES

We sublease approximately 5,500 square feet of office space in Santa Monica, California under a sublease agreement with PIA that expires in 2012. BT Management Holding Corporation subleases approximately 2,305

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square feet of office space in San Francisco, California, for Belvedere Trust under an agreement with Keefe, Bruyette and Woods, Inc. that expires July 31, 2008. We believe these facilities are adequate for our intended level of operations.

Item 3. LEGAL PROCEEDINGS

We are not a party to any material pending legal proceedings.

Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2006.

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PART II

Item 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our Series A Preferred Stock began trading under the symbol ANHPrA on the New York Stock Exchange on November 8, 2004. The high and low sale prices for our Series A Preferred Stock, as reported by the New York Stock Exchange, for the periods indicated are as follows:

	2005		2006	
	High	Low	High	Low
First Quarter	$ 25.60	$ 24.98	$ 24.92	$ 24.06
Second Quarter	$ 26.22	$ 24.95	$ 25.10	$ 23.70
Third Quarter	$ 25.85	$ 24.60	$ 25.05	$ 23.90
Fourth Quarter	$ 25.00	$ 23.82	$ 25.60	$ 24.75

Our common stock began trading under the symbol ANH on the New York Stock Exchange on May 9, 2003. Our common stock previously traded under the symbol ANH on the American Stock Exchange. Prior to March 17, 1998, there had been no public market for our common stock. The high and low sale prices for our common stock, as reported by the New York Stock Exchange, for the periods indicated are as follows:

	2005		2006	
	High	Low	High	Low
First Quarter	$ 10.41	$ 9.39	$ 8.43	$ 7.35
Second Quarter	$ 10.10	$ 9.28	$ 8.30	$ 7.41
Third Quarter	$ 9.85	$ 8.20	$ 8.46	$ 7.73
Fourth Quarter	$ 8.35	$ 7.16	$ 9.76	$ 8.27

Holders

As of March 9, 2007, there were approximately 7 record holders of our Series A Preferred Stock. On March 9, 2007, the last reported sale price of our Series A Preferred Stock on the New York Stock Exchange was $25.05 per share. As of March 9, 2007, there were approximately 1,214 record holders of our common stock. On March 9, 2007, the last reported sale price of our common stock on the New York Stock Exchange was $8.63 per share.

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Dividends

We pay cash dividends on a quarterly basis. The following table lists the cash dividends declared on each share of our Series A Preferred Stock and on each share of our common stock for our most recent two fiscal years. The dividends listed below were based primarily on the board of directors evaluation of earnings and consideration of actions necessary to maintain our REIT status for each listed quarter and were declared on the date indicated:

	Cash Dividends Per Preferred Share	Date Dividends Declared	Cash Dividends Per Common Share	Date Dividends Declared
2005				
First Quarter ended March 31, 2005	$ 0.539063	March 15, 2005	$ 0.27	April 6, 2005
Second Quarter ended June 30, 2005	$ 0.539063	May 27, 2005	$ 0.18	July 19, 2005
Third Quarter ended September 30, 2005	$ 0.539063	July 19, 2005	$ 0.08	October 13, 2005
Fourth Quarter ended December 31, 2005(1)	$ 0.539063	October 13, 2005	$ 0.02	December 15, 2005
2006				
First Quarter ended March 31, 2006	$ 0.539063	December 15, 2005	$ 0.02	April 12, 2006
Second Quarter ended June 30, 2006	$ 0.539063	April 12, 2006	$ 0.02	July 12, 2006
Third Quarter ended September 30, 2006	$ 0.539063	July 12, 2006	$ 0.02	October 11, 2006
Fourth Quarter ended December 31, 2006(2)	$ 0.539063	October 11, 2006	$ 0.02	December 13, 2006

(1) The Series A Preferred Stock dividend was paid on January 16, 2006 to holders of record as of the close of business on December 30, 2005. The common stock dividend was paid on January 25, 2006 to holders of record as of the close of business on December 28, 2005.

(2) The Series A Preferred Stock dividend was paid on January 15, 2007 to holders of record as of the close of business on December 29, 2006. The common stock dividend was paid on January 19, 2007 to holders of record as of the close of business on December 29, 2006.

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Total Return Comparison

The following graph presents a total return comparison of our common stock with the Standard & Poor s 500 Index and the National Association of Real Estate Investment Trusts, Inc. Mortgage REIT Index:

	12/31/2001	12/31/2002	12/31/2003	12/31/2004	12/31/2005	12/31/2006
Anworth Mortgage Asset Corp	$ 100	$ 165	$ 213	$ 181	$ 135	$ 168
S&P Composite-500 Index	$ 100	$ 78	$ 100	$ 111	$ 117	$ 135
NAREIT Mortgage REIT Index	$ 100	$ 131	$ 206	$ 244	$ 188	$ 224

The total return reflects stock price appreciation, if any, and the value of dividends for our common stock and for each of the comparative indices. The graph assumes that $100 was invested on December 31, 2001 (or the first trading day thereafter) in our common stock, that $100 was invested in each of the indices on December 31, 2001 (or the first trading day thereafter) and that all dividends were reinvested. The total return performance shown in this graph is not necessarily indicative of and is not intended to suggest future total return performance. Measurement points are at the last trading day of the fiscal years represented above.

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Item 6. SELECTED FINANCIAL DATA

The selected financial data as of December 31, 2006 and 2005 and for the years ended December 31, 2006, 2005 and 2004 are derived from our audited financial statements included in this Form 10-K. The selected financial data as of December 31, 2004, 2003 and 2002 and for the years ended December 31, 2003 and 2002 are derived from audited financial statements not included in this Form 10-K. You should read these selected financial data together with Management s Discussion and Analysis of Financial Condition and Results of Operations and our audited and unaudited financial statements and notes thereto that are included in this Form 10-K beginning on page F-1.

	Year Ended December 31,				
	2002	**2003**	**2004**	**2005**	**2006**
	(amounts in thousands, except per share data)				
Consolidated Statements of Income Data					
Days in period	365	365	366	365	365
Interest income net of amortization of premium and discount	$ 66,855	$ 100,077	$ 163,378	$ 281,752	$ 309,360
Interest expense	(29,576)	(45,661)	(98,304)	(242,509)	(307,096)
Net interest income	$ 37,279	$ 54,416	$ 65,074	$ 39,243	$ 2,264
Net gain (loss) on sale of mortgage-related assets	4,709	3,497	259	129	(7,585)
Net gain on derivative instruments			340		
Expenses	(10,318)	(7,718)	(9,575)	(10,211)	(8,939)
Income (loss) from operations before minority interest	31,670	50,195	56,098	29,161	(14,260)
Minority interest in net (income) loss of a subsidiary			(293)	(276)	56
Net income (loss)	$ 31,670	$ 50,195	$ 55,805	$ 28,885	$ (14,204)
Dividend on Series A Cumulative Preferred Stock			(369)	(3,901)	(4,044)
Net income (loss) available to common stockholders	$ 31,670	$ 50,195	$ 55,436	$ 24,984	$ (18,248)
Basic earnings (loss) per share available to common stockholders	$ 1.81	$ 1.52	$ 1.23	$ 0.53	$ (0.40)
Average number of shares outstanding	17,461	32,927	45,244	47,103	45,430
Diluted earnings per share available to common stockholders	$ 1.80	$ 1.52	$ 1.22	$ 0.53	$ (0.40)
Average number of diluted shares outstanding	17,591	33,112	45,329	47,128	45,430
Dividends declared per preferred share			$ 0.335417	$ 2.156252	$ 2.156252
Dividends declared per common share	$ 2.00	$ 1.56	$ 1.25	$ 0.55	$ 0.08

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	As of December 31,				
	2002	2003	2004	2005	2006
	(amounts in thousands, except per share data)				
Consolidated Balance Sheets Data					
Agency MBS issued, net	$ 2,430,103	$ 4,245,853	$ 4,588,541	$ 4,524,683	$ 4,678,907
BT Residential Loans	$	$	$ 2,622,321	$ 2,497,881	$ 1,682,522
BT Other MBS	$	$	$ 63,470	$ 95,929	$ 162,799
Total assets	$ 2,443,884	$ 4,263,274	$ 7,319,070	$ 7,184,249	$ 6,687,389
Repurchase agreements (Anworth)	$ 2,153,870	$ 3,775,691	$ 4,172,930	$ 4,099,410	$ 4,329,921
Repurchase agreements (Belvedere Trust)	$	$	$ 544,506	$ 429,919	$ 275,733
Whole loan financing facilities	$	$	$ 556,233	$ 493	$
MBS issued	$	$	$ 1,494,851	$ 2,069,634	$ 1,471,724
Junior subordinated notes	$	$	$	$ 37,380	$ 37,380
Total liabilities	$ 2,178,362	$ 3,805,877	$ 6,811,803	$ 6,701,006	$ 6,196,299
Stockholders equity (common and preferred)	$ 265,522	$ 457,397	$ 507,036	$ 483,099	$ 491,002
Number of common shares outstanding	25,346	42,707	46,497	45,397	45,609
Book value per common share	$ 10.48	$ 10.71	$ 10.31	$ 9.61	$ 9.74

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Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with our financial statements included elsewhere in this Form 10-K. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors including those set forth under Risk Factors herein.

General

We were formed in October 1997 and commenced operations on March 17, 1998. We are in the business of investing primarily in mortgage-related assets including mortgage pass-through certificates, collateralized mortgage obligations, mortgage loans and other securities representing interests in, or obligations backed by, pools of mortgage loans which can be readily financed. Our principal business objective is to generate net income for distribution to stockholders based upon the spread between the interest income on our mortgage-related assets and the costs of borrowing to finance our acquisition of these assets.

We are organized for tax purposes as a REIT. Accordingly, we generally distribute substantially all of our earnings to stockholders without paying federal or state income tax at the corporate level on the distributed earnings. At December 31, 2006, our qualified REIT assets (real estate assets, as defined in the Code, cash and cash items and government securities) were greater than 90% of our total assets, as compared to the Code requirement that at least 75% of our total assets must be qualified REIT assets. Greater than 99% of our 2005 revenue qualifies for both the 75% source of income test and the 95% source of income test under the REIT rules. We believe we met all REIT requirements regarding the ownership of our common stock and the distributions of our net income. Therefore, we believe that we continue to qualify as a REIT under the provisions of the Code.

Our investments consist of the following portfolios: Agency mortgage-backed securities, or Agency MBS; Non-Agency mortgage-backed securities, or Non-Agency MBS; Belvedere Trust s residential real estate loans, or BT Residential Loans; and Belvedere Trust s Other mortgage-backed securities, or BT Other MBS.

On November 3, 2003, we formed Belvedere Trust, our wholly-owned subsidiary. Belvedere Trust acquires high credit-quality jumbo adjustable-rate and hybrid first-lien mortgage loans and other mortgage-related assets, securitizes a substantial amount of those mortgage loans and then retains a portion of those MBS while selling the balance to third parties in the secondary market. The MBS that are retained are purchased by a qualified REIT subsidiary to maximize tax efficiency on the interest income on those securities. Belvedere Trust was formed as a qualified REIT subsidiary but it structures securitizations through taxable REIT subsidiaries (which generally are taxed as C corporations subject to full corporate taxation) which, in turn, establish SPEs that issue securities through REMIC trusts.

At December 31, 2006, we had total assets of $6.7 billion. Agency MBS portfolio, consisting of $4.7 billion, was distributed as follows: 26% agency adjustable-rate MBS, 58% agency hybrid adjustable-rate MBS, 16% agency fixed-rate MBS and less than 1% agency floating-rate CMOs. Non-Agency MBS portfolio consisted of $107 million of floating-rate CMOs. BT Other MBS held at December 31, 2006 were approximately $163 million. Belvedere Trust had no mortgage loans held for securitization at December 31, 2006. Securitized mortgage loans were $1.7 billion. At December 31, 2006, Belvedere Trust s assets comprised 28% of our overall assets, or approximately $1.9 billion in mortgage-related assets. Total equity at December 31, 2006 was $491 million. Common stockholders equity was approximately $444 million, or $9.74 per share. For the year ended December 31, 2006, we reported a net loss of $14.2 million. Net loss to common stockholders was $18.2 million, or a net loss of $(0.40) per diluted share. This includes a net loss of $7.6 million on the sale of securities during 2006 and a net loss of $2.7 million for Belvedere Trust.

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Results of Operations

Years Ended December 31, 2006 and 2005

For the year ended December 31, 2006, our net loss was $14.2 million. Our net loss to common stockholders was $18.2 million, or a net loss of $(0.40) per diluted share, based on an average of 45.4 million shares outstanding. For the year ended December 31, 2005, our net income was $28.9 million and our net income available to common stockholders was $25 million, or $0.53 per diluted share, based on an average of 47.1 million shares outstanding.

Net interest income for the year ended December 31, 2006 totaled $2.3 million, or 1% of total interest income, compared to $39.2 million, or 13.9% of total interest income, for the year ended December 31, 2005. The decline in net interest income is due primarily to the increase in short-term interest rates during most of the year and the mismatch between longer maturities on the mortgage-related assets and the shorter maturities on the related liabilities that finance those assets. Net interest income is comprised of the interest income earned on mortgage investments less interest expense from borrowings. Interest income net of premium amortization expense for the year ended December 31, 2006 was $309.4 million, compared to $281.8 million for the year ended December 31, 2005, an increase of 9.8%. Interest expense for the year ended December 31, 2006 was $307.1 million, compared to $242.5 million for the year ended December 31, 2005, an increase of 26.6%. The increase in both interest income and interest expense was due primarily to the increase in short-term interest rates during most of the year.

During the year ended December 31, 2006, premium amortization expense for Anworth decreased $13.2 million, or 32.4%, from $40.8 million during the year ended December 31, 2005 to $27.6 million, and for Belvedere Trust, it increased $2.4 million, or 12.8%, from $18.7 million during the year ended December 31, 2005 to $21.1 million. During the year ended December 31, 2006, the decrease in premium amortization expense for Anworth resulted from a decrease of the constant prepayment rate of its portfolio and the increase in premium amortization expense for Belvedere Trust resulted primarily from impairment charges of $3.3 million related to some of Belvedere Trust s interest-only securities.

The table below shows the approximate constant prepayment rate of our (including Belvedere Trust s) mortgage-related assets:

	Year Ended December 31,2006				Year Ended December 31,2005			
Portfolio	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**	**First Quarter**	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
Agency and Non-Agency MBS	25%	29%	26%	26%	27%	31%	36%	32%
BT Loans	35%	35%	29%	32%	19%	31%	37%	35%
BT Other MBS	10%	8%	13%	7%	21%	16%	17%	19%

During the year ended December 31, 2006, we sold approximately $398 million in face amount of Agency MBS, resulting in a loss of approximately $10.2 million, as part of our asset/liability management program. The proceeds from the sale were used to invest in higher-yielding Agency MBS. This loss was partially offset by a gain of approximately $2.6 million on the sale of $103 million in face amount of BT Other MBS. Belvedere Trust s sales of BT Other MBS were part of its asset/liability management program and were designed to reduce credit exposure. During the year ended December 31, 2005, we realized a gain on sale of securities of $129 thousand, or 0.05% of total interest income. During the years ended December 31, 2006 and 2005, we did not have any realized gain or loss on derivative instruments.

Total expenses were $8.9 million for the year ended December 31, 2006, compared to $10.2 million for the year ended December 31, 2005. The decrease of $1.3 million in total expenses was due primarily to a decrease in compensation and benefits of $140 thousand (due primarily to reductions in compensation at Belvedere Trust), a decrease in incentive compensation of $708 thousand, a decrease in Other expenses of $456 thousand (due

primarily to reductions of $286 thousand in legal and accounting fees and reductions of $257 thousand in loan subservicing fees) and a decrease of $503 thousand related to Belvedere Trust s offering costs partially offset by an increase in the provision for loan losses of $179 thousand (relating to the residential real estate loans at Belvedere Trust) and an increase in compensation costs of $357 thousand relating to amortization of restricted stock.

Years Ended December 31, 2005 and 2004

For the year ended December 31, 2005, our net income was $28.9 million. Our net income available to common stockholders was $25 million, or $0.53 per diluted share, based on an average of 47.1 million shares outstanding. For the year ended December 31, 2004, our net income was $55.8 million and our net income available to common stockholders was $55.4 million, or $1.22 per diluted share, based on an average of 45.3 million shares outstanding.

Net interest income for the year ended December 31, 2005 totaled $39.2 million, or 13.9% of total interest income, compared to $65.1 million, or 39.8% of total interest income, for the year ended December 31, 2004. Net interest income is comprised of the interest income earned on mortgage investments less interest expense from borrowings. Interest income net of premium amortization expense for the year ended December 31, 2005 was $281.8 million, compared to $163.4 million for the year ended December 31, 2004, an increase of 72.5%. Interest expense for the year ended December 31, 2005 was $242.5 million, compared to $98.3 million for the year ended December 31, 2004, an increase of 146.7%. The larger percentage increase in interest expense was due primarily to the increase in short-term interest rates during the year.

During the year ended December 31, 2005, premium amortization expense for Anworth decreased $6.8 million, or 14.3%, from $47.6 million to $40.8 million, and for Belvedere Trust, it increased $14.9 million, or 392.1%, from $3.8 million to $18.7 million. During the year ended December 31, 2005, the decrease in premium amortization expense for Anworth resulted from a decrease of the constant prepayment rate of its portfolio and the increase in premium amortization expense for Belvedere Trust resulted from an increase in its assets and an increase in the constant prepayment rate of its portfolio of loans and other mortgage-related assets.

The table below shows the approximate constant prepayment rate of our (including Belvedere Trust s) mortgage-related assets:

	Year Ended December 31, 2005				Year Ended December 31, 2004			
Portfolio	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Agency MBS	27%	31%	36%	32%	27%	42%	36%	29%
BT Loans	19%	31%	37%	35%	3%	21%	15%	17%
BT Other MBS	21%	16%	17%	19%	30%	35%	35%	23%

During the year ended December 31, 2005, we realized a gain on sale of securities of $129 thousand, or 0.05% of total interest income, compared to $259 thousand, or 0.2% of total interest income, during the year ended December 31, 2004. During the year ended December 31, 2005, we did not have any gain or loss on derivative instruments, compared to a realized net gain on derivative instruments (Belvedere Trust s Eurodollar futures contracts) of $340 thousand, or 0.2% of total interest income, during the year ended December 31, 2004.

Total expenses were $10.2 million for the year ended December 31, 2005, compared to $9.6 million for the year ended December 31, 2004. The increase of $636 thousand in total expenses was due primarily to an increase in compensation and benefits of $1.2 million (due primarily to increased staffing and compensation at Belvedere Trust and an increase in salaries at the company), an increase in the provision for loan losses of $495 thousand (relating to the residential real estate loans at Belvedere Trust), an increase in Other expenses of $476 thousand, Belvedere Trust s offering costs of $725 thousand, partially offset by a decrease in incentive compensation of $2.2 million.

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Other expenses for the year ended December 31, 2005 were $4.2 million, compared to $3.8 million for the year ended December 31, 2004. This increase was due primarily to an increase in professional service fees of $240 thousand (due primarily to increased accounting and auditing fees relating to Sarbanes-Oxley), an increase in board of directors fees and expenses of $160 thousand, an increase in rent expenses of $46 thousand and a net increase in all other costs of $30 thousand.

Financial Condition

Agency MBS Portfolio

At December 31, 2006, we held agency mortgage assets whose amortized cost was approximately $4.70 billion, consisting primarily of $3.94 billion of adjustable-rate MBS, $756.8 million of fixed-rate MBS and $11 million of floating-rate CMOs. This amount represents an approximate 2.6% increase from the $4.58 billion held at December 31, 2005. Of the adjustable-rate Agency MBS owned by us, 31% were adjustable-rate pass-through certificates whose coupons reset within one year. The remaining 69% consisted of hybrid adjustable-rate MBS whose coupons will reset between one year and five years. Hybrid adjustable-rate MBS have an initial interest rate that is fixed for a certain period, usually three to five years, and thereafter adjust annually for the remainder of the term of the loan.

The following table presents a schedule of our Agency MBS at fair value owned at December 31, 2006 and December 31, 2005, classified by type of issuer (dollar amounts in thousands):

	At December 31, 2006		At December 31, 2005	
Agency	Fair Value	Portfolio Percentage	Fair Value	Portfolio Percentage
Fannie Mae (FNM)	$ 2,895,583	61.9%	$ 2,969,471	65.6%
Freddie Mac (FHLMC)	1,728,525	36.9%	1,471,900	32.5%
Ginnie Mae (GNMA)	54,799	1.2%	83,312	1.9%
Total Agency MBS:	$ 4,678,907	100.0%	$ 4,524,683	100.0%

The following table classifies our portfolio of Agency MBS owned at December 31, 2006 and December 31, 2005, by type of interest rate index (dollar amounts in thousands):

	At December 31, 2006		At December 31, 2005	
Index	Fair Value	Portfolio Percentage	Fair Value	Portfolio Percentage
One-month LIBOR	$ 10,940	0.2%	$ 13,074	0.3%
Six-month LIBOR	66,262	1.4%	31,333	0.7%
One year LIBOR	2,877,311	61.5%	2,473,909	54.7%
Six-month Certificate of Deposit	3,259	0.1%	4,365	0.1%
Six-month Constant Maturity Treasury	1,093	0.0%	1,287	0.0%
One-year Constant Maturity Treasury	914,451	19.6%	1,474,110	32.6%
Cost of Funds Index	55,112	1.2%	66,890	1.5%
Fixed-rate	750,479	16.0%	459,715	10.1%
Total Agency MBS:	$ 4,678,907	100.0%	$ 4,524,683	100.0%

The fair values indicated do not include interest earned but not yet paid. With respect to our hybrid adjustable-rate MBS, the fair value of these securities appears on the line associated with the index based on which the security will eventually reset once the initial fixed interest rate period has expired.

At December 31, 2006, our total agency portfolio had a weighted average coupon of 5.63%. The average coupon of the adjustable-rate securities was 5.76%, the hybrid securities average coupon was 5.49%, the fixed-

rate securities average coupon was 5.95% and the CMO floaters average coupon was 6.13%. At December 31, 2005, our total agency portfolio had a weighted average coupon of 4.73%. The average coupon of the adjustable-rate securities was 4.64%, the hybrid average coupon was 4.65%, the fixed-rate securities average coupon was 5.46% and the CMO floaters average coupon was 5.18%.

At December 31, 2006, the average amortized cost of our agency mortgage-related assets was 101.55%, the average amortized cost of our adjustable-rate securities was 101.64% and the average amortized cost of our fixed-rate securities was 101.10%. Relative to our Agency and Non-Agency MBS portfolio at December 31, 2006, the average interest rate on outstanding repurchase agreements was 5.36% and the average days to maturity was 90 days. After adjusting for interest rate swap transactions, the average interest rate on outstanding repurchase agreements was 5.19% and the weighted average term to next rate adjustment was 301 days.

At December 31, 2005, the average amortized cost of our agency mortgage-related assets was 101.9%, the average amortized cost of our adjustable-rate securities was 101.9% and the average amortized cost of our fixed-rate securities was 101.6%. Relative to our Agency and Non-Agency MBS portfolio at December 31, 2005, the average interest rate on outstanding repurchase agreements was 3.99% and the average days to maturity was 126 days. After adjusting for interest rate swap transactions, the average interest rate on outstanding repurchase agreements was 3.90% and the weighted average term to next rate adjustment was 213 days.

At December 31, 2006 and December 31, 2005, the unamortized net premium paid for our Agency MBS was $72 million and $84 million, respectively.

At December 31, 2006, the current yield on our Agency MBS was 5.54% based on a weighted average coupon of 5.63% divided by the average amortized cost of 101.55%. At December 31, 2005, the current yield on our Agency MBS was 4.64% based on a weighted average coupon of 4.73% divided by the average amortized cost of 101.9%.

We analyze our MBS and the extent to which prepayments impact the yield of the securities. When the rate of prepayments exceeds expectations, we amortize the premiums paid on mortgage assets over a shorter time period, resulting in a reduced yield to maturity on our mortgage assets. Conversely, if actual prepayments are less than the assumed constant prepayment rate, the premium would be amortized over a longer time period, resulting in a higher yield to maturity.

Non-Agency MBS Portfolio

At December 31, 2006, our Non-Agency MBS portfolio consisted of $107 million of CMO floaters with an average coupon of 5.61% which were acquired at par value.

BT Other MBS Portfolio

At December 31, 2006, Belvedere Trust s portfolio of BT Other MBS at fair value included securities which are backed by first-lien hybrid and adjustable-rate residential mortgages. These MBS include investment grade and non-investment grade securities with a carrying value of approximately $162.8 million backed by 29.7% hybrid, 70.0% adjustable-rate and 0.3% fixed-rate mortgages by carrying value. This amount includes approximately $21.9 million in securities that were retained from Belvedere Trust s first securitization (HYB1) (accounted for as a sale) during the first quarter of 2004 consisting of $13.3 million in securities rated AAA, $6.8 million in other investment grade securities and $1.8 million in non-investment grade securities. The remaining balance of approximately $140.9 million were securities that were purchased from major issuers and consist of $127.0 million in investment grade securities and $13.9 million in non-investment grade securities.

At December 31, 2005, Belvedere Trust s portfolio of BT Other MBS at fair value included securities which are backed by first-lien hybrid and adjustable-rate residential mortgages. These MBS include investment grade

and non-investment grade securities with a carrying value of approximately $96 million backed by 53.7% hybrid, 45.8% adjustable-rate and 0.5% fixed-rate mortgages by carrying value. This amount includes approximately $30 million in securities that were retained from Belvedere Trust s first securitization (HYB1)(accounted for as a sale) during the first quarter of 2004 consisting of $20 million in securities rated AAA, $8 million in other investment grade securities and $2 million in non-investment grade securities. The remaining balance of approximately $66 million were securities that were purchased from major issuers and consist of $46 million in investment grade securities and $20 million in non-investment grade securities.

At December 31, 2006, Belvedere Trust s $13.9 million in acquired non-investment grade securities includes securities with a carrying value of $1.3 million which are first loss securities and, as such, credit enhance $1.5 billion of underlying residential real estate loans. At December 31, 2005, the underlying amount of residential real estate loans was $1.85 billion. At December 31, 2006, the principal amount of these first loss securities is $4.1 million with a related discount of $2.8 million. If the credit losses from the underlying residential real estate loans exceed this discount, this would cause a reduction in earnings. For the years ended December 31, 2006 and 2005, Belvedere Trust had incurred $17 thousand and $0, respectively, in credit losses on these loans, which was applied against the discount.

At December 31, 2006, Belvedere Trust s portfolio of BT Other MBS had a weighted average coupon of 6.52%. At December 31, 2005, Belvedere Trust s portfolio of BT Other MBS had a weighted average coupon of 4.16%.

At December 31, 2006, the average amortized cost of BT Other MBS was 90.70%. At December 31, 2005, the average amortized cost of BT Other MBS was 74.38%.

Belvedere Trust s Residential Real Estate Loan Portfolio

Residential real estate loans held for securitization and held in securitization trusts are reflected in the financial statements at their amortized cost. At December 31, 2006, residential real estate loans consisted of the following (in thousands):

Residential Real Estate Loans	Residential Real Estate Loans Pending Securitization	Securitized Residential Real Estate Loans	Total Residential Real Estate Loans
Principal balance	$	$ 1,652,773	$ 1,652,773
Principal receivable		11	$ 11
Unamortized premium		30,788	$ 30,788
Valuation reserve on real estate owned		(1,050)	$ (1,050)
Carrying value	$	$ 1,682,522	$ 1,682,522

At December 31, 2005, residential real estate loans consisted of the following (in thousands):

Residential Real Estate Loans	Residential Real Estate Loans Pending Securitization	Residential Real Estate Loans, Securitized	Total Residential Real Estate Loans
Principal balance	$ 499	$ 2,450,894	$ 2,451,393
Principal receivable	101		101
Unamortized premium	13	46,374	46,387
Carrying value	$ 613	$ 2,497,268	$ 2,497,881

At December 31, 2006, the weighted average coupon on residential real estate loans which Belvedere Trust had securitized (including HYB1) was 6.12%. At December 31, 2005, the weighted average coupon on residential real estate loans which Belvedere Trust had securitized (including HYB1) was 5.54%. At December 31, 2006, the weighted average FICO was 727 and the loan-to-value (LTV) was 72. At December 31, 2005, the weighted average FICO was 725 and the LTV was 72.

At December 31, 2006, Belvedere Trust s residential real estate loan portfolio had a weighted average gross coupon of 6.18% and a weighted average net coupon of 5.82%. At December 31, 2005, Belvedere Trust s residential real estate loan portfolio had a weighted average gross coupon of 5.56% and a weighted average net coupon of 5.20%.

At December 31, 2006, the average amortized cost of Belvedere Trust s residential real estate loan portfolio was 101.59%. At December 31, 2005, the average amortized cost of Belvedere Trust s residential real estate loan portfolio was 101.73%.

At December 31, 2006, Belvedere Trust s residential real estate loan portfolio was $1.7 billion, consisting of securitized loans. There were no loans pending securitization. The residential real estate loan portfolio consisted of 4,522 loans with an average loan balance of $365 thousand. The securitized residential real estate loans serve as collateral for $1.5 billion of MBS issued and $155 million of repurchase agreement financings. More detailed information on Belvedere Trust s residential real estate loans is included in Note 4 to the consolidated financial statements.

At December 31, 2005, Belvedere Trust s residential real estate loan portfolio was $2.5 billion, consisting of securitized loans of $2.5 billion and loans pending securitization of $613 thousand. The residential real estate loan portfolio consisted of 6,769 loans with an average loan balance of $362 thousand. The weighted average coupon on residential real estate loans which have been securitized was 5.54% at December 31, 2005. The securitized residential real estate loans served as collateral for $2.07 billion of MBS issued and $359 million of repurchase agreement financings.

Hedging

We periodically enter into derivative transactions, in the form of forward purchase commitments and interest rate swaps, which are intended to hedge our exposure to rising rates on funds borrowed to finance our investments in securities. We designate interest rate swap transactions as cash flow hedges. We also periodically enter into derivative transactions, in the form of forward purchase commitments, which are not designated as hedges. To the extent that we enter into hedging transactions to reduce our interest rate risk on indebtedness incurred to acquire or carry real estate assets, any income or gain from the disposition of hedging transactions should be qualifying income for purposes of the 95% gross income test, but not the 75% gross income test.

As part of our asset/liability management policy, we may enter into hedging agreements such as interest rate caps, floors or swaps. These agreements would be entered into to try to reduce interest rate risk and would be designed to provide us with income and capital appreciation in the event of certain changes in interest rates. We review the need for hedging agreements on a regular basis consistent with our capital investment policy. At December 31, 2006, we were a counter-party to swap agreements, which are derivative instruments as defined by the Financial Accounting Standards Board in FASB 133 and FASB 138, with an aggregate notional amount of $900 million and an average maturity of 2.9 years. We utilize swap agreements to manage interest rate risk and do not anticipate entering into derivative transactions for speculative or trading purposes. In accordance with the swap agreements, we pay a fixed rate of interest during the term of the swap agreements and receive a payment that varies with the three-month LIBOR rate. At December 31, 2006, there were unrealized gains of approximately $4.9 million on our swap agreements.

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Liquidity and Capital Resources

Our primary source of funds consists of repurchase agreements, relative to our Agency and Non-Agency MBS portfolio, which totaled $4.3 billion at December 31, 2006 and Belvedere Trust s repurchase agreements, which totaled $276 million at December 31, 2006. Our other significant source of funds for the year ended December 31, 2006 consisted of payments of principal from our Agency MBS portfolio, BT Other MBS and Belvedere Trust s residential real estate loans in the amounts of $1.44 billion, $14.9 million and $798 million, respectively.

Relative to our Agency MBS portfolio at December 31, 2006, all of our repurchase agreements were fixed-rate term repurchase agreements with original maturities ranging from one month to 10 months. Belvedere Trust enters into its own repurchase agreements. At December 31, 2006, other than one repurchase agreement that resets monthly based on one-month LIBOR, all of Belvedere Trust s repurchase agreements were fixed-rate term repurchase agreements with original maturities ranging from five days to 36 months. At December 31, 2006, we had borrowing arrangements with 22 different financial institutions and had borrowed funds under repurchase agreements with 15 of these firms. As the repurchase agreements mature, we enter into new repurchase agreements to take their place. Because we borrow money based on the fair value of our MBS and because increases in short-term interest rates can negatively impact the valuation of MBS, our borrowing ability could be reduced and lenders may initiate margin calls in the event short-term interest rates increase or the value of our MBS declines for other reasons. We had adequate cash flow, liquid assets and unpledged collateral with which to meet our margin requirements during the year ended December 31, 2006.

We acquire residential mortgage loans from third party originators, including banks and other mortgage lenders, through our Belvedere Trust subsidiary. Belvedere Trust structures securitization transactions primarily through SPEs (such as REMIC trusts). The principal business activity involves issuing various series of MBS (in the form of pass-through certificates or bonds collateralized by residential real estate loans). The collateral specific to each MBS series is the sole source of repayment of the debt and, therefore, our exposure to loss is limited to our net investment in the collateral. During the year ended December 31, 2006, Belvedere Trust did not transfer any residential mortgage loans to securitization trusts. To date, Belvedere Trust has transferred approximately $3.8 billion of residential real estate loans to securitization trusts. These transactions (except for the first transaction which is more fully described in Note 3 to the accompanying consolidated financial statements) utilized non-qualified SPEs requiring consolidation, which effectively resulted in the transactions being accounted for as financings. The servicing of the residential real estate loans is performed by third parties under servicing arrangements that resulted in no servicing asset or liability.

In accordance with our investment guidelines, Belvedere Trust has the opportunity to invest in asset classes other than mortgage loans intended for securitization. Such investments may be attractive, among other times, when the cost of acquiring residential real estate loans has increased to a point where it becomes un-economical to securitize these loans. This situation may happen at various points of the business and credit cycle, especially when loan production decreases. Belvedere Trust has not securitized loans since May 25, 2005 because of such circumstances. Investments have instead been made in senior and subordinated tranches from various issuers securitizations. The analyses and investment decisions have been based on a similar approach to what Belvedere Trust typically has done for the acquisition of whole loans intended for its own securitizations. It is Belvedere Trust s intent to securitize whole loans again under its shelf registration statement when the price of residential real estate loans relative to securitization execution makes it feasible again.

In the future, we expect that our primary sources of funds will continue to consist of borrowed funds under repurchase agreement transactions and of monthly payments of principal and interest on our MBS portfolio and other mortgage-related assets. Our liquid assets generally consist of unpledged MBS, cash and cash equivalents.

During the year ended December 31, 2006, we raised approximately $359 thousand in capital under our Dividend Reinvestment and Stock Purchase Plan.

At December 31, 2006, our authorized capital included 20 million shares of $0.01 par value preferred stock. During the year ended December 31, 2006, we did not issue any shares of Series A Preferred Stock.

At December 31, 2006, Belvedere Trust did not have any commitments to purchase mortgage loans. Belvedere Trust had whole loan financing facilities which provide for up to $400 million in financing secured by single-family mortgage loans. At December 31, 2006, Belvedere Trust had no outstanding borrowings under these facilities.

At December 31, 2006, Belvedere Trust had no commitments to acquire MBS.

During the year ended December 31, 2006, we repurchased (as more fully described in Note 10 to the accompanying consolidated financial statements) 37,500 shares of our common stock at an average cost of $7.60 per share. The shares were acquired at prevailing prices through open market transactions and were made subject to restrictions to volume, pricing and timing subject to applicable SEC rules.

On February 1 and 7, 2007, we issued an aggregate of 1.15 million shares of Series B Cumulative Convertible Preferred Stock, or Series B Preferred Stock, (as more fully described in Note 18 to the consolidated financial statements) and received net proceeds of approximately $27 million. We intend to use the proceeds from this offering to acquire mortgage-related assets consistent with our investment policy.

Off-Balance Sheet and Contractual Arrangements

The following table represents our contractual obligations at December 31, 2006 (in thousands):

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Repurchase agreements (Anworth(1))	$ 4,329,921	$ 4,329,921	$	$	$
Repurchase agreements (Belvedere Trust(1))	275,733	235,733	40,000		
MBS issued(2)	1,472,876	368,219	483,287	271,849	349,521
Junior subordinated notes(3)	37,380				37,380
Lease commitment (Anworth)	1,626,907	276,669	578,480	613,746	158,012
Lease commitment (Belvedere Trust)	102	65	37		
Total(4):	$ 7,742,919	$ 5,210,607	$ 1,101,804	$ 885,595	$ 544,913

(1) These represent amounts due by maturity.

(2) Principal is paid on the MBS issued following receipt of principal payments on the loans. For the table above, the principal payments have been estimated based on the underlying contractual payments as adjusted for prepayment assumptions. The actual principal paid in each year will be dependent upon the principal received on the underlying loans. These estimates may change significantly from the amounts presented above.

(3) These represent amounts due by contractual maturity. However, we do have the option to redeem these after March 30, 2010 and April 30, 2010 as more fully described in Note 7 to the accompanying consolidated financial statements.

(4) This does not include annual compensation agreements and incentive compensation agreements, which are more fully described in Note 11 to the accompanying consolidated financial statements.

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The following table represents our contractual obligations at December 31, 2005 (in thousands):

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Repurchase agreements (Anworth(1))	$ 4,099,410	$ 4,099,410	$	$	$
Repurchase agreements (Belvedere Trust(1))	429,919	348,519	81,400		
Whole loan financing facilities	493	493			
MBS issued(2)	2,070,333	517,583	679,328	382,122	491,300
Junior subordinated notes(3)	37,380				37,380
Lease commitment (Anworth)	1,895,518	268,611	561,634	595,847	469,426
Lease commitment (Belvedere Trust)	167	65	102		
Total(4):	$ 8,533,220	$ 5,234,681	$ 1,322,464	$ 977,969	$ 998,106

(1) These represent amounts due by maturity.
(2) Principal is paid on the MBS issued following receipt of principal payments on the loans. For the table above, the principal payments have been estimated based on the underlying contractual payments as adjusted for prepayment assumptions. The actual principal paid in each year will be dependent upon the principal received on the underlying loans.
(3) These represent amounts due by contractual maturity. However, we do have the option to redeem these after March 30, 2010 and April 30, 2010.
(4) This does not include annual compensation agreements and incentive compensation agreements, which are more fully described in Note 11 to the accompanying consolidated financial statements.

Stockholders Equity

We use available-for-sale treatment for our Agency and Non-Agency MBS and BT Other MBS, which are carried on our balance sheet at fair value rather than historical cost. Residential real estate loans are held for investment and carried at historical amortized cost. Based upon these treatments, our total equity base at December 31, 2006 was $491 million. Common stockholders equity was approximately $444 million, or $9.74 book value per share.

Under our available-for-sale accounting treatment, unrealized fluctuations in fair values of assets are assessed to determine whether they are other-than-temporary. To the extent we determine that these unrealized fluctuations are not other-than-temporary, they do not impact GAAP income or taxable income but rather are reflected on the balance sheet by changing the carrying value of the assets and reflecting the change in stockholders equity under Accumulated other comprehensive income, unrealized gain (loss) on available-for-sale securities.

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 on all of our assets. As a result, comparisons with some companies that use historical cost accounting for all of their balance sheet may not be meaningful.

Unrealized changes in the fair value of MBS have one significant and direct effect on our potential earnings and dividends: positive mark-to-market changes will increase our equity base and allow us to increase our borrowing capacity, while negative changes will tend to reduce borrowing capacity under our capital investment policy. A very large negative change in the net market value of our MBS might reduce our liquidity, requiring us to sell assets with the likely result of realized losses upon sale. Accumulative other comprehensive income, unrealized loss on available-for-sale Agency MBS was $50.5 million, or 1.1% of the amortized cost of Agency MBS, at December 31, 2006. This, along with Accumulative other comprehensive gain, derivatives, of $4.9 million, and Accumulative other comprehensive gain, Other MBS, of $0.2 million, constitute the total Accumulative other comprehensive loss of $45.4 million.

Critical Accounting Policies

Management has the obligation to ensure that its policies and methodologies are in accordance with GAAP. Management has reviewed and evaluated its critical accounting policies and believes them to be appropriate.

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions in certain circumstances that affect amounts reported in the accompanying consolidated financial statements. In preparing these consolidated financial statements, management has made its best estimates and judgments of certain amounts included in the consolidated financial statements, giving due consideration to materiality. We do not believe that there is a great likelihood that materially different amounts would be reported related to accounting policies described below. Nevertheless, application of these accounting policies involves the exercise of judgment and use of assumptions as to future uncertainties and, as a result, actual results could differ materially from these estimates.

Our accounting policies are described in Note 1 to the accompanying consolidated financial statements. Management believes the more significant of these to be as follows:

Revenue Recognition

The most significant source of our revenue is derived from our investments in mortgage-related assets. We reflect income using the effective yield method which, through amortization of premiums and accretion of discounts at an effective yield, recognizes periodic income over the estimated life of the investment on a constant yield basis, as adjusted for actual prepayment activity. Management believes our revenue recognition policies are appropriate to reflect the substance of the underlying transactions.

Interest income on our mortgage-related assets is accrued based on the actual coupon rate and the outstanding principal amounts of the underlying mortgages. Premiums and discounts are amortized or accreted into interest income over the expected lives of the securities using the effective interest yield method, adjusted for the effects of actual prepayments and estimated prepayments based on the Statement of Financial Accounting Standards, or SFAS, No. 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases, an amendment of FASB Statements No. 13, 60, and 65 and a rescission of FASB Statement No. 17. 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, as compared to the aforementioned references, 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.

Interest income on BT Other MBS is determined in accordance with FASB Emerging Issues Task Force (EITF) 99-20. The excess of estimated future cash flows over the initial investment is the accretable yield to be recognized as interest income over the life of the investment using the effective yield method. If the current fair value of any individual security is lower than its current amortized cost, we determine whether an impairment charge is required to be taken through current income. If there is a continued adverse change in estimated cash flows (considering both the timing and the amount of the cash flows, and taking into consideration receipt of cash flows to date), then the security is written down to fair value, which then becomes the new amortized cost basis for future amortization.

Allowance for Loan Losses

We establish and maintain an allowance for estimated loan losses inherent in our residential real estate loan portfolio. The loan loss reserves are based upon our assessment of various factors affecting the credit quality of our assets including, but not limited to, the characteristics of the loan portfolio, review of loan level data, borrowers credit scores, delinquency and collateral value. The reserves are reviewed on a regular basis and

adjusted as deemed necessary. The allowance for loan losses on our residential real estate loans is established by taking loan loss provisions through our Consolidated Statements of Income.

Valuation and Classification of Investment Securities

We carry our investment securities on the balance sheet at fair value. The fair values of our MBS are generally based on market prices provided by certain dealers who make markets in such securities. The fair values of other marketable securities are obtained from the last reported sale of such securities on its principal exchange or, if no representative sale is reported, the mean between the closing bid and ask prices. If, in the opinion of management, one or more securities prices reported to us are not reliable or unavailable, management estimates the fair value based on characteristics of the security it receives from the issuer and available market information. The fair values reported reflect estimates and may not necessarily be indicative of the amounts we could realize in a current market exchange. We review various factors (i.e., expected cash flows, changes in interest rates, credit protection, etc.) in determining whether and to what extent an other-than-temporary impairment exists. To the extent that unrealized losses on our Agency MBS and BT Other MBS are attributable to changes in interest rates and not credit quality, and we have the ability and intent to hold these investments until a recovery of fair value up to (or beyond) its cost, which may be maturity, we do not consider these investments to be other-than-temporarily impaired. Losses on securities classified as available-for-sale, which are determined by management to be other-than-temporary in nature, are reclassified from Accumulated other comprehensive income to current-period income.

Variable Interest Entities

Belvedere Trust structures securitization transactions primarily through non-qualified SPEs (such as REMIC trusts). The principal business activity involves issuing various series of MBS (in the form of pass-through certificates or bonds collateralized by residential real estate loans). The collateral specific to each series of MBS is the sole source of repayment of the debt and, therefore, our exposure to loss is limited to our net investment in the collateral. Under FIN 46, these interests in non-qualified SPEs are deemed to be VIEs and we are considered the primary beneficiary. Therefore, we consolidate these non-qualified SPEs. In addition, we consolidate our interests in loans financed through warehouse agreements where we are acquiring assets prior to securitization. We disclose our interests in VIEs under FIN 46 in the Investments in Residential Real Estate Loans footnote (Note 4 to the accompanying consolidated financial statements).

Accounting for Derivatives and Hedging Activities

In accordance with FASB No. 133, Accounting for Derivative Instruments and Hedging Activities, or FASB 133, as amended by FASB No. 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities, or FASB 138, a derivative that is designated as a hedge is recognized as an asset/liability and measured at estimated fair value. In order for our interest rate swap agreements to qualify for hedge accounting, upon entering into the swap agreement, we must anticipate that the hedge will be highly effective, as defined by FASB 133.

On the date we enter into a derivative contract, we designate the derivative as a hedge of the variability of cash flows that are to be received or paid in connection with a recognized asset or liability (a cash flow hedge). Changes in the fair value of a derivative that are highly effective and that are designated and qualify as a cash flow hedge, to the extent that the hedge is effective, are recorded in Other comprehensive income and reclassified to income when the forecasted transaction affects income (e.g., when periodic settlement interest payments are due on repurchase agreements). The swap agreements are carried on our Consolidated Balance Sheets at their fair value based on values obtained from major financial institutions. Hedge ineffectiveness, if any, is recorded in current-period income.

We formally assess, both at the hedge s inception and on an ongoing basis, whether the derivatives that are used in hedging transactions have been highly effective in offsetting changes in the cash flows of hedged items

and whether those derivatives may be expected to remain highly effective in future periods. If it is determined that a derivative is not (or has ceased to be) highly effective as a hedge, we discontinue hedge accounting.

When we discontinue hedge accounting, the gain or loss on the derivative remains in Accumulated other comprehensive income and is reclassified into income when the forecasted transaction affects income. In all situations in which hedge accounting is discontinued and the derivative remains outstanding, we will carry the derivative at its fair value on the balance sheet, recognizing changes in the fair value in current-period income.

For purposes of the cash flow statement, cash flows from derivative instruments are classified with the cash flows from the hedged item.

In connection with its loan acquisitions, Belvedere Trust enters into forward loan purchase commitments. To mitigate the impact of rising interest rates on the consummation of forward loan purchase commitments in connection with planned securitization funding, Belvedere Trust may enter into Eurodollar futures transactions. Both of these are treated as derivatives, carried at fair value, and any changes in fair value are recognized in current-period income.

Residential Real Estate Loans

We acquire residential mortgage loans and hold them as long-term investments through our Belvedere Trust subsidiary. We finance the mortgage loans with short-term debt (see Note 6 to the accompanying consolidated financial statements) until a sufficient quantity has been accumulated for securitization into MBS in order to obtain long-term financing and to enhance liquidity. While all mortgage loans are acquired with the intention of securitizing them, we may not be successful in our efforts to securitize the loans into MBS. Our residential real estate loans are classified as held-for-investment and are carried at their unpaid principal balance, adjusted for unamortized premiums or discounts. Premiums or discounts are amortized into current operations using the effective interest yield method, as adjusted for actual prepayments and considering estimated future prepayments, based on SFAS 91.

To meet our investment criteria, mortgage loans acquired by us will generally conform to the underwriting guidelines established by Freddie Mac, Fannie Mae and Ginnie Mae, or to secondary market standards for high credit-quality mortgage loans. Applicable banking laws generally require that an appraisal be obtained in connection with the original issuance of mortgage loans by the lending institution and we do not intend to obtain additional appraisals at the time of acquiring mortgage loans. Mortgage loans may be originated by or purchased from various suppliers of mortgage-related assets throughout the United States including savings and loan associations, banks, mortgage bankers and other mortgage lenders. We may acquire mortgage loans directly from originators and from entities holding mortgage loans originated by others.

Belvedere Trust maintains an allowance for loan losses for residential real estate loans held in consolidated securitization trusts and for loans held prior to securitization. The balance is included in Allowance for loan losses on the Consolidated Balance Sheets.

Income Taxes

Other than BT Finance, as noted below, our financial results do not reflect provisions for current or deferred income taxes. Management believes that we have and intend to continue to operate in a manner that will continue to allow us to be taxed as a REIT and, as a result, does not expect to pay substantial corporate level taxes. Many of these requirements, however, are highly technical and complex. If we were to fail to meet these requirements, we would be subject to federal income tax.

BT Finance, our indirect wholly-owned subsidiary, is a taxable REIT subsidiary and may be liable for corporate income tax expenses.

Subsequent Events

On February 1 and 7, 2007, we issued an aggregate of 1.15 million shares of Series B Preferred Stock and received net proceeds of approximately $27 million (net of underwriting fees, commissions and other costs). The shares have a liquidation value of $25.00 per share and will pay cash dividends at a rate of 6.25% per year of the $25.00 liquidation preference. The conversion rate will initially be 2.3809 shares of our common stock per share of Series B Preferred Stock. The conversion rate will be adjusted in any fiscal quarter in which the cash dividends paid to common stockholders results in an annualized common dividend yield which is greater than 6.25%. The conversion ratio will also be subject to adjustment upon the occurrence of certain specific events such as a change of control.

We intend to classify the Series B Preferred Stock as temporary equity, which we believe follows the guidance of Emerging Issues Task Force (EITF) Topic D-98, Classification and Measurement of Redeemable Securities. The Series B Preferred Stock contains certain fundamental change provisions that allow the holder to redeem the preferred stock for cash only if certain events occur. As redemption under these circumstances is not solely within our control, we believe the guidance specifies the treatment of these securities as temporary equity.

We have also analyzed whether the conversion features in the Series B Preferred Stock should be bifurcated under the guidance in FAS 133, Accounting for Derivative Instruments and Hedging Activities and EITF Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock and have determined that these do not need to be bifurcated.

Since December 31, 2006, we have entered into five additional swap agreements with an aggregate notional amount of $500 million for terms of up to three years. We utilize swap agreements to manage interest rate risk. In accordance with these swap agreements, we pay a fixed rate of interest during the term of the swap agreements and receive a payment that varies with the three-month LIBOR rate.

In February 2007, Belvedere Trust sold one of its interest-only securities for approximately $2.37 million. At December 31, 2006, we wrote down the value of this security from an amortized cost of approximately $3.34 million to its fair value of approximately $2.51 million. This write-down of approximately $830 thousand was reflected in impairment charges. Based on the sales price of approximately $2.37 million, Belvedere Trust recorded in February 2007 an additional loss of approximately $140 thousand on the sale of this security. In addition to the sale of this security, during January and February 2007, Belvedere Trust sold six other securities from its BT Other MBS portfolio, having a fair value at December 31, 2006 of approximately $27.4 million. Belvedere Trust expects to recognize a gain on the sale of these six securities of approximately $1 million. Belvedere Trust sold all of these securities as part of its asset/liability management program in order to reduce its credit risk exposure and to minimize future volatility to its earnings.

Item 7A. QUALITATIVE AND QUANTITATIVE DISCLOSURES ABOUT MARKET RISK

We seek to manage the interest rate, market value, liquidity, prepayment and credit risks inherent in all financial institutions in a prudent manner designed to insure our longevity while, at the same time, seeking to provide an opportunity for stockholders to realize attractive total rates of return through ownership of our common stock. While we do not seek to avoid risk completely, we do seek, to the best of our ability, to assume risk that can be quantified from historical experience, to actively manage that risk, to earn sufficient compensation to justify taking those risks and to maintain capital levels consistent with the risks we undertake.

Interest Rate Risk

We primarily invest in adjustable-rate, hybrid and fixed-rate mortgage-related assets. Hybrid mortgages are ARMs that have a fixed interest rate for an initial period of time (typically three years or greater) and then convert to an adjustable-rate for the remaining loan term. Our debt obligations are generally repurchase agreements of limited duration that are periodically refinanced at current market rates.

ARM-related assets are typically subject to periodic and lifetime interest rate caps that limit the amount an ARM-related asset s interest rate can change during any given period. ARM securities are also typically subject to a minimum interest rate payable. Our borrowings are not subject to similar restrictions. Hence, in a period of increasing interest rates, interest rates on our borrowings could increase without limitation, while the interest rates on our mortgage-related assets could be limited. This problem would be magnified to the extent we acquire mortgage-related assets that are not fully indexed. Further, some ARM-related assets may be subject to periodic payment caps that result in some portion of the interest being deferred and added to the principal outstanding. These factors could lower our net interest income or cause a net loss during periods of rising interest rates, which would negatively impact our liquidity, net income and our ability to make distributions to stockholders.

We fund the purchase of a substantial portion of our ARM-related assets with borrowings that have interest rates based on indices and repricing terms similar to, but of somewhat shorter maturities than, the interest rate indices and repricing terms of our mortgage assets. Thus, we anticipate that in most cases the interest rate indices and repricing terms of our mortgage assets and our funding sources will not be identical, thereby creating an interest rate mismatch between assets and liabilities. During periods of changing interest rates, such interest rate mismatches could negatively impact our net interest income, dividend yield and the market price of our common stock.

Most of our adjustable-rate assets are based on the one-year constant maturity treasury rate and the one-year LIBOR rate and our debt obligations are generally based on LIBOR. These indices generally move in the same direction, but there can be no assurance that this will continue to occur.

Our ARM-related assets and borrowings reset at various different dates for the specific asset or obligation. In general, the repricing of our debt obligations occurs more quickly than on our assets. Therefore, on average, our cost of funds may rise or fall more quickly than does our earnings rate on the assets.

Further, our net income may vary somewhat as the spread between one-month interest rates and six- and twelve-month interest rates varies.

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At December 31, 2006, our Agency and Non-Agency MBS and related borrowings will prospectively reprice based on the following time frames (dollar amounts in thousands):

	Investments(1)		Borrowings	
	Amount	Percentage of Total Investments	Amount	Percentage of Total Borrowings
	(amounts in thousands)			
Investment Type/Rate Reset Dates:				
Fixed-rate investments	$ 750,479	15.7%	$	
Adjustable-Rate Investments/Obligations:				
Less than 3 months	368,428	7.7%	2,560,750	59.1%
Greater than 3 months and less than 1 year	962,617	20.1%	1,769,171	40.9%
Greater than 1 year and less than 2 years	681,347	14.2%		
Greater than 2 years and less than 3 years	502,303	10.5%		
Greater than 3 years and less than 5 years	1,520,756	31.8%		
Total:	$ 4,785,930	100.0%	$ 4,329,921	100.0%

(1) Based on when they contractually reprice and do not consider the effect of any prepayments.

At December 31, 2005, our Agency MBS and related borrowings will prospectively reprice based on the following time frames (dollar amounts in thousands):

	Investments(1)		Borrowings	
	Amount	Percentage of Total Investments	Amount	Percentage of Total Borrowings
	(amounts in thousands)			
Investment Type/Rate Reset Dates:				
Fixed-rate investments	$ 459,715	10.2%	$	
Adjustable-Rate Investments/Obligations:				
Less than 3 months	459,456	10.1%	2,087,310	50.9%
Greater than 3 months and less than 1 year	1,028,930	22.7%	2,012,100	49.1%
Greater than 1 year and less than 2 years	998,882	22.1%		
Greater than 2 years and less than 3 years	941,552	20.8%		
Greater than 3 years and less than 5 years	636,148	14.1%		
Total:	$ 4,524,683	100.0%	$ 4,099,410	100.0%

(1) Based on when they contractually reprice and do not consider the effect of any prepayments.

At December 31, 2006, BT Other MBS and related borrowings will prospectively reprice based on the following time frames (dollar amounts in thousands):

	Investments(1)		Borrowings	
	Amount	Percentage of Total Investments	Amount	Percentage of Total Borrowings
	(in thousands)			
Investment Type/Rate Reset Dates:				
Fixed-rate investments	$ 572	0.4%	$	

Adjustable-Rate Investments/Obligations:				
Less than 3 months	115,300	70.8%	105,486	87.0%
Greater than 3 months and less than 1 year			11,788	9.7%
Greater than 1 year and less than 2 years	23,829	14.6%	3,959	3.3%
Greater than 2 years and less than 3 years				
Greater than 3 years and less than 5 years	23,098	14.2%		
Total:	$ 162,799	100.0%	$ 121,233	100.0%

(1) Based on when they contractually reprice and do not consider the effect of any prepayments.

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At December 31, 2005, BT Other MBS and related borrowings will prospectively reprice based on the following time frames (dollar amounts in thousands):

	Investments(1)		Borrowings	
	Amount	Percentage of Total Investments	Amount	Percentage of Total Borrowings
	(in thousands)			
Investment Type/Rate Reset Dates:				
Fixed-rate investments	$ 520	0.5%	$	
Adjustable-Rate Investments/Obligations:				
Less than 3 months	43,923	45.8%	51,378	72.9%
Greater than 3 months and less than 1 year			9,600	13.6%
Greater than 1 year and less than 2 years	20,088	20.9%	9,500	13.5%
Greater than 2 years and less than 3 years	13,787	14.4%		
Greater than 3 years and less than 5 years	17,611	18.4%		
Total:	$ 95,929	100.0%	$ 70,478	100.0%

(1) Based on when they contractually reprice and do not consider the effect of any prepayments.

Belvedere Trust has implemented an interest rate risk management program intended to protect its portfolio of mortgage-related assets and the related debt against the effects of major interest rate changes. Belvedere Trust primarily uses securitization transactions to manage the interest rate risk of its mortgage portfolio. The payments due on the securities generally match the cash flow from the underlying mortgage loans. Belvedere Trust s interest rate risk management program is formulated with the intent to offset, to some extent, the potential adverse effects resulting from rate adjustment limitations on its portfolio of mortgage-related assets and the differences between interest rate adjustment indices and interest rate adjustment periods of its adjustable-rate mortgage-related assets and related borrowings. Belvedere Trust finances certain of its retained and acquired securities with repurchase agreements which have different adjustment periods than the related assets. As part of its interest rate risk management program, Belvedere Trust has entered into term repurchase agreements that fix the rate of interest or, in some cases, cap the rate of interest on a portion of the borrowings secured by Belvedere Trust s mortgage-related assets.

Market Value Risk

Substantially all of our MBS are classified as available-for-sale assets. As such, they are reflected at fair value (i.e., market value) with the periodic adjustment to fair value reflected as part of Accumulated other comprehensive income that is included in the equity section of our balance sheet. The market value of our assets can fluctuate due to changes in interest rates and other factors.

Liquidity Risk

Our primary liquidity risk arises from financing long-maturity MBS with short-term debt. The interest rates on our borrowings generally adjust more frequently than the interest rates on our adjustable-rate MBS. For example, at December 31, 2006, our Agency and Non-Agency adjustable-rate MBS had a weighted average term to next rate adjustment of approximately 28 months, while our borrowings had a weighted average term to next rate adjustment of 90 days. After adjusting for interest rate swap transactions, the weighted average term to next rate adjustment was 301 days. Accordingly, in a period of rising interest rates, our borrowing costs will usually increase faster than our interest earnings from MBS. As a result, we could experience a decrease in net income or a net loss during these periods (as what has occurred in 2006). Our assets that are pledged to secure short-term borrowings are high-quality liquid assets. As a result, we have not had difficulty rolling over our short-term borrowings as they mature. There can be no assurance that we will always be able to roll over our short-term debt.

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At December 31, 2006, we had unrestricted cash of $175 thousand, $232.3 million in unpledged Agency and Non-Agency MBS and $15.2 million in unpledged BT Other MBS available to meet margin calls on short-term borrowings that could be caused by asset value declines or changes in lender collateralization requirements.

Prepayment Risk

Prepayments are the full or partial repayment of principal prior to the original term to maturity of a mortgage loan and typically occur due to refinancing of mortgage loans. Prepayment rates on mortgage-related securities and mortgage loans vary from time to time and may cause changes in the amount of our net interest income. Prepayments of ARM loans usually can be expected to increase when mortgage interest rates fall below the then-current interest rates on such loans and decrease when mortgage interest rates exceed the then-current interest rate on such loans, although such effects are not entirely predictable. Prepayment rates may also be affected by the conditions in the housing and financial markets, general economic conditions and the relative interest rates on fixed-rate loans and ARM loans underlying MBS. The purchase prices of MBS are generally based upon assumptions regarding the expected amounts and rates of prepayments. Where slow prepayment assumptions are made, we may pay a premium for MBS. To the extent such assumptions differ from the actual amounts of prepayments, we could experience reduced earnings or losses. The total prepayment of any MBS purchased at a premium by us would result in the immediate write-off of any remaining capitalized premium amount and a reduction of our net interest income by such amount. Finally, in the event that we are unable to acquire new MBS to replace the prepaid MBS, our financial condition, cash flows and results of operations could be harmed.

We often purchase mortgage-related assets that have a higher interest rate than the market interest rate at the time. In exchange for this higher interest rate, we must pay a premium over par value to acquire these assets. In accordance with accounting rules, we amortize this premium over the term of the mortgage-backed security. As we receive repayments of mortgage principal, we amortize the premium balances as a reduction to our income. If the mortgage loans underlying a mortgage-backed security were prepaid at a faster rate than we anticipate, we would amortize the premium at a faster rate. This would reduce our income.

Tabular Presentation

Anworth s MBS Portfolio

The information presented in the table below projects the impact of sudden changes in interest rates on Anworth s annual Projected Net Interest Income and Projected Portfolio Value (excluding Belvedere Trust s operations) as more fully discussed below, based on investments in place at December 31, 2006, and includes all of our interest rate-sensitive assets, liabilities and hedges, such as interest rate swap agreements.

Changes in Projected Net Interest Income equals the change that would occur in the calculated Projected Net Interest Income for the next twelve months relative to the 0% change scenario if interest rates were to instantaneously parallel shift to and remain at the stated level for the next twelve months.

Changes in Projected Portfolio Value equals the change in value of our assets that we carry at fair value rather than at historical amortized cost and any change in the value of any derivative instruments or hedges, such as interest rate swap agreements. We acquire interest rate-sensitive assets and fund them with interest rate-sensitive liabilities. We generally plan to retain such assets and the associated interest rate risk to maturity.

Change in Interest Rates	Percentage Change in Projected Net Interest Income	Percentage Change In Projected Portfolio Value
2.0%	109%	0.2%
1.0%	16%	0.4%
0%		
1.0%	193%	1.5%
2.0%	410%	3.5%

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When interest rates are shocked, prepayment assumptions are adjusted based on management s best estimate of the effects of changes in interest rates on prepayment speeds. For example, under current market conditions, a 100 basis point decline in interest rates is estimated to result in a 57% increase in the prepayment rate of our Agency MBS portfolio. The base interest rate scenario assumes interest rates at December 31, 2006. Actual results could differ significantly from those estimated in the table. The above table includes the effect of interest rate swap agreements. At December 31, 2006, the aggregate notional amount of the interest rate swap agreements was $900 million and the weighted average maturity was 2.9 years.

The information presented in the table below projects the impact of sudden changes in interest rates on Anworth s annual Projected Net Income and Projected Portfolio Value compared to the base case used in the table above (excluding Belvedere Trust s operations) and excludes the effect of the interest rate swap agreements.

Change in Interest Rates	**Percentage Change in Projected Net Interest Income**	**Percentage Change In Projected Portfolio Value**
2.0%	33%	1.0%
1.0%	16%	0.8%
0%		
1.0%	349%	1.9%
2.0%	642%	4.4%

BT Other MBS Portfolio

The information presented in the table below projects the impact of sudden changes in interest rates on Belvedere Trust s annual Projected Net Income and Projected Portfolio Value as more fully discussed below based on investments in place at December 31, 2006. Changes in Projected Portfolio Value equals the change in value of the assets that Belvedere Trust carries at fair value (shown on the Consolidated Balance Sheets as Other MBS) rather than at historical amortized cost and any change in the value of any derivative instruments or hedges, such as interest rate swap agreements and Eurodollar futures contracts, divided by Belvedere Trust s equity. Belvedere Trust s residential real estate loans are carried at historical amortized cost and, therefore, are not included in Projected Portfolio Value in the table below. Belvedere Trust acquires interest rate-sensitive assets and funds them with interest rate-sensitive liabilities. Belvedere Trust generally plans to retain such assets and the associated interest rate risk to maturity.

Change in Interest Rates	**Percentage Change in Projected Net Interest Income**	**Percentage Change In Projected Portfolio Value**
2.0%	8.3%	1.8%
1.0%	6.2%	0.6%
0%		
1.0%	17.4%	1.0%
2.0%	38.0%	1.7%

When interest rates are shocked, prepayment assumptions are adjusted based on management s best estimate of the effects of changes in interest rates on prepayment speeds. For example, under current market conditions, a 100 basis point decline in interest rates is estimated to result in an increase from 28% to 32% in the prepayment rate of Belvedere Trust s mortgage-related assets (which include those assets that have been securitized). The base interest rate scenario assumes interest rates at December 31, 2006. Actual results could differ significantly from those estimated in the table.

General

Many assumptions are made to present the information in the above tables and, as such, there can be no assurance that assumed events will occur, or that other events will not occur, that would affect the outcomes;

therefore, the above tables and all related disclosures constitute forward-looking statements. The analyses presented utilize assumptions and estimates based on management s judgment and experience. Furthermore, future sales, acquisitions and restructuring could materially change the interest rate risk profile for us and Belvedere Trust. The tables quantify the potential changes in net income and net asset value should interest rates immediately change (are shocked). The results of interest rate shocks of plus and minus 100 and 200 basis points are presented. The cash flows associated with the portfolio of mortgage-related assets for each rate shock are calculated based on a variety of assumptions including prepayment speeds, time until coupon reset, yield on future acquisitions, slope of the yield curve and size of the portfolio. Assumptions made on the interest rate-sensitive liabilities, which are repurchase agreements, include anticipated interest rates (no negative rates are utilized), collateral requirements as a percent of the repurchase agreement and amount of borrowing. Assumptions made in calculating the impact on net asset value of interest rate shocks include interest rates, prepayment rates and the yield spread of mortgage-related assets relative to prevailing interest rates.

Item 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY INFORMATION

The financial statements and related financial information required to be filed hereunder are indexed under Item 15 of this report and are incorporated herein by reference.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not applicable.

Item 9A. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), designed to ensure that information required to be disclosed by us in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

Our management, with the participation of our Principal Executive Officer and Principal Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on such evaluation, our Principal Executive Officer and Principal Financial Officer have concluded that, as of the end of such period, our disclosure controls and procedures are effective.

Management Report on Internal Control Over Financial Reporting

The management of Anworth is responsible for establishing and maintaining adequate internal control over financial reporting. Anworth s internal control system was designed to provide reasonable assurance to the company s management and board of directors regarding the preparation and fair presentation of prepared financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Anworth s management assessed the effectiveness of the company s internal control over financial reporting as of December 31, 2006. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control Integrated Framework.* Based on our assessment, we believe that, as of December 31, 2006, Anworth s internal control over financial reporting is effective based on those criteria. BDO Seidman, LLP has audited this assessment of our internal control over financial reporting; their report is included in Item 9A.

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Report of Independent Registered Public Accounting Firm on

Internal Control over Financial Reporting

To the Board of Directors and Stockholders

Anworth Mortgage Asset Corporation

Santa Monica, California

We have audited management s assessment, included in the accompanying Management s Report on Internal Control Over Financial Reporting, that Anworth Mortgage Asset Corporation (Anworth) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria)*. Anworth s management is responsible 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 management s assessment and an opinion on the effectiveness of Anworth s internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit 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 audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed 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 its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that 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, management s assessment that Anworth maintained effective internal control over financial reporting as of December 31, 2006 is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Anworth maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Anworth Mortgage Asset Corporation, as of December 31, 2006 and 2005 and the related consolidated statements of income, stockholders equity, cash flows and comprehensive income for each of the three years in the period ended December 31, 2006, and our report dated March 15, 2007 expressed an unqualified opinion thereon.

BDO Seidman, LLP

Los Angeles, California

March 15, 2007

Item 9B. OTHER INFORMATION

None.

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PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item is incorporated herein by reference from the information under the captions entitled Election of Directors Information Regarding Nominees for Director, Executive Officers and Section 16(a) Beneficial Ownership Reporting Compliance in our definitive proxy statement to be filed with the SEC no later than April 30, 2007.

Item 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference from the information under the caption entitled Executive Compensation in our definitive proxy statement to be filed with the SEC no later than April 30, 2007.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Certain of the information required by this Item is incorporated by reference from the information under the caption entitled Security Ownership of Certain Beneficial Owners and Management in our definitive proxy statement to be filed with the SEC no later than April 30, 2007.

Equity Compensation Plan Information

The following table provides information as of December 31, 2006 with respect to our common shares issuable under our 2004 Equity Compensation Plan:

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders(1)	1,360,670	$ 12.123	1,220,662
Equity compensation plans not approved by security holders(2)	N/A	N/A	N/A
Total	1,360,670	$ 12.123	1,220,662

(1) In May 2004, our stockholders adopted the Anworth Mortgage Asset Corporation 2004 Equity Compensation Plan, or the Plan, which amended and restated our 1997 Stock Option and Awards Plan. The Plan authorized the board of directors or a committee of our board to grant options to purchase of up to 3,500,000 of the outstanding shares of our common stock. The Plan does not provide for automatic annual increases in the aggregate share reserve or the number of shares remaining available for grant. On November 7, 2005, we filed a registration statement on Form S-8 to register an aggregate of 3,500,000 shares of our common stock, which may be issued pursuant to our 2004 Equity Compensation Plan.

(2) The Company has not authorized the issuance of its equity securities under any plan not approved by security holders.

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Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this Item is incorporated by reference from the information under the caption entitled Certain Transactions and Relationships in our definitive proxy statement to be filed with the SEC no later than April 30, 2007.

Item 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this Item is incorporated by reference from the information under the caption entitled Principal Accountant Fees and Services in our definitive proxy statement to be filed with the SEC no later than April 30, 2007.

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PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Documents filed as part of this report:

(1) The following financial statements of the Company are included in Part II, Item 8 of this annual report on Form 10-K:

Report of Independent Registered Public Accounting Firm, BDO Seidman, LLP;
Consolidated Balance Sheets as of December 31, 2006 and December 31, 2005;
Consolidated Statements of Income: Years Ended December 31, 2006, December 31, 2005 and December 31, 2004;
Consolidated Statements of Stockholders Equity: Years Ended December 31, 2006, December 31, 2005 and December 31, 2004;
Consolidated Statements of Cash Flows: Years Ended December 31, 2006, December 31, 2005 and December 31, 2004; and
Notes to Consolidated Financial Statements.

(2) Schedules to financial statements:

All financial statement schedules have been omitted because they are either inapplicable or the information required is provided in the Company s Consolidated Financial Statements and Notes thereto, included in Part II, Item 8 of this annual report on Form 10-K.

(3) The following exhibits are filed herewith:

Exhibit Number	Description
3.1	Amended Articles of Incorporation of Anworth (incorporated by reference from our Registration Statement on Form S-11, Registration No. 333-38641, which became effective under the Securities Act of 1933 on March 12, 1998)
3.2	Articles of Amendment to Amended Articles of Incorporation (incorporated by reference from our Definitive Proxy Statement filed pursuant to Section 14(a) of the Securities Exchange Act of 1934, as filed with the SEC on May 14, 2003)
3.3	Articles Supplementary for Series A Cumulative Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on November 3, 2004)
3.4	Articles Supplementary for Series A Cumulative Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 21, 2005)
3.5	Articles Supplementary for Series B Cumulative Convertible Preferred Stock (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 30, 2007)
3.6	Bylaws (incorporated by reference from our Registration Statement on Form S-11, Registration No. 333-38641, which became effective under the Securities Act of 1933 on March 12, 1998)
4.1	Specimen Common Stock Certificate (incorporated by reference from our Registration Statement on Form S-11, Registration No. 333-38641, which became effective under the Securities Act of 1933 on March 12, 1998)
4.2	Specimen Series A Cumulative Preferred Stock Certificate (incorporated by reference from our Current Report on Form 8-K filed with the SEC on November 3, 2004)
4.3	Specimen Series B Cumulative Convertible Preferred Stock Certificate (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 30, 2007)

Exhibit Number	Description
4.4	Form of stock certificate evidencing Anworth Capital Trust I Floating Rate Preferred Securities (liquidation amount $1,000 per Preferred Security) (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.5	Form of stock certificate evidencing Anworth Capital Trust I Floating Rate Common Securities (liquidation amount $1,000 per Common Security) (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.6	Form of note evidencing the Anworth s Floating Rate Junior Subordinated Note Due 2035 (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
4.7	Junior Subordinated Indenture dated as of March 15, 2005, between Anworth and JPMorgan Chase Bank (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
10.1*	2004 Equity Compensation Plan (incorporated by reference from our Definitive Proxy Statement filed pursuant to Section 14(a) of the Securities Exchange Act of 1934, as filed with the SEC on April 26, 2004)
10.2	2003 Dividend Reinvestment and Stock Purchase Plan (incorporated by reference from Post-Effective Amendment No. 1 to our Registration Statement on Form S-3, Registration No. 333-110744, which became effective under the Act on February 20, 2004)
10.3*	2002 Incentive Compensation Plan (incorporated by reference from our Definitive Proxy Statement filed pursuant to Section 14(a) of the Securities Exchange Act of 1934, as filed with the Securities Exchange Commission on May 17, 2002)
10.4	Agreement and Plan of Merger dated April 18, 2002 by and among Anworth, Anworth Mortgage Advisory Corporation (the Manager) and the stockholder of the Manager (incorporated by reference from our Definitive Proxy Statement filed pursuant to Section 14(a) of the Securities Exchange Act of 1934, as filed with the Securities Exchange Commission on May 17, 2002)
10.5*	Employment Agreement dated January 1, 2002, between the Manager and Lloyd McAdams(incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002)
10.6*	Employment Agreement dated January 1, 2002, between the Manager and Heather U. Baines (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002)
10.7*	Employment Agreement dated January 1, 2002, between the Manager and Joseph E. McAdams (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002)
10.8*	Addendum to Employment Agreement dated April 18, 2002, among Anworth, the Manager and Lloyd McAdams (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002)
10.9*	Addendum to Employment Agreement dated April 18, 2002, among Anworth, the Manager and Heather U. Baines (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002)
10.10*	Addendum to Employment Agreement dated April 18, 2002, among Anworth, the Manager and Joseph E. McAdams (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002)

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Exhibit Number	Description
10.11*	Second Addendum to Employment Agreement dated as of May 28, 2004 between Anworth and Lloyd McAdams (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2004, as filed with the SEC on August 9, 2004)
10.12*	Second Addendum to Employment Agreement dated as of June 13, 2002 between Anworth and Joseph E. McAdams (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002)
10.13*	Second Addendum to Employment Agreement dated as of June 27, 2006, between Anworth and Heather U. Baines (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2007)
10.14*	Third Addendum to Employment Agreement dated as of June 27, 2006, between Anworth and Lloyd McAdams (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2007)
10.15*	Third Addendum to Employment Agreement dated as of May 28, 2004, between Anworth and Joseph E. McAdams (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2004, as filed with the SEC on August 9, 2004)
10.16*	Fourth Addendum to Employment Agreement dated as of June 27, 2006, between Anworth and Joseph E. McAdams (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2007)
10.17	Sublease dated June 13, 2002, between Anworth and PIA (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2002, as filed with the SEC on August 14, 2002)
10.18	Amendment to Sublease dated July 8, 2003 between Anworth and PIA (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2003, as filed with the SEC on August 8, 2003)
10.19	Administrative Agreement dated October 14, 2002, between Anworth and PIA (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended September 30, 2002, as filed with the SEC on November 14, 2002)
10.20	Deferred Compensation Plan (incorporated by reference from our annual report on Form 10-K for the year ended December 31, 2002, as filed with the SEC on March 26, 2003)
10.21	BT Management Operating Agreement dated November 3, 2003 (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, as filed with the SEC on November 13, 2003)
10.22	Management Agreement dated November 3, 2003 between BT Management and Belvedere Trust Mortgage Corporation (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, as filed with the SEC on November 13, 2003)
10.23	Employment Agreement dated November 3, 2003 between BT Management and Claus Lund (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, as filed with the SEC on November 13, 2003)*
10.24	Employment Agreement dated November 3, 2003 between BT Management and Russell J. Thompson (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended September 30, 2003, as filed with the SEC on November 13, 2003)*
10.25	Amended and Restated Sales Agreement dated January 19, 2005 between Anworth and Cantor Fitzgerald & Co. (incorporated by reference from our Current Report on Form 8-K filed with the SEC on January 21, 2005)

Exhibit Number	Description
10.26	Purchase Agreement dated as of March 15, 2005, by and among Anworth, Anworth Capital Trust I, TABERNA Preferred Funding I, Ltd., and Merrill Lynch International (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
10.27	Amended and Restated Trust Agreement dated as of March 15, 2005, by and among Anworth, JPMorgan Chase Bank, National Association, Chase Bank USA, National Association, Lloyd McAdams, Joseph McAdams, Thad Brown and the several Holders, as defined therein (incorporated by reference from our Current Report on Form 8-K filed with the SEC on March 16, 2005)
10.28	Assignment and Assumption of Sublease and Consent of Sublessor dated May 16, 2005 among Belvedere Trust, BT Management Holding Corporation and Keefe, Bruyette & Woods, Inc. (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, as filed with the Securities and Exchange Commission on August 9, 2005)
10.29	Guaranty of Sublease dated May 16, 2005 between Anworth and Keefe, Bruyette & Woods, Inc. (incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, as filed with the Securities and Exchange Commission on August 9, 2005)
10.30	Second Amended and Restated Trust Agreement dated as of September 26, 2005 by and among Anworth, JPMorgan Chase Bank, National Association, Chase Bank USA, National Association, Lloyd McAdams, Joseph McAdams, Thad Brown and the several Holders, as defined therein (incorporated by reference from our Annual Report on Form 10-K for the fiscal year ended December 31, 2005, as filed with the Securities and Exchange Commission on March 16, 2006)
10.31*	Change in Control and Arbitration Agreement dated June 27, 2006, between Anworth and Thad M. Brown (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2007)
10.32*	Change in Control and Arbitration Agreement dated June 27, 2006, between Anworth and Charles J. Siegel (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2007)
10.33	Change in Control and Arbitration Agreement dated June 27, 2006, between Anworth and Evangelos Karagiannis (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2007)
10.34*	Change in Control and Arbitration Agreement dated June 27, 2006, between Anworth and Bistra Pashamova (incorporated by reference from our Current Report on Form 8-K filed with the SEC on June 28, 2007)
12.1	Computation of Ratio of Earnings to Combined Fixed Charges and Preferred Stock Dividends
14.1	Code of Ethics and Business Conduct
21.1	List of Subsidiaries
23.1	Consent of BDO Seidman, LLP
31.1	Certification of the Principal Executive Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934
31.2	Certification of the Principal Financial Officer, as required by Rule 13a-14(a) of the Securities Exchange Act of 1934
32.1	Certifications of the Principal Executive Officer provided pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certifications of the Principal Financial Officer provided pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Represents a management contract or compensatory plan, contract or arrangement in which any director or any of the named executives participates.

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SIGNATURES

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

DATED: March 16, 2007

ANWORTH MORTGAGE ASSET CORPORATION

/s/ JOSEPH LLOYD MCADAMS

Joseph Lloyd McAdams

Chairman of the Board, President and

Chief Executive Officer

(Principal Executive Officer)

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ JOSEPH LLOYD MCADAMS **Joseph Lloyd McAdams**	Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer)	March 16, 2007
/s/ THAD M. BROWN **Thad M. Brown**	Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	March 16, 2007
/s/ JOSEPH E. MCADAMS **Joseph E. McAdams**	Executive Vice President, Chief Investment Officer and Director	March 16, 2007
/s/ LEE A. AULT, III **Lee A. Ault, III**	Director	March 16, 2007
/s/ CHARLES H. BLACK **Charles H. Black**	Director	March 16, 2007
/s/ JOE E. DAVIS **Joe E. Davis**	Director	March 16, 2007
/s/ ROBERT C. DAVIS **Robert C. Davis**	Director	March 16, 2007

ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Anworth Mortgage Asset Corporation

Santa Monica, California

We have audited the accompanying consolidated balance sheets of Anworth Mortgage Asset Corporation (Anworth) as of December 31, 2006 and 2005 and the related consolidated statements of income, comprehensive income, stockholders equity and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements 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. An audit includes 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, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Anworth at December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006**,** in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Anworth s internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated March 15, 2007 expressed an unqualified opinion thereon.

As discussed in Note 14 to the financial statements, effective January 1, 2006, the Company changed its method of quantifying misstatements of prior year financial statements. The Company adopted the dual method, as required by SEC Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.

BDO Seidman, LLP

Los Angeles, California

March 15, 2007

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

	December 31, 2006	December 31, 2005
ASSETS		
Agency MBS:		
Agency MBS pledged to counterparties at fair value	$ 4,449,129	$ 4,302,139
Agency MBS at fair value	229,778	222,544
	4,678,907	4,524,683
Non-Agency MBS:		
Non-Agency MBS pledged to counterparties at fair value	104,508	
Non-Agency MBS at fair value	2,515	
	107,023	
BT Other MBS:		
BT Other MBS pledged to counterparties at fair value	147,644	91,153
BT Other MBS at fair value	15,155	4,776
	162,799	95,929
BT Residential Loans	1,682,522	2,497,881
Allowance for loan losses	(1,608)	(1,655)
Cash and cash equivalents	175	8,248
Restricted cash		1,250
Interest and dividends receivable	35,523	32,740
Derivative instruments at fair value	11,757	12,948
Prepaid expenses and other	10,291	12,225
	$ 6,687,389	$ 7,184,249
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Accrued interest payable	$ 69,106	$ 43,084
Repurchase agreements (Anworth)	4,329,921	4,099,410
Repurchase agreements (Belvedere Trust)	275,733	429,919
Whole loan financing facilities		493
MBS issued	1,471,724	2,069,634
Junior subordinated notes	37,380	37,380
Derivative instruments at fair value	6,877	
Dividends payable on preferred stock	2,022	1,011
Dividends payable on common stock	912	908
Accrued expenses and other	2,624	19,167
	$ 6,196,299	$ 6,701,006
Minority interest	$ 88	$ 144
Stockholders equity:		
Series A Cumulative Preferred Stock: par value $0.01 per share; liquidation preference $25.00 per share; authorized 20,000 shares, 1,876 and 1,876 shares issued and outstanding, respectively	$ 45,397	$ 45,397
	456	454

Common Stock: par value $0.01 per share; authorized 100,000 shares, 45,609 and 45,397 issued and outstanding, respectively		
Additional paid-in capital	525,607	524,993
Accumulated other comprehensive loss consisting of unrealized losses and gains	(45,435)	(75,620)
Accumulated deficit	(35,023)	(12,125)
	$ 491,002	$ 483,099
	$ 6,687,389	$ 7,184,249

See accompanying notes to consolidated financial statements.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME (LOSS)

(in thousands, except per share amounts)

	For the Year Ended December 31,		
	2006	2005	2004
Interest income net of amortization of premium and discount:			
Interest on Agency MBS	$ 205,755	$ 159,247	$ 127,239
Interest on Non-Agency MBS	532		
Interest on BT Other MBS	8,391	3,987	2,522
Interest on BT Residential Loans	94,682	118,518	33,617
	309,360	281,752	163,378
Interest expense:			
Interest expense on repurchase agreements (Anworth)	198,953	129,101	70,184
Interest expense on repurchase agreements (Belvedere Trust)	16,689	17,143	6,020
Interest expense on whole loan financing facilities	3	4,024	3,830
Interest expense on MBS issued	88,367	90,243	18,270
Interest expense on junior subordinated notes	3,084	1,998	
	307,096	242,509	98,304
Net interest income	2,264	39,243	65,074
(Loss) gain on sale of Agency MBS	(10,207)		101
Gain on sale of BT Other MBS	2,627		
(Loss) gain on sale of BT Residential Loans	(5)	129	158
Net gain on derivative instruments			340
Expenses:			
Compensation and benefits	(3,310)	(3,450)	(2,262)
Compensation-amortization of restricted stock	(397)	(40)	
Incentive compensation		(708)	(2,956)
Provision for loan losses	(1,265)	(1,086)	(591)
Belvedere Trust offering costs	(222)	(725)	
Other expenses	(3,745)	(4,202)	(3,766)
Total expenses	(8,939)	(10,211)	(9,575)
(Loss) income from operations before minority interest	(14,260)	29,161	56,098
Minority interest in net loss (income) of a subsidiary	56	(276)	(293)
Net (loss) income	$ (14,204)	$ 28,885	$ 55,805
Dividend on Series A Cumulative Preferred Stock	$ (4,044)	$ (3,901)	$ (369)
Net (loss) income available to common stockholders	$ (18,248)	$ 24,984	$ 55,436
Basic (loss) earnings per common share	$ (0.40)	$ 0.53	$ 1.23

Weighted average number of shares outstanding	45,430	47,103	45,244
Diluted (loss) earnings per common share	$ (0.40)	$ 0.53	$ 1.22
Weighted average number of diluted shares outstanding	45,430	47,128	45,329
Dividends declared per preferred share	$ 2.156252	$ 2.156252	$ 0.335417
Dividends declared per common share	$ 0.08	$ 0.55	$ 1.25

See accompanying notes to consolidated financial statements.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

Years ended December 31, 2006, 2005 and 2004

(in thousands, except per share amounts)

	Preferred Stock Shares	Common Stock Shares	Preferred Stock Par Value	Common Stock Par Value	Additional Paid-In Capital	Accum. Other Comp. Income (Loss) Agency MBS	Accum. Other Comp. Income (Loss) Derivatives	Accum. Other Comp. Income (Loss) Other MBS	Retained Earnings (Deficit)	Treasury Stock at Cost	Comp. Income (Loss)	Total
Balance, December 31, 2003		42,707	$	$ 427	$ 488,234	$ (21,933)	$	$	$ (9,331)	$		$ 457,397
Issuance of Series A Preferred stock	1,101		26,435									26,435
Issuance of common stock		3,790		38	45,412							45,450
Other comprehensive income (loss), fair value adjustments						(23,558)	4,122	(1,229)			(20,665)	(20,665)
Net income									55,805		55,805	55,805
Total comprehensive income											$ 35,140	
Amortization of restricted stock					79							79
Dividends declared $0.335417 per preferred share									(369)			(369)
Dividends declared $1.25 per common share									(57,096)			(57,096)
Balance, December 31, 2004	1,101	46,497	$ 26,435	$ 465	$ 533,725	$ (45,491)	$ 4,122	$ (1,229)	$ (10,991)	$		$ 507,036
Issuance of Series A Preferred stock	775		18,962									18,962
Issuance of common stock		2,282		23	20,956							20,979
Issuance of restricted stock		201		2	(2)							
Purchases of treasury stock										(29,841)		(29,841)
Retired treasury stock		(3,583)		(36)	(29,805)					29,841		
Other comprehensive income (loss), fair value adjustments						(39,936)	8,827	(1,913)			(33,022)	(33,022)
Net income									28,885		28,885	28,885
Total comprehensive income (loss)											$ (4,137)	

Amortization of restricted stock					119							119
Dividends declared $2.156252 per preferred share									(3,901)			(3,901)
Dividends declared $0.55 per common share									(26,118)			(26,118)
Balance, December 31, 2005	1,876	45,397	$ 45,397	$ 454	$ 524,993	$ (85,427)	$ 12,949	$ (3,142)	$ (12,125)	$		$ 483,099
Issuance of common stock		45			359							359
Issuance of restricted stock		205		2	64							66
Purchases of treasury stock										(285)		(285)
Retired treasury stock		(38)			(285)					285		
Other comprehensive income (loss), fair value adjustments and reclassifications						34,908	(8,067)	3,344			30,185	30,185
Net income (loss)									(14,204)		(14,204)	(14,204)
Total comprehensive income											$ 15,981	
Amortization of restricted stock					476							476
Dividends declared $2.156252 per preferred share									(4,044)			(4,044)
Dividends declared $0.08 per common share									(3,639)			(3,639)
Cumulative effect adjustment									(1,011)			(1,011)
Balance, December 31, 2006	1,876	45,609	$ 45,397	$ 456	$ 525,607	$ (50,519)	$ 4,882	$ 202	$ (35,023)	$		$ 491,002

See accompanying notes to consolidated financial statements.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	For the Year Ended December 31,		
	2006	2005	2004
Operating Activities:			
Net (loss) income	$ (14,204)	$ 28,885	$ 55,805
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:			
Amortization of premium and discounts (Agency MBS)	27,631	40,846	47,619
Amortization of premium and discounts (BT Other MBS)	2,178	1,990	347
Impairment charges on BT Other MBS	3,328		
Amortization of premium and discounts (BT Residential Loans)	15,575	16,669	3,437
Amortization of premium and discounts as long-term debt issued	185	(193)	(206)
Loss (gain) on sale of Agency MBS	10,207		(102)
Gain on sale of BT Other MBS	(2,627)		
Loss (gain) on sale of BT Residential Loans	5	(129)	(157)
Gain on derivative instruments			(340)
Provision for loan losses	909	1,086	591
Provision for losses on real estate owned	355		
Adjustment for minority interest in net (loss) income	(56)	276	293
Amortization of restricted stock	476	119	79
Changes in assets and liabilities:			
(Increase) in interest receivable	(2,783)	(4,599)	(11,135)
Decrease (increase) in prepaid expenses and other	2,050	(3,508)	(6,279)
Increase in accrued interest payable	26,022	19,840	8,560
(Decrease) increase in accrued expenses and other	(16,543)	14,330	3,428
Net cash provided by (used in) operating activities	$ 52,708	$ 115,612	$ 101,940
Investing Activities:			
Available-for-sale Agency MBS:			
Purchases	$ (1,988,185)	$ (1,770,019)	$ (2,281,202)
Principal payments	1,437,972	1,753,094	1,748,572
Proceeds from sales	393,057		119,356
Available-for-sale Non-Agency MBS:			
Purchases	(108,775)		
Principal payments	1,752		
Available-for-sale BT Other MBS:			
Purchases	(178,591)	(50,495)	(18,546)
Principal payments	14,947	14,169	14,367
Proceeds from sales	97,215		
BT Residential Loans:			
Purchases		(893,390)	(3,024,392)
Proceeds from sales	508	73,765	196,428
Principal payments	11	5,515	
ARM loans collateralizing MBS issued:			
Principal payments	797,859	925,271	141,350
Net cash provided by (used in) investing activities	$ 467,770	$ 57,910	$ (3,104,067)
Financing Activities:			
Borrowings from repurchase agreements	$ 23,957,370	$ 18,609,164	$ 13,444,247
Repayments on repurchase agreements	(23,881,045)	(18,797,271)	(12,502,502)
Borrowings on whole loan financing facilities		855,658	2,381,804
Repayments on whole loan financing facilities	(493)	(1,411,398)	(1,825,571)
Decrease (increase) in restricted cash	1,250		(1,250)
Borrowings on MBS issued	139,790	1,363,394	1,577,582

Repayments on MBS issued		(737,885)		(791,735)		(82,525)
Proceeds from junior subordinated notes issued, net				35,160		
Proceeds from preferred stock issued, net				18,962		26,435
Proceeds from common stock issued, net		426		20,979		45,449
Minority investments						50
Preferred stock dividends paid		(4,044)		(3,260)		
Common stock dividends paid		(3,635)		(37,764)		(58,635)
Treasury stock purchased		(285)		(29,841)		
Minority profit distributions				(364)		(111)
Net cash (used in) provided by financing activities	$	(528,551)	$	(168,316)	$	3,004,973
Net increase (decrease) in cash and cash equivalents	$	(8,073)	$	5,206	$	2,846
Cash and cash equivalents at beginning of period		8,248		3,042		196
Cash and cash equivalents at end of period	$	175	$	8,248	$	3,042
Supplemental Disclosure of Cash Flow Information:						
Cash paid for interest	$	277,781	$	219,351	$	89,389
Supplemental Disclosure of Investing and Financing Activities:						
Certificates retained from securitization	$		$		$	64,451
Restricted stock issued	$	1,800	$	1,550	$	
Retirement of treasury stock	$	285	$	29,841	$	

See accompanying notes to consolidated financial statements.

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ANWORTH MORTGAGE ASSET CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)