Arlington Asset Investment Corp.
Form 10-Q
May 03, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

# FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2013

OR

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

For the transition period from to

Commission File Number: 001-34374

ARLINGTON ASSET INVESTMENT CORP.
(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| Virginia<br>(State or Other Jurisdiction of Incorporation or Organization) | 54-1873198<br>(I.R.S. Employer Identification No.) |
| 1001 Nineteenth Street North<br>Arlington, VA<br>(Address of Principal Executive Offices) | 22209<br>(Zip Code) |

(703) 373-0200
(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Sec.232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act): Yes o No x

Number of shares outstanding of each of the registrant’s classes of common stock, as of April 30, 2013:

| Title | Outstanding |
|---|---|
| Class A Common Stock | 16,008,959 shares |
| Class B Common Stock | 554,055 shares |

ARLINGTON ASSET INVESTMENT CORP.
FORM 10-Q
FOR THE QUARTER ENDED MARCH 31, 2013
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PART I
FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

ARLINGTON ASSET INVESTMENT CORP.
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands)
(Unaudited)

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| ASSETS | | |
| Cash and cash equivalents | $ 21,085 | $ 35,837 |
| Receivables | | |
| Interest | 4,131 | 4,869 |
| Sold securities receivable | 26,632 | 26,773 |
| Other | 634 | 644 |
| Mortgage-backed securities, at fair value | | |
| Available-for-sale | 275,913 | 199,156 |
| Trading | 1,637,335 | 1,556,440 |
| Other investments | 2,180 | 2,347 |
| Derivative assets, at fair value | 9 | — |
| Deferred tax assets, net | 159,391 | 162,281 |
| Deposits | 83,618 | 85,652 |
| Prepaid expenses and other assets | 482 | 159 |
| Total assets | $ 2,211,410 | $ 2,074,158 |
| | | |
| LIABILITIES AND EQUITY | | |
| Liabilities: | | |
| Repurchase agreements | $ 1,207,171 | $ 1,497,191 |
| Interest payable | 470 | 582 |
| Accrued compensation and benefits | 1,139 | 1,542 |
| Dividend payable | 14,591 | — |
| Derivative liabilities, at fair value | 76,509 | 76,850 |
| Purchased securities payable | 336,504 | — |
| Accounts payable, accrued expenses and other liabilities | 14,210 | 17,837 |
| Long-term debt | 15,000 | 15,000 |
| Total liabilities | 1,665,594 | 1,609,002 |
| | | |
| Commitments and contingencies | — | — |
| Equity: | | |
| Preferred stock, $0.01 par value, 25,000,000 shares authorized, none issued and outstanding | — | — |
| Class A common stock, $0.01 par value, 450,000,000 shares authorized, 16,008,959 and 12,560,970 shares issued and outstanding, respectively | 160 | 126 |
| Class B common stock, $0.01 par value, 100,000,000 shares authorized, 554,055 shares issued and outstanding | 6 | 6 |
| Additional paid-in capital | 1,725,436 | 1,638,061 |

| | | | | |
|---|---|---|---|---|
| Accumulated other comprehensive income, net of taxes of $3,669 and $429, respectively | | 43,647 | | 38,985 |
| Accumulated deficit | | (1,223,433) | | (1,212,022) |
| Total equity | | 545,816 | | 465,156 |
| Total liabilities and equity | $ | 2,211,410 | $ | 2,074,158 |

See notes to consolidated financial statements.

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ARLINGTON ASSET INVESTMENT CORP.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands, except per share data)

(Unaudited)

| | Three Months Ended March 31, 2013 | Three Months Ended March 31, 2012 |
|---|---|---|
| Interest income | $ 18,328 | $ 13,363 |
| | | |
| Interest expense | | |
| Interest on short-term debt | 1,489 | 692 |
| Interest on long-term debt | 115 | 125 |
| Total interest expense | 1,604 | 817 |
| Net interest income | 16,724 | 12,546 |
| Other (loss) income, net | | |
| Investment (loss) gain, net | (13,529) | 2,808 |
| Other loss | (4) | (4) |
| Total other (loss) income, net | (13,533) | 2,804 |
| Operating income before other expenses | 3,191 | 15,350 |
| Other expenses | | |
| Compensation and benefits | 2,349 | 1,960 |
| Professional services | 1,121 | 1,584 |
| Business development | 32 | 17 |
| Occupancy and equipment | 121 | 95 |
| Communications | 47 | 52 |
| Other operating expenses | 106 | 438 |
| Total other expenses | 3,776 | 4,146 |
| (Loss) income before income taxes | (585) | 11,204 |
| Income tax (benefit) provision | (3,762) | 442 |
| Net income | $ 3,177 | $ 10,762 |
| | | |
| Basic earnings per share | $ 0.23 | $ 1.37 |
| Diluted earnings per share | $ 0.23 | $ 1.37 |
| Dividends declared per share | $ 0.875 | $ 0.875 |
| Weighted-average shares outstanding (in thousands) | | |
| Basic | 13,927 | 7,865 |
| Diluted | 14,093 | 7,873 |
| | | |
| Other comprehensive income, net of taxes | | |
| Unrealized (losses) gains for the period on available-for-sale securities (net of taxes of $3,646 and $-0-, respectively) | $ 5,654 | $ (4,903) |
| Reclassification | | |
| Included in investment (loss) gain, net, in the statement of comprehensive income related to sales of available-for-sale securities (net of taxes of $473 and $-0-, respectively) | (1,154) | — |
| Included in investment (loss) gain, net, in the statement of comprehensive income related to other-than-temporary impairment charges on available-for-sale securities (net of taxes of $67 and $-0-, respectively) | 162 | — |

| | | | | |
|---|---|---|---|---|
| Comprehensive income | $ | 7,839 | $ | 5,859 |

See notes to consolidated financial statements.

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ARLINGTON ASSET INVESTMENT CORP.
CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY
(Dollars in thousands)
(Unaudited)

| | Class A Common Stock (#) | Class A Amount ($) | Class B Common Stock (#) | Class B Amount ($) | Additional Paid-In Capital | Accumulated Other Comprehensive Income | Accumulated Deficit | Total |
|---|---|---|---|---|---|---|---|---|
| Balances, December 31, 2011 | 7,099,336 | $ 71 | 566,112 | $ 6 | $ 1,508,713 | $ 38,367 | $ (1,363,785) | $ 183,372 |
| Net income | — | — | — | — | — | — | 191,826 | 191,826 |
| Conversion of Class B shares to Class A shares | 12,057 | — | (12,057) | — | — | — | — | — |
| Issuance of Class A common stock | 5,493,750 | 55 | — | — | 129,194 | — | — | 129,249 |
| Repurchase of Class A common stock | (41,790) | — | — | — | (786) | — | — | (786) |
| Forfeitures of Class A common stock | (2,383) | — | — | — | (55) | — | — | (55) |
| Amortization of Class A common shares issued as stock-based awards | — | — | — | — | 995 | — | — | 995 |
| Other comprehensive income | | | | | | | | |
| Net change in unrealized gain on available-for-sale investment securities, (net of taxes of $429) | — | — | — | — | — | 618 | — | 618 |
| Dividends declared | — | — | — | — | — | — | (40,063) | (40,063) |
| Balances, December 31, 2012 | 12,560,970 | 126 | 554,055 | 6 | 1,638,061 | 38,985 | (1,212,022) | 465,156 |
| Net income | — | — | — | — | — | — | 3,177 | 3,177 |
| Issuance of Class A common stock | 3,450,000 | 34 | — | — | 86,930 | — | — | 86,964 |
| Forfeitures of Class A common stock | (2,011) | — | — | — | (51) | — | — | (51) |
| Amortization of Class A common shares issued as stock-based awards | — | — | — | — | 496 | — | — | 496 |
| Other comprehensive income | | | | | | | | |
| Net change in unrealized gain on available-for-sale investment securities, (net of taxes of $3,240) | — | — | — | — | — | 4,662 | — | 4,662 |
| Dividends declared | — | — | — | — | — | — | (14,588) | (14,588) |
| Balances, March 31, 2013 | 16,008,959 | $ 160 | 554,055 | $ 6 | $ 1,725,436 | $ 43,647 | $ (1,223,433) | $ 545,816 |

See notes to consolidated financial statements.

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ARLINGTON ASSET INVESTMENT CORP.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)
(Unaudited)

| | Three Months Ended March 31, 2013 | Three Months Ended March 31, 2012 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 3,177 | $ 10,762 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Net investment loss (gain), net | 13,529 | (2,808) |
| Net discount accretion on mortgage-backed securities | (1,795) | (2,633) |
| Depreciation and amortization | 2 | 12 |
| Other | (2,747) | 161 |
| Changes in operating assets | | |
| Interest receivable | 738 | (169) |
| Other receivables | 12 | (4) |
| Prepaid expenses and other assets | 189 | 1,470 |
| Deferred tax assets | 2,890 | — |
| Changes in operating liabilities | | |
| Accounts payable and accrued expenses | (3,934) | 302 |
| Accrued compensation and benefits | (403) | (4,863) |
| Net cash provided by operating activities | 11,658 | 2,230 |
| Cash flows from investing activities: | | |
| Purchases of available-for-sale mortgage-backed securities | (71,878) | — |
| Purchases of trading mortgage-backed securities | (125,557) | (170,224) |
| Proceeds from sales of available-for-sale mortgage-backed securities | 4,779 | — |
| Proceeds from sales of trading mortgage-backed securities | 304,750 | 21,548 |
| Receipt of principal payments on available-for-sale mortgage-backed securities | 9,311 | 3,516 |
| Receipt of principal payments on trading mortgage-backed securities | 33,675 | 13,771 |
| Proceeds from sold securities receivable | 26,773 | 41,321 |
| Proceeds from derivatives and deposits, net | 2,428 | 926 |
| Other | (7,784) | 38,262 |
| Net cash provided by (used in) investing activities | 176,497 | (50,880) |
| Cash flows from financing activities: | | |
| (Repayments of) proceeds from repurchase agreements, net | (290,020) | 20,641 |
| Proceeds from stock issuance | 87,113 | 40,164 |
| Dividends paid | — | (6,785) |
| Net cash (used in) provided by financing activities | (202,907) | 54,020 |
| Net (decrease) increase in cash and cash equivalents | (14,752) | 5,370 |
| Cash and cash equivalents, beginning of period | 35,837 | 20,018 |
| Cash and cash equivalents, end of period | $ 21,085 | $ 25,388 |
| Supplemental cash flow information | | |
| Cash payments for interest | $ 1,716 | $ 979 |

| | | | | |
|---|---|---|---|---|
| Cash payments for taxes | $ | 123 | $ | — |

See notes to consolidated financial statements.

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ARLINGTON ASSET INVESTMENT CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per share data)
(Unaudited)

1. Basis of Presentation:

The consolidated financial statements of Arlington Asset Investment Corp. (Arlington Asset) and its subsidiaries (unless the context otherwise provides, collectively, the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to Form 10-Q. Therefore, they do not include all information required by GAAP for complete financial statements. The interim financial statements reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair statement of the results for the periods presented. All significant intercompany accounts and transactions have been eliminated in consolidation. The results of operations for the three months ended March 31, 2013 are not necessarily indicative of the operating results for the entire year or any other subsequent interim period. The Company's unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the Company's audited consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

The preparation of the Company's financial statements in conformity with GAAP requires the Company to make estimates and assumptions affecting the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Although the Company based the estimates and assumptions on historical experience, when available, market information, and on various other factors that the Company believes to be reasonable under the circumstances, management exercises significant judgment in the final determination of the estimates. Actual results may differ from these estimates.

Certain amounts in the consolidated financial statements and notes for prior periods have been reclassified to conform to the current period presentation. These reclassifications had no effect on the results of operations of the Company.

2. Financial Instruments:

Fair Value of Financial Instruments

The accounting principles related to fair value measurements define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date, not adjusted for transaction costs. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures (ASC 820), establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels giving the highest priority to quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3) as described below:

| | |
|---|---|
| Level 1 Inputs— | Unadjusted quoted prices in active markets for identical assets or liabilities that are accessible by the Company; |
| Level 2 Inputs— | Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly; and |
| Level 3 Inputs— | |

Unobservable inputs for the asset or liability, including significant assumptions of the Company and other market participants.

The Company determines fair values for the following assets and liabilities:

Mortgage-backed securities (MBS), at fair value—

Agency-backed MBS - The Company's agency-backed MBS, the principal and interest payments on which are guaranteed by the Federal National Mortgage Association (Fannie Mae) or the Federal Home Loan Mortgage Corporation (Freddie Mac), are generally classified within Level 2 of the fair value hierarchy as they are valued after considering quoted market prices provided by a broker or dealer, or alternative pricing sources with reasonable levels of price transparency. The Company reviews broker or pricing service quotes to determine whether the quotes are relevant, for example, whether an active market exists to provide price transparency or whether the quote is an indicative price or a binding offer. The independent brokers and dealers providing market prices are those who make markets in or specialists with expertise in the valuation of these financial instruments.

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Private-label MBS - The Company classifies private-label MBS within Level 3 of the fair value hierarchy because they trade infrequently and, therefore, have little or no price transparency. The Company utilizes present value techniques based on estimated cash flows of the instrument taking into consideration various assumptions derived by management and other assumptions used by other market participants. These assumptions are corroborated by evidence such as historical data, risk characteristics, transactions in similar instruments, and completed or pending transactions, when available. The significant inputs in the Company's valuation process include default rate, loss severity, prepayment rate and discount rate. In general, significant increases (decreases) in default rate, loss severity or discount rate, in isolation, would result in a significantly lower (higher) fair value measurement. However, significant increases (decreases) in prepayment rate may result in a significantly higher (lower) fair value measurement. It is difficult to generalize the interrelationships between these significant inputs as the actual results could differ considerably on an individual security basis. For example, an increase in the default rate may not increase the loss severity rate if actual losses are lower than the average. Also, changes in discount rates may be greatly influenced by market expectation at any given point based upon many variables not directly related to the MBS market. Therefore, each significant input is closely analyzed to ascertain the reasonableness for the Company's valuation purposes.

Establishing fair value is inherently subjective given the volatile and sometimes illiquid markets for these private-label MBS and requires management to make a number of assumptions, including assumptions about the future of interest rates, prepayment rates, discount rates, credit loss rates, and the timing of cash flows and credit losses. The assumptions the Company applies are specific to each security. Although the Company relies on the internal calculations to compute the fair value of these private-label MBS, the Company requests and considers indications of value (mark) from third-party dealers and the actual sales of private-label MBS to assist in the valuation process and calibrate our model.

Other investments—The Company's other investments consist of investments in equity securities, investment funds, interest-only MBS, and other MBS-related securities. Interest-only MBS is classified within Level 3 of the fair value hierarchy.

Derivative instruments—In the normal course of the Company's operations, the Company is a party to various financial instruments that are accounted for as derivatives in accordance with ASC 815, Derivatives and Hedging (ASC 815). The derivative instruments that trade in active markets or exchanges are classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices. Other derivative instruments are generally classified within Level 2 of the fair value hierarchy because they are valued using broker or dealer quotations, which are model-based calculations based on market-based inputs, including, but not limited to, contractual terms, market prices, yield curves, credit curves, measures of volatility, prepayment rates and correlations of such inputs.

Other—Cash and cash equivalents, interest receivable, deposits, other receivable, interest payable, accounts payable, accrued expenses and other liabilities are reflected in the consolidated balance sheets at their amortized cost, which approximates fair value because of the short term nature of these instruments and classified within Level 1 of the fair value hierarchy.

—Sold securities receivable, repurchase agreements and purchase securities payable are reflected in the consolidated balance sheets at the cost basis, which approximates fair value because of the short term nature of these instruments and classified within Level 2 of the fair value hierarchy.

—Long-term debt represents a remaining balance of trust preferred debt issued by the Company which approximates fair value due to the nature of the debenture and is classified within Level 3 of the fair value hierarchy.

The estimated fair values of the Company's financial instruments are as follows:

| | March 31, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Financial assets | | | | |
| Cash and cash equivalents | $ 21,085 | $ 21,085 | $ 35,837 | $ 35,837 |
| Interest receivable | 4,131 | 4,131 | 4,869 | 4,869 |
| Sold securities receivable | 26,632 | 26,632 | 26,773 | 26,773 |
| Other receivables | 634 | 634 | 644 | 644 |
| MBS | | | | |
| Agency-backed MBS | 1,637,392 | 1,637,392 | 1,556,510 | 1,556,510 |
| Private-label MBS | | | | |
| Senior securities | 7,400 | 7,400 | 7,519 | 7,519 |
| Re-REMIC securities | 268,456 | 268,456 | 191,567 | 191,567 |
| Derivative assets | 9 | 9 | — | — |
| Deferred tax assets, net | 159,391 | 159,391 | 162,281 | 162,281 |
| Other investments | 2,180 | 2,180 | 2,347 | 2,347 |
| Deposits | 83,618 | 83,618 | 85,652 | 85,652 |
| | | | | |
| Financial liabilities | | | | |
| Repurchase agreements | 1,207,171 | 1,207,171 | 1,497,191 | 1,497,191 |
| Purchased securities payable | 336,504 | 336,504 | — | — |
| Interest payable | 470 | 470 | 582 | 582 |
| Long-term debt | 15,000 | 15,000 | 15,000 | 15,000 |
| Derivative liabilities | 76,509 | 76,509 | 76,850 | 76,850 |
| Accounts payable, accrued expenses and other liabilities | 14,210 | 14,210 | 17,837 | 17,837 |

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Fair Value Hierarchy

The following tables set forth financial instruments accounted for under ASC 820 by level within the fair value hierarchy as of March 31, 2013 and December 31, 2012. As required by ASC 820, assets and liabilities that are measured at fair value are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

Financial Instruments Measured at Fair Value on a Recurring Basis

| | March 31, 2013 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| MBS, at fair value | | | | |
| Trading | | | | |
| Agency-backed MBS | $ 1,637,335 | $ — | $ 1,637,335 | $ — |
| Available-for-sale | | | | |
| Agency-backed MBS | 57 | — | 57 | — |
| Private-label MBS | | | | |
| Senior securities | 7,400 | — | — | 7,400 |
| Re-REMIC securities | 268,456 | — | — | 268,456 |
| Total available-for-sale | 275,913 | — | 57 | 275,856 |
| Total MBS | 1,913,248 | — | 1,637,392 | 275,856 |
| Derivative assets, at fair value | 9 | — | 9 | — |
| Derivative liabilities, at fair value | (76,509) | (76,237) | (272) | — |
| Interest-only MBS, at fair value | 449 | — | — | 449 |
| Total | $ 1,837,197 | $ (76,237) | $ 1,637,129 | $ 276,305 |

| | December 31, 2012 | | | |
|---|---|---|---|---|
| | Total | Level 1 | Level 2 | Level 3 |
| MBS, at fair value | | | | |
| Trading | | | | |
| Agency-backed MBS | $ 1,556,440 | $ — | $ 1,556,440 | $ — |
| Available-for-sale | | | | |
| Agency-backed MBS | 70 | — | 70 | — |
| Private-label MBS | | | | |
| Senior securities | 7,519 | — | — | 7,519 |
| Re-REMIC securities | 191,567 | — | — | 191,567 |
| Total available-for-sale | 199,156 | — | 70 | 199,086 |
| Total MBS | 1,755,596 | — | 1,556,510 | 199,086 |
| Derivative liabilities, at fair value | (76,850) | (76,850) | — | — |
| Interest-only MBS, at fair value | 478 | — | — | 478 |
| Total | $ 1,679,224 | $ (76,850) | $ 1,556,510 | $ 199,564 |

The total financial assets measured and reported at fair value on a recurring basis and classified within Level 3 were $276,305, or 12.49%, and $199,564, or 9.62%, of the Company's total assets as of March 31, 2013 and December 31, 2012, respectively.

There were no transfers of securities in or out of Levels 1, 2 or 3 during the three months ended March 31, 2013 or the year ended December 31, 2012.

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Level 3 Financial Assets and Liabilities

Financial Instruments Measured at Fair Value on a Recurring Basis

The fair value of the Company's Level 3, available-for-sale, private-label MBS was $275,856 and $199,086 as of March 31, 2013 and December 31, 2012, respectively. These securities are primarily senior and re-REMIC tranches in securitization trusts issued between 2005 and 2010. The senior securities represent interests in securitizations that have the first right to cash flows and absorb losses last. The re-REMIC securities represent interests in re-securitizations of senior MBS and pro-rata mezzanine securities. For re-REMIC securities, the cash flows from, and any credit losses absorbed by, the underlying MBS are allocated among the re-REMIC securities issued in the re-securitization transactions based on the re-REMIC structure. For example, prime and non-prime residential senior securities have been resecuritized to create a two-tranche structure with a re-REMIC senior security and a re-REMIC subordinated security. In these re-REMIC securities, all principal payments from the underlying securities are directed to the re-REMIC senior security until the face value is fully paid off. Thereafter, all principal payments are directed to the re-REMIC subordinated security. For pro-rata mezzanine securities, principal payments from the underlying MBS are typically allocated concurrently and proportionally to the mezzanine securities along with senior securities. The re-REMIC subordinated and mezzanine securities absorb credit losses, if any, first; however, these credit losses occur only when credit losses exceed the credit protection provided to the underlying securities. Senior, re-REMIC and mezzanine securities receive interest while any face value is outstanding.

The Company's senior securities and re-REMIC securities were collateralized by residential Prime and Alt-A mortgage loans and had the following weighted-averages as of the dates indicated.

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Original loan-to-value | $ 70% | $ 70% |
| Original FICO score | 728 | 730 |
| Three-month prepayment rate | 18% | 17% |
| Three-month loss severities | 48% | 46% |
| Weighted average coupon | 4.17% | 4.40% |

The significant unobservable inputs for the valuation model include the following weighted-averages as of the dates indicated:

| | March 31, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Senior Securities | Re-REMIC Securities | Senior Securities | Re-REMIC Securities |
| Discount rate | 6.50% | 6.69% | 6.50% | 7.43% |
| Default rate | 9.30% | 4.87% | 9.30% | 5.00% |
| Loss severity rate | 55.00% | 46.01% | 60.00% | 46.60% |
| Prepayment rate | 16.30% | 13.22% | 16.30% | 13.75% |

The ranges of the significant unobservable inputs for the valuation model were as follows as of the dates indicated:

| | March 31, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Senior Securities | Re-REMIC Securities | Senior Securities | Re-REMIC Securities |
| Discount rate | 6.50% | 5.50 – 10.00% | 6.50% | 6.50 – 13.25% |
| Default rate | 9.30% | 0.95 – 11.60% | 9.30% | 0.95 – 11.10% |

| | | | | |
|---|---|---|---|---|
| Loss severity rate | 55.00% | 28.31 – 57.50% | 60.00% | 28.26 – 57.50% |
| Prepayment rate | 16.30% | 6.95 – 20.80% | 16.30% | 6.95 – 20.40% |

The tables below set forth a summary of changes in the fair value and gains and losses of the Company's Level 3 financial assets and liabilities that are measured at fair value on a recurring basis for the three months ended March 31, 2013 and 2012.

| | Three Months Ended March 31, 2013 | | |
|---|---|---|---|
| | Senior Securities | Re-REMIC Securities | Total |
| Beginning balance, January 1, 2013 | $ 7,519 | $ 191,567 | $ 199,086 |
| Total net gains (losses) | | | |
| Included in earnings | — | 1,448 | 1,448 |
| Included in other comprehensive income | 36 | 7,867 | 7,903 |
| Purchases | — | 71,878 | 71,878 |
| Sales | — | (4,779) | (4,779) |
| Payments, net | (383) | (5,006) | (5,389) |
| Accretion of discount | 228 | 5,481 | 5,709 |
| Ending balance, March 31, 2013 | $ 7,400 | $ 268,456 | $ 275,856 |
| The amount of net gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to Level 3 assets still held at the reporting date | $ — | $ (162) | $ (162) |

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| | Three Months Ended March 31, 2012 | | |
|---|---|---|---|
| | Senior Securities | Re-REMIC Securities | Total |
| Beginning balance, January 1, 2012 | $ 9,311 | $ 170,116 | $ 179,427 |
| Total net gains (losses) | | | |
| Included in earnings | — | — | — |
| Included in other comprehensive income | (607) | (4,276) | (4,883) |
| Purchases | — | — | — |
| Sales | — | — | — |
| Payments, net | (256) | (3,260) | (3,516) |
| Accretion of discount | 199 | 4,312 | 4,511 |
| Ending balance, March 31, 2012 | $ 8,647 | $ 166,892 | $ 175,539 |
| The amount of net gains (losses) for the period included in earnings attributable to the change in unrealized gains (losses) relating to Level 3 assets still held at the reporting date | $ — | $ — | $ — |

Gains and losses included in earnings for the three months ended March 31, 2013 and 2012 are reported in the following statement of comprehensive income line descriptions:

| | Other (Loss) Income, Investment (Loss) Gain, net | |
|---|---|---|
| | Three Months Ended March 31, | |
| | 2013 | 2012 |
| Total gains included in earnings for the period | $ 1,448 | $ — |
| Change in unrealized gains (losses) relating to Level 3 assets still held at the reporting date | $ (162) | $ — |

Level 3 Financial Instruments Measured at Fair Value on a Non-Recurring Basis

The Company also measures certain financial assets at fair value on a non-recurring basis. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets due to impairments. Due to the nature of these financial assets, enterprise values are primarily used to value these financial assets. In determining the enterprise value, the Company analyzes various financial, performance and market factors to estimate fair value, including where applicable, market trading activity. As a result, these financial assets are classified within Level 3 of the fair value hierarchy. As of March 31, 2013 and December 31, 2012, these financial assets are classified within the other investments category and represent the Company’s interest in non-public equity securities and investment funds and valued at $1,731 and $1,869, respectively. For the three months ended March 31, 2013, the Company recorded a loss of $138 in the carrying value of these financial assets. For the three months ended March 31, 2012, there were no changes to the carrying value of these financial assets.

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MBS, at Fair Value

MBS, at fair value(1) (2), consisted of the following as of the dates indicated:

| | March 31, 2013 | | | | | December 31, 2012 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Fair Value | Net Unamortized Premium (Discount) | Percent of Total Fair Value | Weighted Average Life | Weighted Average Rating(3) | Fair Value | Net Unamortized Premium (Discount) | Percent of Total Fair Value | Weighted Average Life | Weighted Average Rating(3) |
| Trading | | | | | | | | | | |
| Fannie Mae | $ 1,156,713 | $ — | 60.46% | 8.0 | AAA | $ 1,083,810 | $ — | 61.73% | 4.9 | AAA |
| Freddie Mac | 480,622 | — | 25.12% | 8.3 | AAA | 472,630 | — | 26.92% | 5.1 | AAA |
| Available-for-sale: | | | | | | | | | | |
| Agency-backed | | | | | | | | | | |
| Fannie Mae | 57 | — | — | 4.7 | AAA | 70 | — | 0.01% | 2.8 | AAA |
| Private-label | | | | | | | | | | |
| Senior securities | 7,400 | (6,107) | 0.39% | 5.1 | C- | 7,519 | (6,519) | 0.43% | 5.2 | C |
| Re-REMIC securities | 268,456 | (210,987) | 14.03% | 11.5 | NR | 191,567 | (164,422) | 10.91% | 11.4 | NR |
| | $ 1,913,248 | $ (217,094) | 100.00% | | | $ 1,755,596 | $ (170,941) | 100.00% | | |

(1) The Company's MBS portfolio was primarily comprised of fixed-rate MBS at March 31, 2013 and December 31, 2012. The weighted-average coupon of the MBS portfolio at March 31, 2013 and December 31, 2012 was 4.10% and 4.11%, respectively.

(2) As of March 31, 2013 and December 31, 2012, the Company's MBS investments with a fair value of $1,313,300 and $1,615,421, respectively, were pledged as collateral for repurchase agreements.

(3) The securities issued by Fannie Mae and Freddie Mac are not rated by any rating agency; however, they are commonly thought of as having an implied rating of "AAA." There is no assurance, particularly given the downgrade of the U.S.'s credit rating to "AA" by Standard & Poors during the quarter ended September 30, 2011, that these securities would receive such a rating if they were ever rated by a rating agency. The weighted-average rating of the Company's private-label senior securities is calculated based on face value of the securities.

The Company has generally purchased private-label MBS at a discount. The Company, at least on a quarterly basis, estimates the future expected cash flows based on the Company's observation of current information and events and applying a number of assumptions related to prepayment rates, interest rates, default rates, loss severity rates, and the timing and amount of cash flows and credit losses. These assumptions are difficult to predict as they are subject to uncertainties and contingencies related to future events that may impact the Company's estimates and its interest income.

Interest income on the private-label MBS that were purchased at a discount to face value is recognized based on the security's expected effective interest rate. At acquisition, the accretable yield is calculated as the difference between the undiscounted expected cash flows and the purchase price which is expected to be accreted into interest income over the remaining life of the security on a level-yield basis. The difference between the contractually required payments and the undiscounted expected cash flows represents the non-accretable difference. Based on actual payment activities and changes in estimates of undiscounted expected future cash flows, the accretable yield and the non-accretable difference can change over time. Significant increases in the amount or timing of undiscounted expected future cash flows are recognized prospectively as an adjustment to the accretable yield.

The following table presents the changes in the accretable yield on available-for-sale, private-label MBS for the three months ended March 31, 2013 and 2012.

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| Beginning balance | $ 207,853 | $ 194,619 |
| Accretion of discount | (5,709) | (6,292) |
| Reclassifications, net | 3,907 | (5,460) |
| Acquisitions | 62,874 | — |
| Sales | (7,534) | — |
| Ending balance | $ 261,391 | $ 182,867 |

The Company purchased no available for sale, private-label MBS during the three months ended March 31, 2012. For the available-for-sale, private-label MBS acquired during the three months ended March 31, 2013, the contractually required payments receivable, the cash flow expected to be collected, and the fair value at the acquisition date were as follows:

| | |
|---|---|
| Contractually required payments receivable | $ 184,171 |
| Cash flows expected to be collected | 134,753 |
| Basis in acquired securities | 71,878 |

The Company's available-for-sale MBS are carried at fair value in accordance with ASC 320, Debt and Equity Securities (ASC 320), with resulting unrealized gains and losses reflected as other comprehensive income or loss. Gross unrealized gains and losses on these securities were the following as of the dates indicated:

| | March 31, 2013 | | | |
|---|---|---|---|---|
| | Amortized Cost/ Cost Basis(1) | Unrealized Gains | Unrealized Losses | Fair Value |
| Agency-backed MBS | $ 52 | $ 5 | $ — | $ 57 |
| Private-label MBS | | | | |
| Senior securities | 5,456 | 1,944 | — | 7,400 |
| Re-REMIC securities | 223,089 | 45,426 | (59) | 268,456 |
| Total | $ 228,597 | $ 47,375 | $ (59) | $ 275,913 |

(1) The amortized cost of MBS includes unamortized net discounts of $217,094 at March 31, 2013.

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| | December 31, 2012 | | | |
|---|---|---|---|---|
| | Amortized Cost/ Cost Basis(1) | Unrealized Gains | Unrealized Losses | Fair Value |
| Agency-backed MBS | $ 64 | $ 6 | $ — | $ 70 |
| Private-label MBS | | | | |
| Senior securities | 5,611 | 1,908 | — | 7,519 |
| Re-REMIC securities | 154,067 | 37,500 | — | 191,567 |
| Total | $ 159,742 | $ 39,414 | $ — | $ 199,156 |

(1) The amortized cost of MBS includes unamortized net discounts of $170,941 at December 31, 2012.

For the three months ended March 31, 2013, the Company recorded other-than-temporary impairment charges of $162 as a component of investment (loss) gain, net on the consolidated statements of comprehensive income related to deterioration in credit quality on available-for-sale, private-label MBS with a cost basis of $510, prior to recognizing the other-than-temporary impairment charges. The Company recorded no other-than-temporary impairment charges on MBS during the three months ended March 31, 2012.

The following table presents a summary of the other-than-temporary impairment charges included in earnings for the periods indicated:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| Cumulative other-than-temporary impairment beginning balance | $ 23,768 | $ 8,594 |
| Additions | | |
| Other-than-temporary impairments not previously recognized | — | — |
| Increases related to other-than-temporary impairments on securities with previously recognized other-than-temporary impairments | 162 | — |
| Cumulative other-than-temporary impairment ending balance | $ 23,930 | $ 8,594 |

The following table presents the results of sales of MBS for the periods indicated:

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| | 2013 | | 2012 | |
| | Agency-Backed MBS | Private-Label MBS | Agency-Backed MBS | Private-Label MBS |
| Proceeds from sales | $ 331,626 | $ 4,779 | $ 21,609 | $ — |
| Gross gains | — | 1,561 | — | — |
| Gross losses | 3,971 | — | 120 | — |

Other Investments

The Company's other investments consisted of the following as of the dates indicated:

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Interest-only MBS | $ 449 | $ 478 |
| Non-public equity securities | 975 | 975 |
| Investment funds | 756 | 894 |
| Total other investments | $ 2,180 | $ 2,347 |

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3. Borrowings:

Repurchase Agreements

The Company has entered into repurchase agreements to fund its investments in MBS. Securities sold under agreements to repurchase, which are treated as financing transactions for financial reporting purposes, are collateralized by MBS and are carried at their contractual amounts, including accrued interest, as specified in the respective agreements. Under the repurchase agreements, the Company pledges its securities as collateral to secure the borrowing, which is equal in value to a specified percentage of the fair value of the pledged collateral, while the Company retains beneficial ownership of the pledged collateral. The counterparty to the repurchase agreements may require that the Company pledge additional securities or cash as additional collateral to secure borrowings when the value of the collateral declines.

As of March 31, 2013, the Company had no amount at risk with a single repurchase agreement counterparty or lender greater than 10% of equity. As of December 31, 2012, the amount at risk related to $482,097 of repurchase agreements with Credit Suisse Securities (USA) LLC was $50,171 or 10.79% of the Company's equity with a weighted-average maturity of 15 days. The amount at risk is defined as the excess of the higher of carrying amount or market value of the collateral provided under repurchase agreements, including any cash or other assets on deposit to secure the repurchase obligation, over the amount of the repurchase liability. The following tables provide information regarding the Company's outstanding repurchase agreement borrowings as of the dates and for the periods indicated:

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Outstanding balance | $ 1,207,171 | $ 1,497,191 |
| Value of assets pledged as collateral | | |
| Agency-backed MBS | 1,232,923 | 1,547,760 |
| Private-label MBS | 80,377 | 67,661 |
| Net amount | 106,129 | 118,230 |
| Weighted-average rate | 0.47% | 0.52% |
| Weighted-average term to maturity | 11.9 days | 14.5 days |

| | March 31, 2013 | March 31, 2012 |
|---|---|---|
| Weighted-average outstanding balance during the three months ended | $ 1,272,862 | $ 645,469 |
| Weighted-average rate during the three months ended | 0.47% | 0.42% |

Long-Term Debt

As of March 31, 2013 and December 31, 2012, the Company had $15,000 of outstanding long-term debentures. The long-term debentures accrue and require payments of interest quarterly at an annual rate of three-month LIBOR plus 2.25% to 3.00%. The weighted-average interest rate on these long-term debentures was 3.05% and 3.09% as of March 31, 2013 and December 31, 2012, respectively. All of these borrowings mature between 2033 and 2035.

4. Derivative Financial Instruments and Hedging Activities:

In the normal course of its operations, the Company is a party to financial instruments that are accounted for as derivative financial instruments in accordance with ASC 815. These instruments may include interest rate swaps, Eurodollar, swap, and U.S. Treasury futures contracts, put options and certain commitments to purchase and sell MBS. The exchange traded derivatives such as Eurodollar futures are cash settled on a daily basis. The Company may be required to pledge collateral for margin requirements with third-party custodians in connection with certain derivative transactions. These transactions are not under master netting agreement.

During the three months ended March 31, 2013, the Company entered into various financial contracts to hedge certain MBS and related borrowings and other long-term debt. These financial contracts are not designated as hedges under ASC 815. The changes in fair value on these derivatives are recorded to net investment gain or loss in the statement of comprehensive income. For the three months ended March 31, 2013 and 2012, the Company recorded net gains (losses) of $1,258 and $(385), respectively, on these derivatives. The Company held the following derivative instruments as of the dates indicated:

| | March 31, 2013 | | December 31, 2012 | |
|---|---|---|---|---|
| | Notional Amount | Fair Value | Notional Amount | Fair Value |
| No hedge designation | | | | |
| Eurodollar futures(1) | $ 14,765,000 | $ (75,151) | $ 17,525,000 | $ (76,850) |
| 10-year swap futures(2) | 175,000 | (1,086) | — | — |
| Commitment to purchase MBS(3) | 50,000 | (164) | — | — |
| Commitment to sell MBS(4) | 240,000 | (99) | — | — |

(1) The $14,765,000 total notional amount of Eurodollar futures contracts as of March 31, 2013 represents the accumulation of Eurodollar futures contracts that mature on a quarterly basis between 2013 and 2017. As of March 31, 2013, the Company maintained $80,257 as a deposit and margin against the open Eurodollar futures contracts.

(2) The total notional amount of $175,000 represents the accumulation of 10-year swap futures that mature in June 2013. As of March 31, 2013, the Company maintained $3,361 as a deposit and margin against the open swap futures contracts.

(3) The total notional amount of commitment to purchase MBS represents forward commitments to purchase fixed-rate MBS securities.

(4) The total notional amount of commitment to sell MBS represents forward commitments to sell fixed-rate MBS securities.

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## 5. Income Taxes:

The total income tax (benefit) provision for the three months ended March 31, 2013 and 2012 was $(3,762) and $442, respectively. The Company generated a pre-tax book (loss) income of $(585) and $11,204 for the three months ended March 31, 2013 and 2012, respectively.

The Company's effective tax rate for the three months ended March 31, 2013 and 2012 was (643.1%) and 3.9%, respectively. The effective tax rate during the three months ended March 31, 2013 was lower than the highest marginal tax rates due to the realization of previously unrecognized tax benefits including related accrued interest that were fully reserved. The effective tax rate during the three months ended March 31, 2012 was lower than the highest marginal tax rates due to the realization of deferred tax assets that were offset by a full valuation allowance. The Company is subject to Alternative Minimum Tax because it does not pay regular tax as a result of available net operating losses. The Company will continue to provide a valuation allowance against the portion of the capital loss carryforwards which the Company believes that it is more likely than not that the benefits will not be realized prior to expiration. The Company will continue to assess the need for a valuation allowance at each reporting date.

The Company is subject to examination by the U.S. Internal Revenue Service (IRS), and other taxing authorities in jurisdictions where the Company has significant business operations, such as Virginia. In March 2013, an IRS examination of the Company's tax years 2009 and 2010 was completed without any adjustment. As a result, the Company reversed $3,200 of unrecognized federal tax benefit related to an uncertain tax position and $544 of related accrued interest as of March 31, 2013.

## 6. Earnings Per Share:

Basic earnings per share includes no dilution and is computed by dividing net income or loss available to common shareholders by the weighted-average number of common shares outstanding for the respective period. Diluted earnings per share includes the impact of dilutive securities such as stock options, unvested shares of restricted stock, and performance share units. The following table presents the computations of basic and diluted earnings per share for the periods indicated:

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| (Shares in thousands) | 2013 | | 2012 | |
| | Basic | Diluted | Basic | Diluted |
| Weighted-average shares outstanding | | | | |
| Common stock | 13,927 | 13,927 | 7,865 | 7,865 |
| Stock options, performance share units, and unvested restricted stock | — | 166 | — | 8 |
| Weighted-average common and common equivalent shares outstanding | 13,927 | 14,093 | 7,865 | 7,873 |
| Net income applicable to common stock | $ 3,177 | $ 3,177 | $ 10,762 | $ 10,762 |
| Net income per common share | $ 0.23 | $ 0.23 | $ 1.37 | $ 1.37 |

The diluted earnings per share for the three months ended March 31, 2013 and 2012 did not include the antidilutive effect of 18,472 and 23,951 shares, respectively, of stock options, unvested shares of restricted stock, and performance share units.

## 7. Equity:

Equity Offering

During the three months ended March 31, 2013, the Company completed a public offering as follows:

| Offering Date | | March 13, 2013 |
|---|---|---|
| Shares offered to public | | 3,000,000 |
| Underwriter's over-allotment | | 450,000 |
| Total shares of Class A common stock | | 3,450,000 |
| Public offering price per share | $ | 25.50 |
| Net proceeds(1) | $ | 86,964 |

(1) Net of underwriting discounts and commissions and expenses.

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Dividends

Pursuant to the Company’s variable dividend policy, the Board of Directors evaluates dividends on a quarterly basis and, in its sole discretion, approves the payment of dividends. The Company’s dividend payments, if any, may vary significantly from quarter to quarter. The Board of Directors has approved and the Company has declared the following dividends to date in 2013:

| Quarter Ended | | Dividend Amount | Declaration Date | Record Date | Pay Date |
|---|---|---|---|---|---|
| March 31 | $ | 0.875 | March 15 | March 28 | April 30 |

The Board of Directors approved and the Company declared and paid the following dividends for 2012:

| Quarter Ended | | Dividend Amount | Declaration Date | Record Date | Pay Date |
|---|---|---|---|---|---|
| December 31 | $ | 0.875 | December 5 | December 17 | December 31 |
| September 30 | | 0.875 | September 13 | September 28 | October 31 |
| June 30 | | 0.875 | June 15 | June 29 | July 31 |
| March 31 | | 0.875 | March 16 | March 26 | April 30 |

Long-Term Incentive Plan

On April 13, 2011, the Board of Directors adopted the Arlington Asset Investment Corp. 2011 Long-Term Incentive Plan (2011 Plan). The 2011 Plan was approved by the Company’s shareholders and became effective on June 2, 2011. Under the 2011 Plan, shares of Class A common stock of the Company may be issued to employees, directors, consultants and advisors of the Company and its affiliates. As of March 31, 2013 and December 31, 2012, 491,459 and 489,448 shares, respectively, remained available for issuance under the 2011 Plan.

Performance-Based Long-Term Incentive Program

On August 13, 2012, the Compensation Committee of the Board of Directors of the Company adopted a performance-based long-term incentive program (Performance-based Program) that provides for the issuance of two types of performance share units (PSUs) pursuant to the Company’s 2011 Plan.

The Compensation Committee established performance goals under the Performance-based Program. The awards under the Performance-based Program comprise of two types of PSUs: Combined Net Worth Units (Book Value PSUs) and Total Shareholder Return Units (TSR PSUs). The Book Value PSUs are eligible to vest based on the compound annualized growth in the Company’s book value per share (i.e., book value change plus dividends on a reinvested basis) during the applicable performance period.  The TSR PSUs are eligible to vest based on the Company’s compound annualized total shareholder return (i.e., share price change plus dividends on a reinvested basis) during the applicable performance period.

The Company recorded $280 in compensation expenses related to the Performance-based Program during the three months ended March 31, 2013. There was no similar compensation expenses during the three months ended March 31, 2012.

Restricted Stock

The following tables present the activities and balances related to restricted stock for the dates and periods indicated:

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| Shares granted | — | — |
| Weight-average share price | $ — | $ — |
| Compensation expense recognized during the period | $ 109 | $ 54 |

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Restricted Class A shares outstanding, unvested | 30,170 | 34,835 |
| Unrecognized compensation cost related to unvested shares | $ 398 | $ 507 |
| Weighted-average vesting period remaining | 2.14 years | 2.22 years |

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8. Recent Accounting Pronouncements:

In February 2013, the FASB issued Accounting Standards Update No. 2013-02, Comprehensive Income (Topic 220), Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. This standard requires the reporting of the effect of significant reclassifications out of accumulated other comprehensive income on the respective line items in net income if the amount being reclassified is required under GAAP to be reclassified in its entirety to net income. For other amounts that are not required under GAAP to be reclassified in their entirety to net income in the same reporting period, the Company is required to cross-reference other disclosures required under GAAP that provide additional detail about those amounts. The Company implemented the requirements of this statement on the Company's reporting period beginning on January 1, 2013 and the implementation had no significant impact to the Company's financial statements.

In January 2013, the FASB issued Accounting Standards Update No. 2013-01, Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. This standard limits the scope of balance sheet offsetting disclosures to certain derivative instruments, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions. This standard requires the disclosures of the presentation of gross and net information about transactions that are (1) offset in the financial statements or (2) subject to an enforceable master netting arrangement or similar agreement, regardless of whether the transactions are actually offset in the statement of financial position. The Company implemented these required disclosures effective for reporting periods beginning on January 1, 2013 and the implementation had no significant impact to the Company's financial statements.

9. Subsequent Events:

On May 1, 2013, the Company completed a public offering of $25,000 of its 6.625% Senior Notes due in 2023 and received net proceeds of $24,038 after payment of underwriting discounts and commissions and expenses. These senior notes will mature on May 1, 2023, and may be redeemed in whole or in part at any time and from time to time at the Company's option on or after May 1, 2016, at a redemption price equal to the principal amount redeemed plus accrued and unpaid interest. The interest payments on these senior notes are payable quarterly on February 1, May 1, August 1, and November 1 of each year, beginning on August 1, 2013.

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Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Unless the context otherwise requires or provides, references in this Quarterly Report on Form 10-Q to “we,” “us,” “our” and “our company” refer to Arlington Asset Investment Corp. (Arlington Asset) and its subsidiaries. This discussion and analysis should be read in conjunction with our financial statements and accompanying notes included in Item 1 of this Quarterly Report on Form 10-Q, as well as our audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012.

The discussion of our consolidated financial condition and results of operations below may contain forward-looking statements. These statements, which reflect management’s beliefs and expectations, are subject to risks and uncertainties that may cause actual results to differ materially. For a discussion of the risks and uncertainties that may affect our future results, please see “Cautionary Statement About Forward-Looking Statements” immediately following Item 4 of Part I of this Quarterly Report on Form 10-Q.

Our Company

We are a principal investment firm that acquires and holds mortgage-related and other assets. We acquire residential mortgage-backed securities (MBS), either issued by U.S. government agencies or guaranteed as to principal and interest by U.S. government agencies or U.S. government-sponsored entities (agency-backed MBS). We also acquire MBS issued by private organizations (private-label MBS) subject to maintaining our exemption from regulation as an investment company under the Investment Company Act of 1940, as amended (1940 Act). We are a Virginia corporation and taxed as a C corporation for federal income tax purposes. We operate primarily in the United States.

Factors that Affect our Results of Operations and Financial Condition

Our business is materially affected by a variety of industry and economic factors, including:

- conditions in the global financial markets and economic conditions;
- changes in interest rates and prepayment rates;
- actions taken by the U.S. Federal Reserve and the U.S. Treasury;
- changes in laws and regulations and industry practices;
- actions taken by ratings agencies with respect to the U.S.’s credit rating; and
- other market developments.

Adverse market conditions and actions by governmental authorities could adversely affect our business in many ways, including but not limited to making it more difficult for us to analyze our investment portfolio, adversely affecting our ability to maintain targeted amounts of leverage on our MBS portfolio and successfully implement our hedging strategy, and limiting our ability to follow our current investment and financing strategies. While uncertain, these potentially adverse market conditions and actions by governmental authorities may adversely affect our liquidity, financial position and results of operations. We have been and will continue to evaluate the potential impact of recent government actions, including developments relating to foreclosure suspensions and affidavit errors and various state and federal government actions affecting the market price of MBS and related derivative securities. While it is predictably difficult to foresee the short- and long-term impact of foreclosure issues given all the uncertainties, at this time, we do not anticipate that the current foreclosure issues will have a material negative effect on our overall position and results of operations. For further discussions on how market conditions and government actions may adversely affect our business, see “Item 1A—Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2012.

Our MBS portfolio is affected by general U.S. residential real estate market conditions and the overall U.S. economic environment. In particular, our MBS strategy and the performance of our MBS portfolio is influenced by the specific characteristics of these markets, including prepayment rates, credit losses, interest rates and the interest rate yield curve. Our results of operations with respect to our MBS portfolio primarily depend on, among other things, the level of our interest income and the amount and cost of borrowings we may obtain by pledging our investment portfolio as collateral for the borrowings. Our interest income, which includes the amortization of purchase premiums and accretion of discounts, if any, varies primarily as a result of changes in prepayment speeds of the securities in our MBS portfolio. Our borrowing cost varies based on changes in interest rates and changes in the amount we can borrow which is generally based on the fair value of the MBS portfolio and the advance rate the lenders are willing to lend against the collateral provided.

The payment of principal and interest on the agency-backed MBS that we acquire and hold is guaranteed by the Federal Home Loan Mortgage Corporation (Freddie Mac) or the Federal National Mortgage Association (Fannie Mae). The payment of principal and interest on agency-backed MBS issued by Freddie Mac or Fannie Mae is not guaranteed by the U.S. government. Any failure to honor its guarantee of agency-backed MBS by Freddie Mac or Fannie Mae or any downgrade of securities issued by Freddie Mac or Fannie Mae by the rating agencies could cause a significant decline in the value of and cash flow from any agency-backed MBS we own that are guaranteed by such entity.

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Current Market Conditions and Trends

On October 4, 2012, the Federal Housing Finance Authority (FHFA) released its white paper entitled "Building a New Infrastructure for the Secondary Mortgage Market" (FHFA White Paper). This release follows upon the FHFA's February 21, 2012 Strategic Plan for Enterprise Conservatorships, which set forth three goals for the next phase of the Fannie Mae and Freddie Mac conservatorships. These three goals are to (i) build a new infrastructure for the secondary mortgage market, (ii) gradually contract Fannie Mae and Freddie Mac's presence in the marketplace while simplifying and shrinking their operations, and (iii) maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

The FHFA White Paper proposes a new infrastructure for Fannie Mae and Freddie Mac that has two basic goals. The first goal is to replace the current, outdated infrastructures of Fannie Mae and Freddie Mac with a common, more efficient infrastructure that aligns the standards and practices of the two entities, beginning with core functions performed by both entities such as issuance, master servicing, bond administration, collateral management and data integration. The second goal is to establish an operating framework for Fannie Mae and Freddie Mac that is consistent with the progress of housing finance reform and encourages and accommodates the increased participation of private capital in assuming credit risk associated with the secondary mortgage market. The FHFA recognizes that there are a number of impediments to their goals which may or may not be surmountable, such as the absence of any significant secondary mortgage market mechanisms beyond Fannie Mae, Freddie Mac and Ginnie Mae, and that their proposals are in the formative stages. As a result, it is unclear if the proposals will be enacted. If such proposals are enacted, it is unclear how closely what is enacted will resemble the proposals from the FHFA White Paper or what the effects of the enactment will be.

On September 13, 2012, the U.S. Federal Reserve announced a third round of quantitative easing (QE3), which is an open-ended program designed to expand the U.S. Federal Reserve’s holdings of long-term securities by purchasing an additional $40 billion of agency-backed MBS per month until key economic indicators, such as the unemployment rate, show signs of improvement. When combined with programs to extend the average maturity of the U.S. Federal Reserve’s holdings of securities, known as “Operation Twist” and described below, and reinvest principal and interest payments from the U.S. Federal Reserve’s holdings of agency debt and agency-backed MBS into agency-backed MBS, QE3 was expected to increase the U.S. Federal Reserve’s holdings of long-term securities by $85 billion each month through the end of 2012. The U.S. Federal Reserve also announced that it would keep the target range for the Federal Funds Rate between zero and 0.25% through at least mid-2015, which is six months longer than previously expected.

The U.S. Federal Reserve provided further guidance to the market in December 2012 by stating that it intended to keep the Federal Funds Rate close to zero while the unemployment rate is above 6.5% and as long as inflation does not rise above 2.5%. In December 2012, the U.S. Federal Reserve also announced that it would initially begin buying $45 billion of long-term Treasury bonds each month and noted that such amount may increase in the future. This bond purchase program will replace the existing program known as “Operation Twist,” in which the U.S. Federal Reserve repurchased approximately $45 billion of long-term Treasury bonds each month and sold approximately the same amount of short-term Treasury bonds.

The immediate impact of the announcement of QE3 was an increase in agency-backed MBS prices. This effect was especially pronounced for agency-backed MBS that the U.S. Federal Reserve is expected to target for acquisition under QE3. Since the initial price spike, prices for all but the target securities have receded below the price levels that existed before the announcement of QE3. To the extent that the scope and effectiveness of government-sponsored refinancing programs increases, prepayments on our target securities could increase accordingly. The combination of higher prices and higher refinancing activity on our target securities could decrease our net interest margin. To the extent QE3 decreases the liquidity in the market of our target securities, which has yet to be the case, we might not be able to acquire the securities we target or acquire them in the quantities we desire.

The U.S. Federal Reserve expects these measures to put downward pressure on long-term interest rates. In the short term, these actions have driven certain agency-backed MBS prices to new highs, which have further compressed interest spreads, and increased the sensitivity to increases in prepayments.

The recent March 2013 minutes made clear that the Fed officials had a wide range of views in determining the appropriate economic climate that would trigger a reduction in the pace of purchases. As the minutes say, "many participants emphasized that any decision to reduce the pace of purchases should reflect both an improvement in their overall outlook for the labor market conditions, as implied by a wide range of available indicators and their confidence in the sustainability of that improvement."

While there are signs of a recovery, uncertainty continues to dominate the market, due to the continued historically low interest rate environment and the European financial crisis. We believe the general business environment will continue to be challenging in 2013 and future periods. Our growth outlook is dependent, in part, on the strength of the financial markets, the impact of fiscal and monetary policy actions by the United States and other countries, the overall market value of U.S. equities and liquidity in the financial system. Depending on the market development and movement, we may seek to re-align our strategy and our portfolio. We will continue to closely monitor the developments in the market and evaluate the opportunities across the spectrum in the mortgage industry and seek the highest risk-adjusted returns for our capital.

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Executive Summary

Following the two successful public offerings of the Company's Class A common stock during 2012, on March 13, 2013, we completed an additional public offering of 3,450,000 shares of Class A common stock, including 450,000 shares of Class A common stock purchased by the underwriters pursuant to an option granted by us to cover over-allotments, at a public offering price of $25.50 per share, for net proceeds of $87.0 million after deducting underwriting discounts and commissions and expenses. We deployed the capital raised from this public offering primarily in 30 year fixed –rate agency-backed MBS and private-label MBS. Based on the improvements we have observed in the general economic indicators and trends in underlying credit and housing data, we reallocated some of our available capital to the private-label MBS portfolio during the quarter ended March 31, 2013. As of March 31, 2013, our MBS portfolio consisted of $1.9 billion in fair value, $1.6 billion in agency-backed MBS and $275.9 million in private-label MBS.

On May 1, 2013, we also completed a public offering of $25.0 million of 6.625% senior notes due in 2023 and received net proceeds of $24.0 million after payment of underwriting discounts and commissions and expenses. These senior notes will mature on May 1, 2023, and may be redeemed in whole or in part at any time and from time to time at our option on or after May 1, 2016, at a redemption price equal to the principal amount redeemed plus accrued and unpaid interest. The interest payments on these senior notes are payable quarterly on February 1, May 1, August 1, and November 1 of each year, beginning on August 1, 2013.

For the three months ended March 31, 2013, we had net income of $3.2 million, or $0.23 per share (diluted). As of March 31, 2013, our book value per share was $32.78.

In addition to the financial results reported in accordance with generally accepted accounting principles as consistently applied in the United States (GAAP), we calculated non-GAAP core operating income for the three months ended March 31, 2013. Our core operating income for the three months ended March 31, 2013 was $14.6 million. In determining core operating income, we excluded certain costs and the following non-cash expenses: (1) compensation costs associated with stock-based awards, (2) accretion of MBS purchase discounts adjusted for principal repayments in excess of proportionate invested capital, (3) unrealized mark-to-market adjustments on the trading MBS and hedge instruments, (4) other-than-temporary impairment charges recognized, and (5) benefit from the reversal of previously accrued federal tax liability and accrued interest related to uncertain tax positions . This non-GAAP measurement is used by management to analyze and assess the operating results and dividends. We believe that this non-GAAP measurement assists investors in understanding the impact of these non-core items and non-cash expenses on our performance and provides additional clarity around our forward earnings capacity and trend. A limitation of utilizing this non-GAAP measure is that the GAAP accounting effects of these events do in fact reflect the underlying financial results of our business and these effects should not be ignored in evaluating and analyzing our financial results. Therefore, we believe net income on a GAAP basis and core operating income on a non-GAAP basis should be considered together.

The following is a reconciliation of GAAP net income to non-GAAP core operating income for the three months ended March 31, 2013 (dollars in thousands):

| | | Three Months Ended March 31, 2013 |
|---|---|---|
| GAAP net income | $ | 3,177 |
| Adjustments | | |
| Adjusted expenses(1) | | 504 |
| | | (3,744) |

| | | |
|---|---|---|
| Benefit from the reversal of federal tax liability and accrued interest related to uncertain tax position | | |
| Stock compensation | | 495 |
| Net unrealized mark-to-market loss on trading MBS and hedge instruments | | 14,738 |
| Other-than-temporary impairment charges | | 162 |
| Adjusted interest related to purchase discount accretion(2) | | (712) |
| Non-GAAP core operating income | $ | 14,620 |

(1) Adjusted expenses reflect certain professional fees, litigation recovery and income taxes that are not considered representative of routine or core operating-related activities of our company.

(2) Adjusted interest related to purchase discount accretion represents purchase discount accretion in excess of principal repayment in excess of proportional share of invested capital.

As of March 31, 2013, our agency-backed MBS consisted of $1.5 billion in face value with a cost basis of $1.6 billion and was fair valued at $1.6 billion. Our agency-backed MBS had a weighted-average coupon of 4.08% and a weighted-average cost of funding of 0.42% at March 31, 2013. During the three months ended March 31, 2013, we received proceeds of $331.6 million from the sale of $307.8 million in face value of our agency-backed MBS, realizing $4.0 million in losses, or realized net losses of $1.0 million from the acquisition price.

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We have entered into Eurodollar futures to mitigate the interest rate sensitivity which directly impacts our cost of borrowing and the market value of our agency-backed MBS. The Eurodollar futures mature through June 30, 2017 and have a lifetime weighted-average rate of 2.99%, as compared to a lifetime weighted-average market rate of 0.96% as of March 31, 2013. The value of these five-year hedge instruments is expected to fluctuate inversely relative to the agency-backed MBS portfolio and decrease in value during periods of declining interest rates and/or widening mortgage spreads. Conversely, during periods of increasing rates and/or tightening mortgage spreads, these instruments are expected to increase in value. The cost of these Eurodollar hedges will increase over their five-year term.

As of March 31, 2013, our private-label MBS portfolio consisted of $445.6 million in face value with an amortized cost basis of $228.5 million and was fair valued at $275.9 million. The unamortized net discount on our private-label MBS portfolio was $217.1 million as of March 31, 2013. During the three months ended March 31, 2013, we recognized net interest income of $5.5 million, representing a 11.9% annualized yield, including coupon and accretion of purchase discount based on the current accretable yield rate, from our private-label MBS portfolio. During the three months ended March 31, 2013, we received proceeds of $4.8 million from the sale of $7.7 million in face value of our private-label MBS, realizing $1.6 million in gains. We also recognized $0.2 million in other-than-temporary impairment charges during the three months ended March 31, 2013. This charge does not affect non-GAAP core operating income or book value, but does reduce our net income and lowers the accounting basis used to record future discount accretion.

Our private-label MBS are primarily senior and re-REMIC tranches in securitization trusts issued between 2005 and 2010. The senior securities represent interests in securitizations that have the first right to cash flows and absorb losses last. The re-REMIC securities represents interests in re-securitizations of senior MBS and pro-rata mezzanine securities. For re-REMIC securities, the cash flows from, and any credit losses absorbed by, the underlying MBS are allocated among the re-REMIC securities issued in the re-securitization transactions based on the re-REMIC structure. For example, prime and non-prime residential senior securities have been resecuritized to create a two-tranche structure with a re-REMIC senior security and a re-REMIC subordinated security. In these re-REMIC securities, all principal payments from the underlying securities are directed to the re-REMIC senior security until the face value is fully paid off. Thereafter, all principal payments are directed to the re-REMIC subordinated security. For pro-rata mezzanine securities, principal payments from the underlying MBS are typically allocated concurrently and proportionally to the mezzanine securities along with senior securities. The re-REMIC subordinated and mezzanine securities absorb credit losses, if any, first; however, these credit losses occur only when credit losses exceed the credit protection provided to the underlying securities. Senior, re-REMIC, and mezzanine securities receive interest while any face value is outstanding. Our private-label MBS have approximately 1% credit enhancement on a weighted-average basis, which provides protection to our invested capital in addition to our purchase discount.

We generally purchased the private-label MBS in our portfolio at a discount to face value. We estimate, at least on a quarterly basis, the future expected cash flows based on our observation and assessment of current information and events and by applying a number of assumptions related to prepayment rates, interest rates, default rates, discount rates and the timing and amount of cash flows and credit losses. These assumptions, which are disclosed in note 2 to our financial statements, are difficult to predict as they are subject to uncertainties and contingencies related to future events that may impact our estimates and interest income.

We recognize interest income on our private-label MBS based on each security's expected effective interest rate. At acquisition, the accretable yield is calculated as the difference between the undiscounted expected cash flows and the purchase price which is expected to be accreted into interest income over the remaining life of the security on a level-yield basis. The difference between the contractually required payments and the undiscounted expected cash flows represents the non-accretable difference. Based on actual payment activities and changes in estimates of undiscounted expected future cash flows, the accretable yield and the non-accretable difference can change over time.

Significant increases in the amount or timing of undiscounted expected future cash flows are recognized prospectively as an adjustment to the accretable yield. As a result, we may recognize higher non-cash interest income over the security's holding period and may not realize the level of interest income recognized using the higher accretion rates. In addition, we may be subject to more frequent and higher non-cash other-than-temporary-impairment charges than actual losses realized on the security as a result.

We evaluate available-for-sale securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In general, when the fair value of an available-for-sale security is less than its amortized cost at the reporting date, the security is considered impaired. In evaluating these available-for-sale securities for other-than-temporary impairment, consideration is given to (1) the length of time and the extent to which the fair value has been lower than carrying value, (2) the severity of the decline in fair value, (3) the financial condition and near-term prospects of the issuer, (4) our intent to sell, and (5) whether it is more likely than not we would be required to sell the security before anticipated recovery.

For available-for-sale, agency-backed MBS securities, if it is determined that the impairment is other-than-temporary, then the amount that the fair value is below its amortized cost basis is recorded as an impairment charge and recorded through earnings. For unrealized losses that are determined to be temporary, a further evaluation is performed to determine the credit portion of the other-than-temporary impairment and the credit portion is recorded through our statement of comprehensive income.

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For available-for-sale, private-label MBS securities that have been acquired at discounts to face value due in part to credit deterioration since origination, we re-evaluate the undiscounted expected future cash flows and the changes in cash flows from those originally projected at the time of purchase or last revised. For those securities in an unrealized loss position, the difference between the carrying value and the net present value of expected future cash flows discounted using current expected rate of return is recorded as other-than-temporary impairment charges through our statement of comprehensive income.

Continued expectations of stabilization and improvement in the housing market, increased liquidity and available leverage have stabilized prices for our private-label MBS, particularly among re-REMIC mezzanine securities. Our re-REMIC securities are predominantly held in the subordinate tranches. We will continue to closely monitor the performance of these securities. We believe we have constructed a private-label MBS portfolio with attractive characteristics and will continue to monitor relative value between the various classes of MBS, including agency-backed MBS, and may re-allocate our portfolio at any time based on management's view of the market. We will continue to seek to identify potential opportunities to strengthen our position and to maximize return to our shareholders.

We have been evaluating, and will continue to evaluate, the opportunities across the spectrum in the mortgage industry and seek the highest risk-adjusted returns for our capital. We evaluate and prioritize the risk-adjusted return we expect to receive on every asset based upon a current cash yield perspective as well as from a total yield perspective that includes expected reflation, which is defined as an increase in value between the amortized cost basis and the par value of the security. Historically, based on market conditions, we believe our MBS assets have provided us with higher relative risk-adjusted rates of return than most other portfolio opportunities we have evaluated. Consequently, we have maintained a high allocation of our assets and capital in this sector. We intend to continue to evaluate acquisition opportunities against the returns available in each of our asset alternatives and endeavor to allocate our assets and capital with an emphasis toward what we believe will generate the highest risk-adjusted return available. This strategy may cause us to have different allocations of capital in different environments. We believe we have constructed a private-label MBS portfolio with attractive characteristics and will continue to monitor relative value between the various classes of MBS.

The following is a summary of our net income for the periods indicated (dollars in thousands):

| | Three Months Ended March 31, 2013 | Three Months Ended March 31, 2012 |
|---|---|---|
| Net interest income | $ 16,724 | $ 12,546 |
| Other (loss) income, net | (13,533) | 2,804 |
| Other expenses | 3,776 | 4,146 |
| (Loss) income before income taxes | (585) | 11,204 |
| Income tax (benefit) provision | (3,762) | 442 |
| Net income | $ 3,177 | $ 10,762 |

For the three months ended March 31, 2013, our net income was $3.2 million compared to net income of $10.8 million for the three months ended March 31, 2012. Our net income includes net interest income of $16.7 million and other net loss of $13.5 million for the three months ended March 31, 2013 compared to net interest income of $12.5 million and other net income of $2.8 million for the three months ended March 31, 2012. The increase in net interest income is due primarily to an increase in the average balance of our agency-backed MBS portfolio. The increase in other net loss is discussed below. Our other expenses decreased to $3.8 million during the three months ended March 31, 2013 compared to $4.1 million for the three months ended March 31, 2012, primarily as a result of decreases in legal and legal settlement expenses offset by an increase in variable compensation.

Principal Investing Portfolio

The following table summarizes our principal investing portfolio including principal receivable on MBS, as of March 31, 2013 (dollars in thousands):

| | Face Amount | Fair Value |
|---|---|---|
| Trading | | |
| Agency-backed MBS | | |
| Fannie Mae | $ 1,058,323 | $ 1,156,713 |
| Freddie Mac | 442,381 | 480,622 |
| Available-for-sale | | |
| Agency-backed MBS | | |
| Fannie Mae | 52 | 57 |
| Private-label MBS | | |
| Senior securities | 11,563 | 7,400 |
| Re-REMIC securities | 434,075 | 268,456 |
| Other mortgage related assets | 91,133 | 449 |
| Total | $ 2,037,527 | $ 1,913,697 |

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Operating Income

Our operating income consists primarily of net interest income, net investment gain and investment fund earnings.

Expenses

Interest expense includes the costs of our repurchase agreement borrowings and long-term debt securities.

Compensation and benefits expense includes base salaries as well as incentive compensation. Salaries, payroll taxes and employee benefits are relatively fixed in nature. In addition, compensation and benefits expense includes estimated performance-based incentive compensation, including the discretionary component that is more likely-than not to be paid and non-cash expenses associated with all stock-based awards granted to employees.

Professional services expense includes accounting, legal and consulting fees. Many of these expenses, such as legal fees, are to a large extent variable related to level of transactions, ongoing litigation and initiatives.

Business development expense includes primarily travel and entertainment expenses.

Occupancy and equipment expense includes rental costs for our facilities and depreciation and amortization of equipment and software. These expenses are largely fixed in nature.

Communications expenses include voice, data and internet service fees, and data processing costs.

Other operating expenses include professional liability and property insurance, directors’ fees including cash and stock awards, printing and copying, business licenses and taxes, offices supplies, penalties and fees, charitable contributions and other miscellaneous office expenses, if any.

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Results of Operations

Three months ended March 31, 2013 compared to three months ended March 31, 2012

We reported net income of $3.2 million for the three months ended March 31, 2013 compared to net income of $10.8 million for the three months ended March 31, 2012 which included the following results for the periods indicated (dollars in thousands):

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| Interest income | $ 18,328 | $ 13,363 |
| Interest expense | 1,604 | 817 |
| Net interest income | 16,724 | 12,546 |
| Other (loss) income, net | | |
| Investment (loss) gain, net | (13,529) | 2,808 |
| Other loss | (4) | (4) |
| Total other (loss) income, net | (13,533) | 2,804 |
| Other expenses | 3,776 | 4,146 |
| Income before income taxes | (585) | 11,204 |
| Income tax (benefit) provision | (3,762) | 442 |
| Net income | $ 3,177 | $ 10,762 |

Net income decreased $7.6 million from net income of $10.8 million for the three months ended March 31, 2012 to net income of $3.2 million for the three months ended March 31, 2013 primarily due to the unrealized market value change in our trading portfolio and the following changes:

Net interest income increased $4.2 million (33.6%) from $12.5 million for the three months ended March 31, 2012 to $16.7 million for the three months ended March 31, 2013. The increase is primarily the result of fully deploying our investable capital on a leveraged basis to our MBS portfolio. See additional yield analysis below.

Investment (loss) gain, net, decreased $16.3 million from a gain of $2.8 million for the three months ended March 31, 2012 to a loss of $13.5 million for the three months ended March 31, 2013. See below for additional discussion on the results of our principal investing portfolio.

The following table summarizes the components of income from our principal investment activities, net of related interest expense, for the periods indicated (dollars in thousands):

| | Three Months Ended March 31, 2013 | 2012 |
|---|---|---|
| Net interest income | $ 16,839 | $ 12,671 |
| Investment (loss) gain, net | (13,529 ) | 2,808 |

The components of net interest income from our MBS related portfolio is summarized in the following table (dollars in thousands):

| | Three Months Ended March 31, 2013 | | | 2012 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Income (Expense) | Yield (Cost) | Average Balance | Income (Expense) | Yield (Cost) |

| | | | | | | |
|---|---|---|---|---|---|---|
| Agency-backed MBS | $ 1,328,451 | $ 12,606 | 3.80% | $ 629,554 | $ 7,037 | 4.47% |
| Private-label MBS | | | | | | |
| Senior securities | 5,568 | 228 | 16.38% | 8,385 | 355 | 16.93% |
| Re-REMIC securities | 179,273 | 5,481 | 12.23% | 133,087 | 5,937 | 17.85% |
| Other investments | 464 | 13 | 10.95% | 1,092 | 34 | 12.44% |
| | $ 1,513,756 | 18,328 | 4.84% | $ 772,118 | 13,363 | 6.92% |
| Repurchase agreements | $ 1,272,862 | (1,489) | (0.47)% | $ 645,469 | (692) | (0.42)% |
| Net interest income/spread | | $ 16,839 | 4.37% | | $ 12,671 | 6.50% |

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The change in the composition of our MBS portfolio and related increase in net interest income by $4.2 million from the three months ended March 31, 2012 to the three months ended March 31, 2013 was primarily due to the deployment of capital raised from our public offerings during 2012 and on March 13, 2013 primarily into our agency-backed MBS portfolio. Interest income from other investments represents interest on interest-only MBS securities.

As discussed above, we realized net investment loss of $13.5 million for the three months ended March 31, 2013 compared to net investment gain of $2.8 million for the three months ended March 31, 2012. The following table summarizes the components of net investment (loss) gain (dollars in thousands):

| | Three Months Ended March 31, 2013 | Three Months Ended March 31, 2012 |
|---|---|---|
| Realized gains on sale of available-for-sale investments, net | $ 1,561 | $ — |
| Available-for-sale and cost method securities – other-than-temporary impairment charges | (162) | — |
| (Losses) gains on trading investments, net | (16,108) | 3,067 |
| Gains (losses) from derivative instruments, net | 1,258 | (385) |
| Other, net | (78) | 126 |
| Investment (loss) gain, net | $ (13,529) | $ 2,808 |

We recorded other-than-temporary impairment charges of $0.2 million for the three months ended March 31, 2013 related to changes in expected credit performance on available-for-sale, private-label MBS with a cost basis of $0.5 million prior to recognizing the other-than-temporary impairment charges. We recorded no other-than-temporary impairment charges on MBS during the three months ended March 31, 2012.

During the three months ended March 31, 2013, the Company received $4.8 million from the sales of $7.7 million in face value of available-for-sale MBS recognizing a net gain of $1.6 million. There were no sales of available-for-sale investments during the three months ended March 31, 2012.

The losses on trading investments, net, recognized for the three months ended March 31, 2013 were primarily the result of net mark-to-market loss adjustments of $12.1 million and net losses of $4.0 million from sales of trading investments. The losses on trading investments, net, recognized for the three months ended March 31, 2013, also reflects net realized losses of $1.0 million on the sold securities from the acquisition price and changes in net unrealized mark-to-market loss adjustments of $15.1 million during the three months ended March 31, 2013. The gains on trading investments, net, recognized for the three months ended March 31, 2012 were primarily the result of net mark-to-market gain adjustments of $3.2 million offset by losses of $0.1 million from sales of trading investments. The gains on trading investments, net, recognized for the three months ended March 31, 2012, also reflects net realized gains of $0.5 million on the sold securities from the acquisition price and changes in net unrealized mark-to-market gain adjustments of $2.6 million during the three months ended March 31, 2012.

Losses from derivative instruments recognized for the three months ended March 31, 2013 were the result of net realized gains of $1.1 million and net unrealized mark-to-market gain adjustments of $0.2 million. Losses from derivative instruments recognized for the three months ended March 31, 2013 also reflects net gains of $0.9 million from disposed derivative instruments from the acquisition price and changes in net unrealized mark-to-market gain adjustments of $0.4 million during the three months ended March 31, 2013. Losses from derivative instruments recognized for the three months ended March 31, 2012 were the result of net realized gains of $0.3 million and net unrealized mark-to-market loss adjustments of $0.7 million. Losses from derivative instruments recognized for the three months ended March 31, 2012 also reflects net gains of $0.4 million from disposed derivative instruments from the acquisition price and changes in net unrealized mark-to-market loss adjustments of $0.8 million during the three months ended March 31, 2012. The value of our hedge instruments is expected to fluctuate inversely relative to the change in value of the agency-backed MBS portfolio.

Interest expense unrelated to our principal investing activity relates to long-term debt. These costs decreased to $114.6 thousand for the three months ended March 31, 2013 from $125.4 thousand for the three months ended March 31, 2012.

Other expenses decreased by $0.3 million (7.3%) from $4.1 million for the three months ended March 31, 2012 to $3.8 million for the three months ended March 31, 2013. The decrease is primarily as a result of reversing a legal settlement reserve previously accrued for related to the litigation filed by Hildene Capital Management, LLC, which was dismissed on March 22, 2013.

Total income tax provision decreased $4.2 million from a provision of $0.4 million for the three months ended March 31, 2012 to a benefit of $3.8 million for the three months ended March 31, 2013. Our effective tax rate was (643.1%) for the three months ended March 31, 2013 as compared to 3.9% for the same period in 2012. The effective tax rate during the three months ended March 31, 2013 was lower than the highest marginal tax rates due to the realization of previously unrecognized tax benefits including related accrued interest that were fully reserved. With the completion of the audits by the IRS for the years 2009 and 2010 in March 2013, we released $3.2 million of federal tax benefit related to an uncertain tax position and $0.5 million of related accrued interest as of March 31, 2013. The effective tax rate during the three months ended March 31, 2012 was lower than the highest marginal tax rates due to the realization of deferred tax assets that were offset by a full valuation allowance. The net deferred tax assets, which are partially offset by a valuation allowance, include net operating losses (NOLs), which are available to offset the current and future taxable income. We recorded an expected tax liability for the period due to the expected alternative minimum taxes.

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Liquidity and Capital Resources

Liquidity is a measurement of our ability to meet potential cash requirements including ongoing commitments to repay borrowings, fund investments, and for other general business purposes. Our primary sources of funds for liquidity consist of short-term borrowings (e.g., repurchase agreements), principal and interest payments on MBS and proceeds from sales of MBS. Other sources of liquidity include proceeds from the offering of common stock, preferred stock, debt securities or other securities registered pursuant to our effective shelf registration statement filed with the SEC. Pursuant to our shelf registration statement, on March 13, 2013, we completed a public offering of 3,450,000 shares of Class A common stock, including 450,000 shares purchased by the underwriters pursuant to an option granted by us to cover over-allotments, at a public offering price of $25.50 per share, for net proceeds of $87.0 million, after deducting underwriting discounts and commissions and expenses.

On May 1, 2013, we completed a public offering of $25.0 million of 6.625% senior notes due in 2023 and received net proceeds of $24.0 million after payment of underwriting discounts and commissions and expenses. These senior notes will mature on May 1, 2023, and may be redeemed in whole or in part at any time and from time to time at our option on or after May 1, 2016, at a redemption price equal to the principal amount redeemed plus accrued and unpaid interest. The interest payments on these senior notes are payable quarterly on February 1, May 1, August 1, and November 1 of each year, beginning on August 1, 2013.

Liquidity, or ready access to funds, is essential to our business. Liquidity is of particular importance to our business and perceived liquidity issues may affect our counterparties' willingness to engage in transactions with us. Our liquidity could be impaired due to circumstances that we may be unable to control, such as a general market disruption or an operational problem that affects us or third parties. Further, our ability to sell assets may be impaired if other market participants are seeking to sell similar assets at the same time. If we cannot obtain funding from third parties or from our subsidiaries, our results of operations could be negatively impacted.

Potential future sources of liquidity for us include existing cash balances, borrowing capacity through margin accounts and repurchase agreements and cash flows from operations, future issuances of common stock, preferred stock, debt securities or other securities registered pursuant to our shelf registration statement. Funding for agency-backed MBS through repurchase agreements continues to be available to us at rates we consider to be attractive from multiple counterparties, and we have observed increased availability for funding for private-label MBS through repurchase agreements.

Cash Flows

As of March 31, 2013, our cash and cash equivalents totaled $21.1 million, representing a net decrease in the balance of $14.7 million from $35.8 million as of December 31, 2012. The cash provided by operating activities of $11.7 million was attributable primarily to net income. The cash provided by investing activities of $176.5 million relates primarily to proceeds from the sales of MBS, net of purchases of MBS. The cash used in financing activities of $202.9 million relates primarily to repayments of repurchase agreements used to finance a portion of the MBS portfolio offset by the completed public offerings of Class A common stock.

Sources of Funding

We believe that our existing cash balances, investments in private-label MBS, net investments in agency-backed MBS, cash flows from operations, borrowing capacity and other sources of liquidity will be sufficient to meet our cash requirements for at least the next 12 months. We have obtained, and believe we will be able to continue to obtain, short-term financing in amounts and at interest rates consistent with our financing objectives. We may, however, seek debt or equity financings, in public or private transactions, to provide capital for corporate purposes and/or strategic business opportunities, including possible acquisitions, joint ventures, alliances or other business arrangements which could require substantial capital outlays. Our policy is to evaluate strategic business opportunities, including acquisitions and divestitures, as they arise. There can be no assurance that we will be able to generate sufficient funds from future operations, or raise sufficient debt or equity on acceptable terms, to take advantage of investment opportunities that become available. Should our needs ever exceed these sources of liquidity, we believe that most of our investments could be sold, in most circumstances, to provide cash. However, we may be required to sell our assets in such instances at depressed prices.

As of March 31, 2013, our liabilities totaled $1.7 billion. In addition to other payables and accrued expenses, our indebtedness consisted of repurchase agreements and long-term debentures. These long-term debentures accrue and require payments of interest quarterly at annual rates of three-month LIBOR plus 2.25% to 3.00%, mature between 2033 and 2035 and are currently redeemable by us, in whole or in part, without penalty. As of March 31, 2013, we had $15.0 million of total long-term debt. As of March 31, 2013, our debt-to-equity leverage ratio was 2.2 to 1.

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We also have short-term financing facilities that are structured as repurchase agreements with various financial institutions to primarily fund our portfolio of agency-backed MBS. As of March 31, 2013, the weighted-average interest rate under these agreements was 0.47%. Our repurchase agreements include provisions contained in the standard master repurchase agreement as published by the Securities Industry and Financial Markets Association and may be amended and supplemented in accordance with industry standards for repurchase facilities. Our repurchase agreements include financial covenants, with which the failure to comply would constitute an event of default under the applicable repurchase agreement. Similarly, each repurchase agreement includes events of insolvency and events of default on other indebtedness. As provided in the standard master repurchase agreement as typically amended, upon the occurrence of an event of default or termination event the applicable counterparty has the option to terminate all repurchase transactions under such counterparty's repurchase agreement and to demand immediate payment of any amount due from us to the counterparty.

Under our repurchase agreements, we may be required to pledge additional assets to our repurchase agreement counterparties in the event the estimated fair value of the existing pledged collateral under such agreements declines and such lenders demand additional collateral (i.e., a margin call), which may take the form of additional securities or cash. Margin calls on repurchase agreements collateralized by our MBS investments primarily result from events such as declines in the value of the underlying mortgage collateral caused by factors such as rising interest rates or prepayments.

To date, we have not had any margin calls on our repurchase agreements that we were not able to satisfy with either cash or additional pledged collateral. However, should we encounter increases in interest rates or prepayments, margin calls on our repurchase agreements could result in a material adverse change in our liquidity position.

In the event that market conditions are such that we are unable to obtain financing for our investments in MBS in amounts and at interest rates consistent with our financing objectives, to the extent deemed appropriate, we may use cash to finance our investments or we may liquidate such investments. Accordingly, depending on market conditions, we may incur significant losses on any such sales of MBS.

The following table provides information regarding our outstanding repurchase agreement borrowings as of the dates and periods indicated (dollars in thousands):

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Outstanding balance | $ 1,207,171 | $ 1,497,191 |
| Weighted-average rate | 0.47% | 0.52% |
| Weighted-average term to maturity | 11.9 days | 14.5 days |
| Maximum amount outstanding at any month-end during the period | $ 1,382,930 | $ 1,497,191 |

Assets

Our principal assets consist of MBS, cash and cash equivalents, receivables, deposits, long-term investments and deferred tax assets. As of March 31, 2013, liquid assets consisted primarily of cash and cash equivalents of $21.1 million and net investments in MBS of $706.1 million. Cash equivalents consist primarily of money market funds invested in debt obligations of the U.S. government. Our total assets increased from $2.1 billion at December 31, 2012 to $2.2 billion as of March 31, 2013. The increase in total assets reflects the deployment of capital raised from our public offerings during the three months ended March 31, 2013 primarily into our agency-backed MBS portfolio on a leveraged basis.

As of March 31, 2013, the total par and fair value of the MBS portfolio was $1.9 billion. As of March 31, 2013, the weighted-average coupon of the portfolio was 4.10%.

Dividends

Pursuant to our variable dividend policy, our Board of Directors evaluates dividends on a quarterly basis and, in its sole discretion, approves the payment of dividends. Our dividend payments, if any, may vary significantly from quarter to quarter. The Board of Directors has approved and we have declared the following dividends to date in 2013:

| Quarter Ended | Dividend Amount | Declaration Date | Record Date | Pay Date |
|---|---|---|---|---|
| March 31 | $ 0.875 | March 15 | March 28 | April 30 |

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The Board of Directors approved and the Company declared and paid the following dividends for 2012:

| Quarter Ended | Dividend Amount | Declaration Date | Record Date | Pay Date |
|---|---|---|---|---|
| December 31 | $ 0.875 | December 5 | December 17 | December 31 |
| September 30 | 0.875 | September 13 | September 28 | October 31 |
| June 30 | 0.875 | June 15 | June 29 | July 31 |
| March 31 | 0.875 | March 16 | March 26 | April 30 |

Off-Balance Sheet Arrangements

As of March 31, 2013 and December 31, 2012, we did not maintain any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, special purpose or variable interest entities, established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. Further, as of March 31, 2013 and December 31, 2012, we had not guaranteed any obligations of unconsolidated entities or entered into any commitment or had any intent to provide funding to any such entities.

## Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk generally represents the risk of loss through a change in realizable value that can result from a change in the prices of securities, a change in the value of financial instruments as a result of changes in interest rates, a change in the volatility of interest rates or a change in the credit rating of an issuer. We monitor market and business risk, including credit, interest rate, equity, operations, liquidity, compliance, legal, reputational, and equity ownership risks through a number of control procedures designed to identify and evaluate the various risks to which our business and assets are exposed. See "Item 1—Business" in our Annual Report on Form 10-K for the year ended December 31, 2012 for a discussion of our risk management strategies.

We are exposed to the following market risks as a result of our investments in MBS and equity investments.

Credit Risk

Although we do not expect to encounter credit risk in our agency-backed MBS portfolio assuming Fannie Mae and Freddie Mac remain solvent, we are exposed to credit risk in our private-label MBS portfolio. With respect to our private-label MBS, credit support contained in these MBS deal structures provides a level of protection from losses, as do the discounted purchase prices in the event of the return of less than 100% of par. We also evaluate the impact of credit risk on our investments through a comprehensive investment review and selection process, which is predominantly focused on quantifying and pricing credit risk. We review our private-label MBS based on quantitative and qualitative analysis of the risk-adjusted returns on such investments. Through modeling and scenario analysis, we seek to evaluate each investment's credit risk. Credit risk is also monitored through our ongoing asset surveillance. Despite these measures to manage credit risk, unanticipated credit losses could nevertheless occur, which could adversely impact our operating results.

Our private-label MBS are generally purchased at a discount. We estimate the future expected cash flows based on our observation of current information and events and applying a number of assumptions related to prepayment rates, interest rates, default rates, and the timing and amount of credit losses. These assumptions are difficult to predict as they are subject to uncertainties and contingencies related to future events that may impact our estimates and interest income.

The following table represents certain statistics of our private-label MBS portfolio as of and for the three months ended March 31, 2013:

| | Senior Securities | Re-REMIC Securities | Total Private-Label Securities |
|---|---|---|---|
| Yield (% of amortized cost) | 16.4% | 12.2% | 12.4% |
| Average cost (% of face value) | 61.7% | 49.8% | 50.1% |
| Weighted-average coupon | 2.6% | 4.2% | 4.2% |
| Delinquencies greater than 60 plus days | 30.7% | 17.7% | 18.1% |
| Credit enhancement | — | 1.3% | 1.2% |
| Severity (three months average) | 51.1% | 47.6% | 47.7% |
| Constant prepayment rate (three months average) | 17.6% | 17.9% | 17.9% |

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Key credit and prepayment measures in our private-label MBS portfolio reflected slight deterioration during the three months ended March 31, 2013. Total 60-day plus delinquencies in our private-label MBS portfolio decreased to 18.1% at March 31, 2013 from 18.5% at December 31, 2012 and trailing three month average loss severities on liquidated loans increased to 47.7% at March 31, 2013 from 45.8% at December 31, 2012. We will continue to monitor the performance of each security in our portfolio and assess the impact on the overall performance of the portfolio.

The table that follows shows the expected change in fair value for our current private-label MBS related to our principal investing activities under several hypothetical credit loss scenarios. Our private-label MBS are classified as Level 3 assets of the fair value hierarchy as they are valued using present value techniques based on estimated cash flows of the security taking into consideration various assumptions derived by management and used by other market participants. These assumptions include, among others, interest rates, prepayment rates, discount rates, credit loss rates, and the timing of cash flows and credit losses. Credit default and loss severity rates can significantly affect the prices of private-label MBS. While it is impossible to project the exact amount of changes in value, the table below illustrates the impact a 10% increase and a 10% decrease in the credit default and loss severity rates from those used as our valuation assumptions would have on the value of our total assets and our book value as of March 31, 2013. The changes in rates are assumed to occur instantaneously. Actual changes in market conditions are likely to be different from these assumptions (dollars in thousands, except per share amounts).

| | March 31, 2013 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Value | Value with 10% Increase in Default Rate | Percent Change | Value with 10% Decrease in Default Rate | Percent Change | Value with 10% Increase in Loss Severity Rate | Percent Change | Value with 10% Decrease in Loss Severity Rate | Percent Change |
| Assets | | | | | | | | | |
| MBS, Private-label | $ 275,856 | $ 268,530 | (2.66)% | $ 283,500 | 2.77% | $ 265,826 | (3.64)% | $ 285,945 | 3.66% |
| MBS, Agency | 1,637,392 | 1,637,392 | — | 1,637,392 | — | 1,637,392 | — | 1,637,392 | — |
| Other | 298,162 | 298,162 | — | 298,162 | — | 298,162 | — | 298,162 | — |
| Total assets | $ 2,211,410 | $ 2,204,084 | (0.33)% | $ 2,219,054 | 0.35% | $ 2,201,380 | (0.45)% | $ 2,221,499 | 0.46% |
| | | | | | | | | | |
| Liabilities | $ 1,665,594 | $ 1,665,594 | — | $ 1,665,594 | — | $ 1,665,594 | — | $ 1,665,594 | — |
| Equity | 545,816 | 538,490 | (1.34)% | 553,460 | 1.40% | 535,786 | (1.84)% | 555,905 | 1.85% |
| Total liabilities and equity | $ 2,211,410 | $ 2,204,084 | (0.33)% | $ 2,219,054 | 0.35% | $ 2,201,380 | (0.45)% | $ 2,221,499 | 0.46% |
| | | | | | | | | | |
| Book value per share | $ 32.78 | $ 32.34 | (1.34)% | $ 33.24 | 1.40% | $ 32.18 | (1.84)% | $ 33.39 | 1.85% |

Interest Rate Risk

Leveraged MBS

We are also subject to interest rate risk in our MBS portfolio. Some of our MBS positions are financed with repurchase agreements, which are interest rate sensitive financial instruments. We are exposed to interest rate risk that fluctuates based on changes in the level or volatility of interest rates and mortgage prepayments and in the shape and slope of the yield curve. We attempt to hedge a portion of our exposure to interest rate fluctuations through the use of Eurodollar futures and U.S. Treasury note futures. The counterparties to our derivative agreements at March 31, 2013 are U.S. financial institutions. We assess and monitor the counterparties' non-performance risk and credit risk on a regular basis.

Our primary risk is related to changes in both short- and long-term interest rates, which affect us in several ways. As interest rates increase, the market value of the MBS may be expected to decline, prepayment rates may be expected to go down, and duration may be expected to extend. An increase in interest rates is beneficial to the market value of our derivative instruments. For example, for interest rate swap positions, the cash flows from receiving the floating rate portion increase and the fixed-rate paid remains the same under this scenario. If interest rates decline, the reverse is true for MBS, paying fixed and receiving floating interest rate swaps, interest rate caps, and Eurodollar and U.S. Treasury futures and MBS put option contracts.

The table that follows shows the expected change in fair value for our current MBS and derivatives related to our principal investing activities under several hypothetical interest-rate scenarios. Interest rates are defined by the U.S. Treasury yield curve. The changes in rates are assumed to occur instantaneously. It is further assumed that the changes in rates occur uniformly across the yield curve and that the level of LIBOR changes by the same amount as the yield curve. Actual changes in market conditions are likely to be different from these assumptions.

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Changes in value are measured as percentage changes from their respective values presented in the column labeled "Value." Management's estimate of change in value for MBS is based on the same assumptions it uses to manage the impact of interest rates on the portfolio. Actual results could differ significantly from these estimates. For MBS, the estimated change in value of the MBS reflects an effective duration of 4.77 in a rising interest rate environment and 2.92 in a declining interest rate environment.

The effective durations are based on observed market value changes, as well as management's own estimate of the effect of interest rate changes on the fair value of the investments including assumptions regarding prepayments based, in part, on age of and interest rate on the mortgages underlying the MBS, prior exposure to refinancing opportunities, and an overall analysis of historical prepayment patterns under a variety of past interest rate conditions (dollars in thousands, except per share amounts).

| | March 31, 2013 | | | | |
|---|---|---|---|---|---|
| | Value | Value with 100 Basis Point Increase in Interest Rates | Percent Change | Value with 100 Basis Point Decrease in Interest Rates | Percent Change |
| Assets | | | | | |
| MBS | $ 1,913,248 | $ 1,822,006 | (4.77)% | $ 1,969,198 | 2.92% |
| Derivative asset | 9 | 1,390 | 15,344.44% | (486) | (5,500.00)% |
| Other | 298,153 | 298,153 | — | 298,153 | — |
| Total assets | $ 2,211,410 | $ 2,121,549 | (4.06)% | $ 2,266,865 | 2.51% |
| Liabilities | | | | | |
| Repurchase agreements | $ 1,207,171 | $ 1,207,171 | — | $ 1,207,171 | — |
| Derivative liability | 76,509 | 15,348 | (79.94)% | 132,949 | 73.77% |
| Other | 381,914 | 381,914 | — | 381,914 | — |
| Total liabilities | 1,665,594 | 1,604,433 | (3.67)% | 1,722,034 | 3.39% |
| Equity | 545,816 | 517,116 | (5.26)% | 544,831 | (0.18)% |
| Total liabilities and equity | $ 2,211,410 | $ 2,121,549 | (4.06)% | $ 2,266,865 | 2.51% |
| | | | | | |
| Book value per share | $ 32.78 | $ 31.06 | (5.26)% | $ 32.72 | (0.18)% |

Equity Price Risk

Although limited, we are exposed to equity price risk as a result of our investments in equity securities and investment partnerships. Equity price risk changes as the volatility of equity prices changes or the values of corresponding equity indices change.

While it is impossible to exactly project what factors may affect the prices of equity sectors and how much the effect might be, the table below illustrates the impact a 10% increase and a 10% decrease in the price of the equities held by us would have on the value of our total assets and our book value as of March 31, 2013 (dollars in thousands, except per share amounts).

| | March 31, 2013 | | | | |
|---|---|---|---|---|---|
| | Value | Value with 10% Increase | Percent Change | Value with 10% Decrease | Percent Change |

| | | | in Price | | in Price |
|---|---|---|---|---|---|
| Assets | | | | | |
| Equity and cost method investments | $ 1,731 | $ 1,904 | 10.00% | $ 1,558 | (10.00)% |
| Other | 2,209,679 | 2,209,679 | — | 2,209,679 | — |
| Total assets | $ 2,211,410 | $ 2,211,583 | 0.01% | $ 2,211,237 | (0.01)% |
| | | | | | |
| Liabilities | $ 1,665,594 | $ 1,665,594 | — | $ 1,665,594 | — |
| Equity | 545,816 | 545,989 | 0.03% | 545,643 | (0.03)% |
| Total liabilities and equity | $ 2,211,410 | $ 2,211,583 | 0.01% | $ 2,211,237 | (0.01)% |
| | | | | | |
| Book value per share | $ 32.78 | $ 32.79 | 0.03% | $ 32.77 | (0.03)% |

Except to the extent that we sell our equity securities or other investments, or a decrease in their fair value is deemed to be other-than-temporary, an increase or decrease in the fair value of those assets will not directly affect our earnings; however, an increase or decrease in the value of equity method investments will directly affect our earnings.

Inflation Risk

Virtually all of our assets and liabilities are interest rate sensitive in nature. As a result, interest rates and other factors influence our performance far more than inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates. Our financial statements are prepared in accordance with GAAP and our distributions are determined by our Board of Directors in its sole discretion pursuant to our variable dividend policy; in each case, our activities and balance sheet are measured with reference to fair value without considering inflation.

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Item 4. Controls and Procedures

Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, our management, with the participation of our Chief Executive Officer, Eric F. Billings, and our Chief Financial Officer, Kurt R. Harrington, carried out an evaluation of the effectiveness of our disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) pursuant to Rule 13a-15(b) of the Exchange Act. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding disclosure.

Changes in Internal Control Over Financial Reporting

There has been no change in our internal control over financial reporting during the quarter ended March 31, 2013 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Cautionary Statement About Forward-Looking Statements

When used in this Quarterly Report on Form 10-Q, in future filings with the SEC or in press releases or other written or oral communications, statements which are not historical in nature, including those containing words such as "believe," "expect," "anticipate," "estimate," "plan," "continue," "intend," "should," "may" or similar expressions, are intende identify "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Exchange Act and, as such, may involve known and unknown risks, uncertainties and assumptions. The forward-looking statements we make in this Quarterly Report on Form 10-Q include, but are not limited to, statements about the following:

- the availability and terms of, and our ability to deploy, capital and our ability to grow our business through a strategy focused on acquiring primarily residential mortgage-backed securities (MBS) that are either issued by U.S. government agencies or guaranteed as to principal and interest by U.S. government agencies or U.S. government sponsored agencies (agency-backed MBS), and MBS issued by private organizations (private-label MBS);
- our ability to forecast our tax attributes, which are based upon various facts and assumptions, and our ability to protect and use our net operating losses (NOLs), and net capital losses (NCLs), to offset future taxable income and gains;
- our investment, hedging and financing strategies and the success of these strategies;
- the effect of changes in prepayment rates, interest rates and default rates on our portfolio;
- the effect of governmental regulation and actions;
- the outcome of contingencies, including pending legal and regulatory proceedings;
- our ability to quantify and manage risk;
- our ability to realize any reflation of our assets;
- our liquidity;
- our asset valuation policies;
- our decisions with respect to, and ability to make, future dividends;
- our ability to maintain our exclusion from the definition of "investment company" under the Investment Company Act of 1940, as amended (1940 Act); and
- the effect of general economic conditions on our business.

Forward-looking statements are based on our beliefs, assumptions and expectations of our future performance, taking into account information currently in our possession. These beliefs, assumptions and expectations may change as a result of many possible events or factors, not all of which are known to us or are within our control. If a change occurs, the performance of our portfolio and our business, financial condition, liquidity and results of operations may vary materially from those expressed, anticipated or contemplated in our forward-looking statements. You should carefully consider these risks, along with the following factors that could cause actual results to vary from our forward-looking statements, before making an investment in our securities:

- effects of regulatory proceedings, litigation and contractual claims against us, our officers and our directors;
- the overall environment for interest rates, changes in interest rates, interest rate spreads, the yield curve and prepayment rates;

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- current conditions and further adverse developments in the residential mortgage market and the overall economy;
- potential risk attributable to our mortgage-related portfolios, including changes in fair value;
- our use of leverage and our dependence on repurchase agreements and other short-term borrowings to finance our mortgage-related holdings;
- the availability of certain short-term liquidity sources;
- the federal conservatorship of the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and related efforts, along with any changes in laws and regulations affecting the relationship between Fannie Mae and Freddie Mac and the federal government;
- mortgage loan prepayment activity, modification programs and future legislative action;
- changes in our acquisition, hedging and leverage strategies, changes in our asset allocation and changes in our operational policies, all of which may be changed by us without shareholder approval;
- competition for investment opportunities, including competition from the U.S. Department of Treasury (U.S. Treasury) and the Federal Reserve, for investments in agency-backed MBS;
- failure of sovereign or municipal entities to meet their debt obligations or a downgrade in the credit rating of such debt obligations;
- fluctuating quarterly operating results;
- changes in laws and regulations and industry practices that may adversely affect our business;
- volatility of the securities markets and activity in the secondary securities markets; and
- the other important factors identified in our Annual Report on Form 10-K for the year ended December 31, 2012 under the caption “Item 1A-Risk Factors”.

These and other risks, uncertainties and factors, including those described elsewhere in this Quarterly Report on Form 10-Q, could cause our actual results to differ materially from those projected in any forward-looking statements we make. All forward-looking statements speak only as of the date on which they are made. New risks and uncertainties arise over time and it is not possible to predict those events or how they may affect us. Except as required by law, we are not obligated to, and do not intend to, update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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# PART II
# OTHER INFORMATION

## Item 1. Legal Proceedings

The disclosure below updates and supplements the information set forth under "Item 3—Legal Proceedings" in our Annual Report on Form 10-K for the year ended December 31, 2012.

As previously disclosed, on August 19, 2011, Hildene Capital Management, LLC filed a purported class action complaint captioned Hildene Capital Management, LLC v. Friedman, Billings, Ramsey Group, Inc. (d/b/a Arlington Asset Investment Corp.), FBR Capital Trust VI, FBR Capital Trust X, Wells Fargo Bank, N.A., as Trustee, and John and Jane Does 1 through 100, No. 11 Civ. 5832, in the United States District Court for the Southern District of New York. On March 22, 2013, the Plaintiffs filed a Stipulation of Voluntary Dismissal, dismissing the case with prejudice.

In addition to the matters described above, we are from time to time involved in civil lawsuits, legal proceedings and arbitration matters relating to our business that we consider to be in the ordinary course. There can be no assurance that these matters individually or in aggregate will not have a material adverse effect on our financial condition or results of operations in a future period. We are also subject to the risk of litigation, including litigation that may be without merit. As we intend to actively defend such litigation, significant legal expenses could be incurred. An adverse resolution of any future litigation against us could materially affect our financial condition, results of operations and liquidity. Furthermore, we operate in highly-regulated markets that currently are under intense regulatory scrutiny, and we have received, and we expect in the future that we may receive, inquiries and requests for documents and information from various federal, state and foreign regulators. However, we believe that the continued scrutiny of MBS, structured financed and derivative market participants increases the risk of additional inquiries and requests from regulatory or enforcement agencies. We cannot provide any assurance that these inquiries and requests will not result in further investigation of or the initiation of a proceeding against us or that, if any such investigation or proceeding were to arise, it would not materially adversely affect our Company.

## Item 1A. Risk Factors

None.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Purchases of Equity Securities by the Issuer

During the three months ended March 31, 2013, we did not repurchase any shares of our Class A common stock.

## Item 4. Mine Safety Disclosures

Not applicable.

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Item 6. Exhibits

| Exhibit Number | Exhibit Title |
|---|---|
| 3.1 | Amended and Restated Articles of Incorporation of the Company, as amended (incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q filed on November 9, 2009). |
| 3.2 | Amended and Restated Bylaws of the Company, as amended (incorporated by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on July 28, 2011). |
| 12.01 | Computation of Ratio of Earnings to Fixed Charges.* |
| 31.01 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended, adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.* |
| 31.02 | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934, as amended, adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.* |
| 32.01 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.** |
| 32.02 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.** |
| 101.INS | INSTANCE DOCUMENT*** |
| 101.SCH | SCHEMA DOCUMENT*** |
| 101.CAL | CALCULATION LINKBASE DOCUMENT*** |
| 101.LAB | LABELS LINKBASE DOCUMENT*** |
| 101.PRE | PRESENTATION LINKBASE DOCUMENT*** |
| 101.DEF | DEFINITION LINKBASE DOCUMENT*** |

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* Filed herewith.

** Furnished herewith.

*** Submitted electronically herewith. Attached as Exhibit 101 are the following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets at March 31, 2013 and December 31, 2012; (ii) Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2013 and 2012; (iii) Consolidated Statements of Changes in Equity for the Three Months Ended March 31, 2013 and the Year Ended December 31, 2012; and (iv) Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2013 and 2012. Pursuant to Rule 406T of Regulation S-T this data is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, and otherwise is not subject to liability under these sections.

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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.

ARLINGTON ASSET INVESTMENT CORP.

By: /s/ KURT R. HARRINGTON
Kurt R. Harrington
Executive Vice President, Chief Financial Officer, and
Chief Accounting Officer
(Principal Financial Officer)

Date: May 3, 2013

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EXHIBIT INDEX

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| 32.02 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.** |
| 101.INS | INSTANCE DOCUMENT*** |
| 101.SCH | SCHEMA DOCUMENT*** |
| 101.CAL | CALCULATION LINKBASE DOCUMENT*** |
| 101.LAB | LABELS LINKBASE DOCUMENT*** |
| 101.PRE | PRESENTATION LINKBASE DOCUMENT*** |
| 101.DEF | DEFINITION LINKBASE DOCUMENT*** |

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* Filed herewith.

** Furnished herewith.

*** Submitted electronically herewith. Attached as Exhibit 101 are the following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets at March 31, 2013 and December 31, 2012; (ii) Consolidated Statements of Comprehensive Income for the Three Months Ended March 31, 2013 and 2012; (iii) Consolidated Statements of Changes in Equity for the Three Months Ended March 31, 2013 and the Year Ended December 31, 2012; and (iv) Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2013 and 2012. Pursuant to Rule 406T of Regulation S-T this data is deemed not filed or part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, is deemed not filed for purposes of section 18 of the Securities and Exchange Act of 1934, and otherwise is not subject to liability under these sections.