ARLINGTON ASSET INVESTMENT

STONEGATE CAPITAL PARTNERS

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MARKET STATISTICS

Exchange / Symbol:	NYSE: AI
Price:	$10.31
Market Cap ($mm):	$290.1
Shares Outstanding (mm):	28.1
Float (%):	97.9
Volume (3-month avg.):	634,000
52 Week Range:	$9.90-$13.95
Industry:	Financial Services

CONDENSED BALANCE SHEET

($mm, except per share data)

Balance Sheet Date:	3/31/2018
Cash & Cash Equivalent:	$15.2
Cash/Common Share:	$0.54
LT Debt:	$73.9
Equity (Book Value):	$319.0
Equity/Common Share:	$11.03

CONDENSED INCOME STATEMENTS

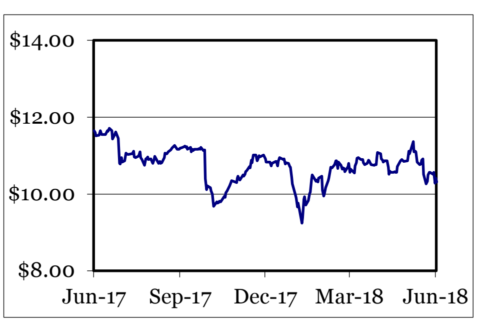
($mm, except per share data)

FY – 12/31	Interest Inc	Net Int. Income	EPS GAAP	EPS Core
FY15	$121.3	$102.4	$(3.02)	$4.09
FY16	$105.3	$76.1	$(1.79)	$2.75
FY17	$121.3	$69.7	$0.66	$2.26
Fy18E	$122.7	$56.6	$(1.24)	$2.32

LARGEST SHAREHOLDERS

American Money Management Corp	1,403,800
Invesco PowerShares Capital	1,371,000
The Vanguard Group, Inc.	1,365,400
BlackRock, Inc.	1,286,300
State Street Global Advisors, Inc.	535,300
Citadel Enterprise Americas, LLC	430500
Miller Value Partners, LLC	400,000
Russell Investment Management, LLC	392,600
Tonkel Jr., J. Rock	341,700
Northern Trust Global Investments	314,200

STOCK CHART



COMPANY DESCRIPTION

Arlington Asset Investment Corp. is an investment firm that focuses on acquiring and holding a levered portfolio of residential mortgage-backed securities (RMBS), consisting of agency MBS and private-label MBS. The Company acquires residential mortgage backed securities from U.S. government agency or government sponsored enterprises (GSE), such as Federal National Mortgage Association and Federal Home Loan Mortgage. Importantly, agency MBS are guaranteed as to principal and interest by the U.S. government agency or U.S. government sponsored enterprise; whereas, private label MBS or non-agency MBS and are not backed by a GSE or U.S. government. Currently, the Company's investment capital is allocated to agency MBS. Arlington Asset Investment Corp. is a Virginia corporation and taxed as a C corporation for U.S. federal tax purposes. Additionally, it is an internally managed company and does not have an external investment advisor. The Company is headquartered in Arlington, VA.

SUMMARY

Arlington Asset Investment Corp. ("Arlington") is an internally managed investment firm focused on acquiring and holding a levered portfolio of RMBS. Using its long-term investment strategy, coupled with its hedging strategy, the Company is focused on maintaining its net interest income spread return and its consistency over an extended period of time. The Company believes this focus should drive a high return on capital and support a consistent dividend. We note the following for Arlington:

- It has a flexible investment approach to seek highest risk-adjusted returns
- The Company invests in highly liquid assets with substantial interest rate hedges
- AI has diversified repo funding sources to enable its RMBS investment strategy
- Arlington also has access to longer-term funding sources from its equity and preferred ATMs
- At Q118, its portfolio was substantially hedged at 96%, helping mitigate impacts from rising interest rates
- The Company is not a REIT but is structured as a C-corp to provide tax benefits to shareholders
- Dividends from C-corp are classified as qualified dividends and taxed at a maximum 23.8% federal income tax rate vs. REIT dividends that are subject to the higher 33.4% maximum effective ordinary income tax rate, starting in 2018
- Reported for Q118, the Company had $51.5M net operating losses, $380.7M net capital losses, and a $9.1M ATM carry forwards that should help mitigate taxable impacts
- Its internally managed investment structure provides operating leverage to the Company
- Arlington's internally managed structure also better aligns management's interests as compensation is based on the Company and stock performance rather than capital raising and portfolio growth

We employ a comparison analysis using a P/TBV framework. Using current comps, along with historical valuation ranges, we believe using a P/TBV multiple range of 0.80x to 1.20x is reasonable. Using this range, we arrive at a valuation range of ~$9.32 to ~$13.98 with a mid-point of ~$11.65. Additional valuation details are on page 7.

We also note that the Q218 dividend of $0.375 (vs. $0.55 for Q118) revises our FY18 estimate to $1.68 per share for the annual dividend, which still appears well supported by our core EPS forecast of $2.32 per share.

BUSINESS OVERVIEW

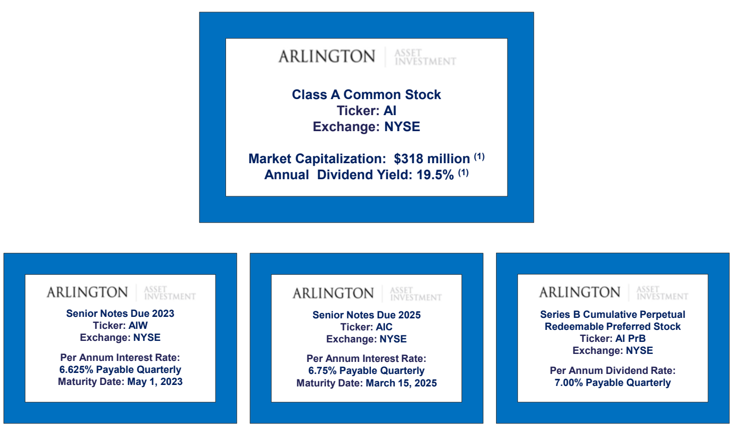
Arlington Asset Investment Corp. is an investment firm that focuses on acquiring and holding a levered portfolio of residential mortgage-backed securities (RMBS), consisting of agency MBS and private-label MBS. The Company acquires residential mortgage backed securities from U.S. government agencies or government sponsored enterprises (GSE), such as Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage (Freddie Mac). Importantly, the agency residential MBS are guaranteed as to principal and interest by the U.S. government agency or GSE. Private label MBS or non-agency MBS are not backed by a GSE or U.S. government. Currently, the Company's investment capital is allocated to agency MBS.

Arlington Asset Investment Corp. uses leverage to increase potential returns to shareholders. The Company funds its investments primarily through short-term financing agreements and enters into various hedging transactions to mitigate interest rate sensitivity of its borrowing costs and the value of the MBS portfolio.

The Company is a Virginia corporation and taxed as a C corporation for U.S. federal tax purposes. This is an important distinction as its dividends to shareholders are thus classified as qualified dividends and taxed at a maximum 23.8% federal income tax rate. This compares to similar dividends of REITs, which are non-qualified dividends, and are subject to the higher 33.4% maximum federal effective income tax rate on ordinary income, starting in 2018.

Additionally, Arlington Asset Investment Corp. is an internally managed company and does not have an external investment advisor. The Company is headquartered in Arlington, VA.

Exhibit 1: Arlington Asset Investment Capital Structure



(1) As of May 1, 2018

Source: Company Reports; Stonegate Capital Partners

INVESTMENT STRATEGY

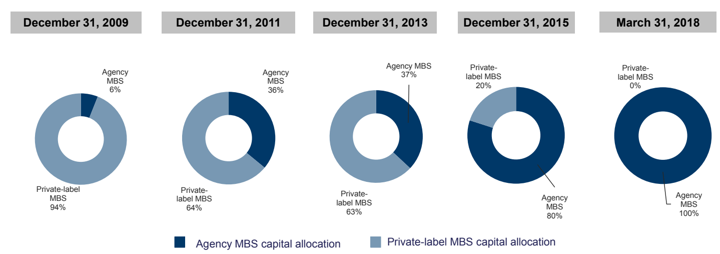
Arlington's investment strategy is focused on obtaining a high risk-adjusted return on capital. The Company starts its process by evaluating the rates of return that can be attained in each asset class and each individual security within an asset class. Next, the Company evaluates the set of opportunities against returns available in other investment alternatives. Subsequently, the Company will attempt to allocate its assets and capital toward what it believes to be the highest risk-adjusted return available. As result of this strategy, the portfolio will have different allocations of capital and leverage in different market environments.

We note that Arlington Asset Investment Corp. may invest in other types of assets such as:

- residential mortgage loans
- mortgage servicing rights
- GSE credit risk transfer securities
- commercial MBS
- asset backed securities
- commercial mortgage loans
- commercial loans
- other real estate related loans and securities
- other structured securities

Currently, the Company believes its RMBS portfolio provides it with the highest relative risk-adjusted return. As a result, the Company has maintained a high allocation of its portfolio toward this sector. Within the RMBS investment portfolio, the Company has also gradually increased its exposure to agency MBS vs. private label MBS, reporting 0% private label as of 3/31/18.

Exhibit 2: Investment Portfolio Historical Changes



Source: Company Reports; Stonegate Capital Partners

Arlington Asset Investment Corp. may purchase MBS securities either in initial offerings or in the secondary market. Importantly, the Company may also use "to-be-announced" (TBA) forward contracts to invest in agency MBS or to hedge investments. A TBA security is a forward contract for the purchase or sale of agency securities at a predetermined price, face amount, issuer, coupon, and stated maturity on an agreed upon future date. However, the specific agency securities to be delivered against the forward contract are not identified until shortly before the settlement date.

FINANCING STRATEGY

As mentioned, the Company uses leverage to finance a portion of its MBS portfolio and to increase potential returns. Arlington typically uses short-term financing, which primarily consist of repurchase agreements or repos. The Company's funding sources are well diversified as it has 16 counterparties with access to 21 total counterparties. Additionally, we note that less than 10% of equity is at risk with any one counterparty.

From time-to-time the Company has, and may continue to use, long-term notes as an additional financing source. Additionally, the Company uses TBA dollar rolls to finance part of its MBS portfolio.

Repurchase Agreements

The Company's repo agreements are typically in the 30 days to 90 days range, but can be as short as one day or as long as a year. Arlington Asset Investment will sell securities to the counterparty in the repo agreement and will receive cash in return. Additionally, the counterparty is obligated to resell the same securities back to Arlington Asset Investment at the end of the repo term. Under the repo agreements, the Company typically pays a floating rate based on LIBOR, plus or minus a fixed spread. All these transactions are reflected on the balance sheet.

TBA Dollar Roll

As mentioned above in the investment strategy section, Arlington invests in TBA forward contracts. TBA forward contracts can settle either by (1) taking physical delivery of an agency MBS security, or (2) by entering into an offsetting position and net settle the paired off position in cash. Historically, the Company has settled its TBA trades by method 2.

Exhibit 3: Illustrative TBA Dollar Roll Example

Hypothethical dollar roll with Freddie Mac, 30-year, 3.5% coupon TBA security:

	Trade Date	Settlement Date	Buy / Sell	Notional	Price	Cash Net Settlement
1	August 17	September 13	Buy	$50,000,000	$103.45	
2	September 11	September 13	Sell	$50,000,000	$103.75	$ 150,000
	September 11	October 12	Buy	$50,000,000	$103.58	
3	October 6	October 12	Sell	$50,000,000	$103.46	$ (60,000)
						$ 90,000

Source: Company Reports; Stonegate Capital Partners

As illustrated above, the Company makes an initial purchase of a TBA at step 1. Prior to the settlement date, (step 2 above) the Company "rolls" the contract forward by executing a sale of a similar contract purchased at step 1, and purchasing another TBA contract with a later settlement date. The final step 3, then closes the dollar roll trade. We note that during step 2, the contract purchased for a forward settlement is normally priced at a discount to the contract sold. This discount is called the "price drop". The "price drop" is economically equivalent to the expected net interest income (interest income minus financing costs) that is earned from a direct investment in an agency MBS (think repo financing).

Importantly, dollar roll transactions are a form of off-balance sheet financing. Over the past few years, these transactions have become more pervasive due to the implied net interest income (price drop), being higher than the net interest income earned from purchasing a specific agency MBS financed via a repo agreement. The Fed's quantitative easing has been a key driver of this trend.

Exhibit 4: Repo Financing vs. TBA Dollar Roll Illustrative Example

	Agency MBS Funded with Repo (1)	TBA Dollar Roll (3)	Dollar Roll Advantage
Agency MBS yield / dollar roll net interest spread	3.00%	2.04%	
Financing cost of agency MBS funded with repo (2)	-1.31%	-	
Economic net interest spread (4)	**1.69%**	**2.04%**	**0.35%**

(1) *Assumes agency MBS effective interest earned is 3.00% inclusive of premium amortization based on expected prepayments*

(2) *Assumes agency MBS is financed 100% with a 30-day repurchase agreement at financing cost of 1.31%*

(3) *TBA dollar roll assumes a "price drop" of $0.17 which equates to an annualized net interest spread of 2.04% on a cost basis of $103.45*

(4) *Economic net interest spread excludes any costs associated with interest rate hedges*

Source: Company Reports; Stonegate Capital Partners

Other Financing

As illustrated in Exhibit 1, Arlington Asset Investment has also used other long-term sources of financing for its operations. These include offering common stock, preferred stock, and debt securities. Currently, the Company has an ATM (at-the-market) equity agreement to offer, from time to time, up to 6M shares of its Class A common stock. It entered into the newest ATM on February 22, 2017. As of Q118, the Company had ~1.5M share remaining on its equity ATM agreement.

Additionally, on May 16, 2017, the Company entered into a Series B Preferred Equity Distribution agreement to sell, from time to time, up to 1.865M shares of its Series B Preferred stock. As of Q118, the Company had ~1.7M shares remaining on its preferred ATM agreement.

RISK MANAGEMENT STRATEGY

Arlington Asset Investment uses a variety of strategies to hedge a portion of its portfolio. The main risks that the Company is looking to hedge or manage include:

(1) interest rate risk
(2) prepayment risk
(3) spread risk
(4) extension risk
(5) credit risk
(6) liquidity risk
(7) and regulatory risks

The Company's hedging instruments include interest rate swaps, interest rate swap futures, U.S. Treasury note futures, Eurodollar futures, and options on U.S. Treasury note futures. As expected, the Company will hedge when it believes the hedge is prudent given its investment strategy and the cost of the hedge. Also, some of the risks above may remain unhedged if the Company believes that bearing the risk will enhance its return relative to its risk/return targets. It's important to note that the Company's hedging activities are designed to minimize certain risk exposures but not eliminate them.

Given Arlington's use of short-term financing (repos) to purchase long-term investments (MBS), the Company primarily uses interest rate swaps to hedge interest rate sensitivity of the financing cost and to protect the value of the MBS portfolio. Therefore, the Company is looking to lock in a portion of the net interest income spread (interest income on MBS less financing costs) and to protect book value. Importantly, the Company's focus on hedging is to maintain this net interest income spread return and its consistency over a long period of time. The Company believes this focus should drive a high return on capital and support a consistent dividend.

Arlington also uses asset selection to help mitigate risks such as prepayment risk. Thus, the Company aims to invest in MBS securities that have a lower probability of prepayment. Typical characteristics of these MBS securities might include mortgages with (1) low remaining balances, (2) have high loan-to-value ratios, (3) credit scores of borrowers are on the lower end of the range for GSE underwriting standards, (4) certain geographic areas, and (5) loans originated through certain government programs.

RISKS

Interest rate risk – The Company's portfolio primarily consists of long-term, fixed rate agency MBS and finances its purchases through short-term rep agreements tied to floating rates based on LIBOR. Any unexpected changes in interest rates may cause asset values, financing costs, and hedging strategies to perform differently than planned. Changes in the yield curve could also negatively affect the Company's portfolio and earnings.

Prepayment risk – Arlington's MBS portfolio receives income derived from payments made by borrowers of the underlying mortgage loans. If borrowers prepay loans at a faster rate than anticipated, the MBS portfolio may be reinvested in lower yielding securities. If rates rise, prepayment trends would likely extend causing the Company to hold lower yielding securities. Additionally, it prepayments are greater than expected, the Company may be required to increase the premium amortization of its assets, which would negatively impact net interest income.

Leverage risk – The Company's investment strategy relies on short-term debt. If the cost of this financing increases or becomes unavailable, the Company's financial results would be negatively impacted.

Liquidity risk – Arlington's strategy is reliant on liquidity. This liquidity comes in the form of access to funds to implement its strategy, and in the Company's ability to sell investments if necessary. Any changes to market liquidity, or perceived liquidity issues of the Company would negatively impact financial results.

RECENT RESULTS

At Q118, the Company's book value was $11.03/ common share compared to $13.43/common share at Q417 end, representing a decrease of ~18%. Tangible book value (book value less deferred tax asset and preferred stock liquidation preference) decreased ~13% from $13.40/common share in Q417 to $11.65/common share in Q118. Arlington declared a dividend of $0.55 per common share for Q118, unchanged from the prior 3 quarters. Higher interest rates and wider agency spreads resulted in underperformance in the pricing of agency MBS relative to the Company's interest rate hedges, which caused the decline in book values.

Exhibit 5: Non-GAAP Core Operating Income

(In thousands, except per share amounts)	2018	2017		
	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
GAAP net interest income	$ 14,304	$ 15,657	$ 14,867	$ 18,933
TBA dollar roll income	6,643	7,171	6,424	4,298
Interest rate swap net interest expense	(816)	(2,434)	(4,198)	(5,293)
Economic net interest income	20,131	20,394	17,093	17,938
Core general and administrative expenses	(3,846)	(3,768)	(3,171)	(3,681)
Preferred stock dividend	(137)	(133)	(83)	(35)
Non-GAAP core operating income	$ 16,148	$ 16,493	$ 13,839	$ 14,222
Non-GAAP core operating income per diluted common share	$ 0.57	$ 0.58	$ 0.52	$ 0.58
Weighted average diluted common shares outstanding	28,430	28,580	26,856	24,552

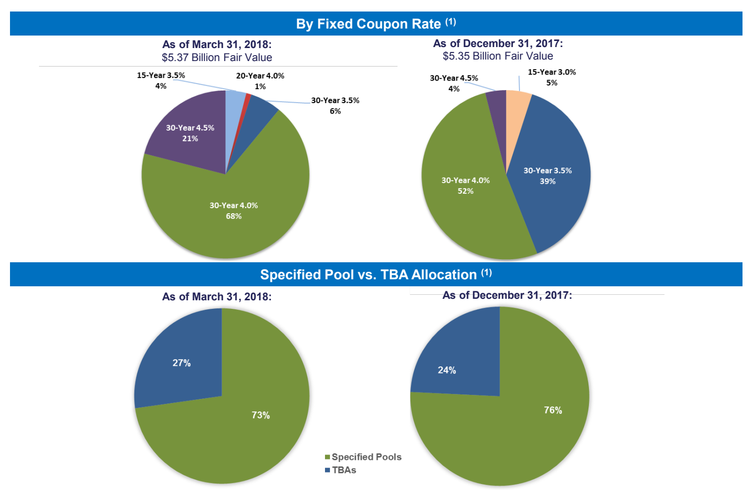
Source: Company Reports; Stonegate Capital Partners

For Q118, Arlington generated a GAAP net loss of $2.00/share, which includes a $0.64 per share income tax provision, compared to a GAAP net income of $0.25/share in the Q417. Also for Q118, Arlington generated a GAAP pre-tax loss of $1.36/share compared to a GAAP pre-tax income of $0.73/share in the Q417. Core EPS for Q118 was $0.57/share compared to $0.58/share in Q417. Core EPS or core operating income is a non-GAAP figure that captures the net swap interest costs, which is excluded from net interest income but shown as a loss on derivatives for GAAP. We note that the figure is a better indicator of dividend capacity compared to GAAP income or GAAP EPS.

The Company's actual constant prepayment rate for its agency MBS decreased to 8.6% in Q118 compared to 9.6% in Q417. The average agency MBS yield was 2.98% in Q118 versus 2.86% in Q417. Additionally, the Company's average cost of its repo agreements was 1.64% in Q118, compared to 1.56% in Q417.

As of 3/31/18, Arlington Asset Investment Corporation's portfolio totaled $5,369M, comprised of $3,907M specified agency MBS and $1,462M net long TBA agency MBS.

Exhibit 6: Investment Portfolio Allocation



(1) Includes the fair value of the agency MBS underlying forward-settling "to-be-announced ("TBA") purchase or sale commitments that are accounted for as derivative instruments in accordance with GAAP. The difference between the contractual forward price of the Company's TBA commitments and the fair value of the underlying MBS is reflected on the Company's consolidated balance sheets as a component of "derivative assets, at fair value" or "derivative liabilities, at fair value."

Source: Company Reports; Stonegate Capital Partners

During the first quarter, the Company increased its allocation to 4% and 4.5% coupon agency MBS while decreasing its exposure to 3.5% securities to take advantage of expected higher risk-adjusted returns in a rising rates environment.

Management noted that the Company continues to utilize tax benefits afforded to C-corps to shield substantially all of its income from taxes. We note that as of Q118, Arlington reported NOL carryforwards of ~$52M, net capital loss carryforwards of ~$381M, and AMT credit carryforwards of ~$9M. Management estimates that the Company will utilize its NOL and any remaining AMT credit carryforwards during 2H19.

The Company also maintained a substantial hedge position, which included primarily interest rate swaps as illustrated in Exhibit 7 below.

Exhibit 7: Hedging Portfolio Summary

Interest Rate Swaps as of March 31, 2018 (dollars in thousands):

		Weighted-average				
	Notional Amount	Fixed Pay Rate	Variable Receive Rate	Net Receive Rate	Remaining Life (Years)	Duration (1)
Less than 3 years to maturity	$ 1,175,000	1.25%	1.96%	0.71%	1.6	(1.4)
3 to less than 7 years to maturity	600,000	1.89%	1.96%	0.07%	3.5	(3.2)
7 or more years to maturity	1,750,000	2.04%	2.09%	0.05%	8.9	(7.6)
Total / weighted average	$ 3,525,000	1.75%	2.03%	0.28%	5.5	(4.8)

U.S. Treasury Note Futures as of March 31, 2018 (dollars in thousands):

U.S. Treasury Note Futures	Maturity Date	Notional Amount	Weighted-average Implied Rate	Duration (1)
10-year U.S. Treasury note futures	June 2018	$ 850,000	2.91%	(7.8)

(1) *Duration is calculated based upon each interest rate swap's "DV01" (a valuation metric illustrating the dollar value of a one basis point increase in interest rates) as reported by the Chicago Mercantile Exchange, the clearinghouse through which those instruments were centrally cleared. Duration is a measure of how much the price of an asset or liability is expected to change if interest rates move in a parallel manner.*

Source: Company Reports; Stonegate Capital Partners

We also note that the Company's interest rate swap notional to repo ratio remained similar - 96% in Q118 compared to 96% in Q417 (Exhibit 8).

Exhibit 8: Portfolio Weighted Average Statistics

(dollars in thousands)	2018	2017		
	First Quarter	Fourth Quarter	Third Quarter	Second Quarter
Specified agency MBS:				
Constant prepayment rate	8.64%	9.55%	10.29%	9.03%
GAAP asset yield	2.98%	2.86%	2.80%	2.85%
Weighted average GAAP amortized cost basis	$ 4,130,072	$ 4,272,021	$ 4,104,083	$ 4,404,798
TBA dollar rolls:				
Implied net interest spread	1.84%	1.98%	2.10%	2.42%
Weighted average implied cost basis	$ 1,442,046	$ 1,457,275	$ 1,225,131	$ 711,190
Total agency MBS weighted average cost basis	$ 5,572,118	$ 5,729,296	$ 5,329,214	$ 5,115,988
Specified agency MBS allocation	74%	75%	77%	86%
TBA dollar roll allocation	26%	25%	23%	14%
Repurchase agreements:				
Weighted average financing rate	1.64%	1.37%	1.31%	1.08%
Weighted average balance	$ 3,730,619	$ 3,930,819	$ 3,819,095	$ 4,125,631
Interest rate swaps:				
Weighted average fixed pay rate	(1.71)%	(1.64)%	(1.74)%	(1.76)%
Weighted average variable receive rate	1.67%	1.36%	1.27%	1.14%
Weighted average net pay rate	(0.04)%	(0.28)%	(0.47)%	(0.62)%
Weighted average notional amount	$ 3,600,000	$ 3,775,661	$ 3,561,667	$ 3,342,473
Interest rate swap notional to repo ratio	96%	96%	93%	81%
Total agency MBS economic net interest margin (1)	**1.53%**	**1.54%**	**1.40%**	**1.50%**

(1) *Calculated as the total of the following, expressed as an annualized percentage of the total agency MBS weighted average cost basis for the period: GAAP interest income from agency MBS, plus TBA dollar roll income, less agency MBS repurchase agreement interest expense, less interest rate swap net interest expense.*

Source: Company Reports; Stonegate Capital Partners

Additionally, we note that Arlington publishes a sensitivity analysis for changes in book value for given changes in interest rates, which we illustrate in Exhibit 9.

Exhibit 9: Interest Rate Sensitivity Analysis

Interest Rate Sensitivity as of March 31, 2018 (3)

	-100 bps	-50 bps	As of 3/31/2018	+50 bps	+100 bps
Agency MBS (4)	$ 355,041	$ 379,976	$ 381,500	$ 364,603	$ 334,599
TBAs (5)	(15,755)	3,025	11,704	10,702	2,767
Other	(82,267)	(82,267)	(82,267)	(82,267)	(82,267)
Equity	$ 257,019	$ 300,734	$ 310,937	$ 293,038	$ 255,099

Interest Rate Sensitivity as of March 31, 2018 (3) - Percentage Change

	-100 bps	-50 bps	+/-0 bps	+50 bps	+100 bps
Agency MBS (4)	-8.5%	-0.5%	-	-5.4%	-15.1%
TBAs (5)	-8.8%	-2.8%	-	-0.3%	-2.9%
Other	-	-	-	-	-
Equity	-17.3%	-3.3%	-	-5.8%	-18.0%

(3) *Interest rate sensitivity of agency MBS and TBA commitments is derived from The Yield Book, a third-party model. Actual results could differ significantly from these estimates. Interest rate sensitivity is based on assumptions resulting in certain limitations, including (i) an instantaneous shift in rates with no changes to the slope of the yield curve, (ii) no changes in agency MBS spreads, (iii) no changes to the investment or hedge portfolio, and (iv) no changes to the deferred tax asset.*
(4) *Reflects agency MBS and associated repurchase agreements, interest receivable, interest payable on repurchase agreements, interest rate swaps and associated initial margin.*
(5) *Reflects TBA commitments, U.S. Treasury note futures, and initial margin posted in respect of U.S. Treasury note futures.*

Source: Company Reports; Stonegate Capital Partners

Lastly, the Company also publishes a sensitivity analysis for spread risk changes to book value.

Exhibit 10: Spread Risk Sensitivity Analysis

Agency MBS Spread Sensitivity as of March 31, 2018 [1]					
	-25 bps	-10 bps	As of 3/31/2018	+10 bps	+25 bps
Agency MBS [2]	$ 437,101	$ 403,740	$ 381,500	$ 359,260	$ 325,899
TBAs [3]	31,202	19,503	11,704	3,905	(7,794)
Other	(82,267)	(82,267)	(82,267)	(82,267)	(82,267)
Equity	$ 386,036	$ 340,976	$ 310,937	$ 280,898	$ 235,838

Agency MBS Spread Sensitivity as of March 31, 2018 [1] - Percentage Change					
	-25 bps	-10 bps	+/-0 bps	+10 bps	+25 bps
Agency MBS [2]	17.9%	7.2%	-	-7.2%	-17.9%
TBAs [3]	6.3%	2.5%	-	-2.5%	-6.3%
Other	-	-	-	-	-
Equity	24.2%	9.7%	-	-9.7%	-24.2%

(1) Agency MBS spread sensitivity is derived from The Yield Book, a third-party model. Actual results could differ significantly from these estimates. The estimated change in book value reflects an assumed spread weighted average duration of 5.6 years, which is a model-based assumption that is dependent upon the size and composition of our portfolio as well as economic conditions present as of March 31, 2018. The agency MBS spread sensitivity is based on assumptions resulting in certain limitations, including (i) no changes in interest rates, (ii) no changes to the investment or hedge portfolio, and (iii) no changes to the deferred tax asset.

(2) Reflects agency MBS and associated repurchase agreements, interest receivable, interest payable on repurchase agreements, interest rate swaps and associated initial margin.

(3) Reflects TBA commitments, U.S. Treasury note futures, and initial margin posted in respect of U.S. Treasury note futures.

Source: Company Reports; Stonegate Capital Partners

Arlington most recently announced the Q218 dividend of $0.375 per share, a reduction from its $0.55 per share dividend reported for the last several quarters.

MARKET TRENDS AND OUTLOOK

As summarized on the most recent earnings call, following a year of relatively low volatility in 2017, Q118 saw a sharp reversal of that trend with rising interest rates and weakened equity markets. In March 2018, the Federal Reserve raised the target federal funds rate by 25 basis points, notably the 5th increase in a 15-month period. The Fed continues to affirm its commitment to its previously announced balance sheet normalization policy, and further gradual increases in the target federal funds rate. Given this, it appears that the fed funds futures prices are indicating that the Fed will raise rates 2x – 3x during 2018.

Also during Q118, the US treasury rate rose 33 basis points, ending at 2.74%, with the treasury rate curve flattening as the spread between the 2-year and 10-year US treasury rate narrowed 5 basis points, with the short end outpacing the long end of the curve. And while interest rates rose modestly and the curve flattened in the most recent quarter, sentiment in early 2018 continues to be that agency spreads could widen further the upcoming year due to an increase in the net supply of agency MBS under the Fed's quantitative tightening policy. Already in this 2018 year, with volatility increased and rising treasury rates widening the agency MBS spread, longer duration investment portfolios are being penalized, again a reversal of last year's trend.

As a whole, prepayment rates in the residential mortgage market were lower than Q417, with mortgage rates rising and typical seasonal patterns, and prepayment rates are expected to remain moderate in the near-term. Notably, that marks 4 sequential months of prepayment reductions.

Lastly, in Q118, the funding dynamics for repo financing improved, especially in March 2018 as the spread between 3-month LIBOR (rose 62 basis points) and repo rates (generally only rose in correlation with the 25 basis points federal funds rate increase) widened, thus reducing the net funding cost of repo financing hedged with interest rate swaps.

We note that the Mortgage Bankers Association (MBA) also projects a somewhat flat yield curve in FY18, as can be seen in Exhibit 11.

Exhibit 11: MBA Economic Forecast

MBA Mortgage Finance Forecast

April 24, 2018

	2017				2018				2019							
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2017	2018	2019	2020
Housing Measures																
Housing Starts (SAAR, Thous)	1,238	1,167	1,172	1,256	1,318	1,310	1,300	1,325	1,340	1,370	1,390	1,405	1,208	1,313	1,376	1,451
Single-Family	839	825	848	893	889	910	920	935	950	980	1,000	1,015	851	914	986	1,065
Two or More	399	342	324	362	429	400	380	390	390	390	390	390	357	400	390	386
Home Sales (SAAR, Thous)																
Total Existing Homes	5,620	5,563	5,393	5,593	5,507	5,636	5,746	5,748	5,705	5,771	5,831	5,858	5,542	5,659	5,791	5,991
New Homes	617	605	587	660	668	642	650	655	652	664	672	678	617	654	666	699
FHFA US House Price Index (YOY % Change)	5.7	6.4	6.4	6.2	5.9	5.6	5.3	4.9	4.6	4.2	3.9	3.6	5.8	5.4	4.1	3.1
Median Price of Total Existing Homes (Thous $)	230.7	253.6	252.9	246.6	244.1	254.0	254.2	250.8	255.7	260.6	261.4	258.5	245.9	250.8	259.1	265.7
Median Price of New Homes (Thous $)	311.6	316.6	322.9	333.1	329.1	330.8	332.8	329.4	335.9	342.3	343.9	340.4	321.1	330.5	340.6	348.8
Interest Rates																
30-Year Fixed Rate Mortgage (%)	4.2	4.0	3.9	3.9	4.3	4.6	4.8	4.9	5.1	5.3	5.4	5.4	3.9	4.9	5.4	5.4
10-Year Treasury Yield (%)	2.4	2.3	2.2	2.4	2.8	3.0	3.1	3.2	3.3	3.4	3.5	3.5	2.4	3.2	3.5	3.5
Mortgage Originations																
Total 1- to 4-Family (Bil $)	361	463	471	415	346	445	450	370	355	465	460	365	1,710	1,611	1,645	1,712
Purchase	212	316	320	262	218	330	350	270	255	365	360	270	1,110	1,168	1,250	1,317
Refinance	149	147	151	153	128	115	100	100	100	100	100	95	600	443	395	395
Refinance Share (%)	41	32	32	37	37	26	22	27	28	22	22	26	35	27	24	23
Mortgage Debt Outstanding																
1- to 4-Family (Bil $)	9,770	9,840	9,930	10,010	10,090	10,180	10,280	10,370	10,460	10,560	10,670	10,760	10,010	10,370	10,760	11,130

Source: Mortgage Bankers Association

VALUATION

We are using a comparison analysis to value Arlington Asset Investment Corp. Our comparison companies include other mortgage REITS that primarily invest in agency mortgage backed securities.

COMPARATIVE COMPANY ANALYSIS

					MRQ			EPS (3)			P/E						
Name	Ticker	Price (1)	S/O	Mrkt Cap	Assets	BV/sh	TBV/sh (2)	2016	2017	2018E	2017	2018E	P/BV	P/TBV	Annual Dividend (4)	Dividend Yield (%)	Leverage Ratio (5)
Annaly Capital Management, Inc.	NLY	$ 10.29	1,159.7	$ 11,933.3	100,382	$ 10.53	$ 10.45	$ 1.39	$ 1.37	$ 1.99	7.5x	5.2x	0.98x	0.98x	$ 1.20	11.7%	5.6x
AGNC Investment Corp.	AGNC	$ 18.59	427.4	$ 7,945.4	69,221	$ 20.07	$ 18.67	$ 1.79	$ 2.04	$ 2.59	9.1x	7.2x	0.93x	1.00x	$ 2.16	11.6%	5.4x
Two Harbors Investment Corp.	TWO	$ 15.80	175.5	$ 2,772.9	24,077	$ 15.76	$ 15.76	$ 2.02	$ 1.81	$ 3.17	8.7x	5.0x	1.00x	1.00x	$ 1.88	11.9%	5.5x
Capstead Mortgage Corporation	CMO	$ 8.95	92.4	$ 827.0	13,293	$ 10.18	$ 10.18	$ 0.70	$ 0.65	$ 0.61	13.8x	14.7x	0.88x	0.88x	$ 0.64	7.2%	10.0x
Anworth Mortgage Asset Corporation	ANH	$ 4.97	98.3	$ 488.6	5,581	$ 5.51	$ 5.51	$ 0.17	$ 0.47	$ 0.34	10.6x	14.6x	0.90x	0.90x	$ 0.60	12.1%	6.5x
Orchid Island Capital, Inc.	ORC	$ 7.52	52.0	$ 391.0	4,123	$ 8.09	$ 8.09	$ 0.08	$ 0.05	$ 0.77	150.4x	9.8x	0.93x	0.93x	$ 1.24	16.5%	8.4x
Ellington Residential Mortgage REIT	EARN	$ 10.90	12.7	$ 138.4	1,847	$ 13.90	$ 13.90	$ 1.31	$ 0.93	$ 0.61	11.7x	17.9x	0.78x	0.78x	$ 1.48	13.6%	8.9x
							Average	**$ 1.07**	**$ 1.05**	**$ 1.44**	**30.3x**	**10.6x**	**0.91x**	**0.93x**		**12.1%**	**7.2x**
							Median	**$ 1.31**	**$ 0.93**	**$ 0.77**	**10.6x**	**9.8x**	**0.93x**	**0.93x**		**11.9%**	**6.5x**
Arlington Asset Investment Corp.	**AI**	**$10.31**	**28.1**	**$ 290.1**	**4,461**	**$ 11.03**	**$ 11.65**	**$ 2.75**	**$ 2.26**	**$ 2.32**	**4.6x**	**4.4x**	**0.93x**	**0.88x**	**$ 1.50**	**14.5%**	**11.2x**

(1) Previous day's closing price

(2) TBV is calculated as Common Equity less intangible assets less deferred tax assets

(3) Estimates are from CapitalIQ except for AI which are Stonegate estimates

(4) Dividend is the MRQ dividend annualized

(5) Leverage ratio is st debt or portfolio debt to common equity

Source: Company Reports, Capital IQ, Stonegate Capital Partners

Price / Book

As seen above, Arlington Asset Investment Corp. is trading a P/TBV 0.88x and has a dividend yield of 14.5%. Considering current and historical trading ranges of comps and AI, as well historical industry multiples, we believe using a P/TBV multiple range of 0.80x to 1.20x is reasonable. Therefore, using the 0.80x to 1.20x P/TBV range, we arrive at a valuation range of ~$9.32 to ~$13.98 with a mid-point of ~$11.65.

Price / Earnings

Based on our FY18 EPS estimate, Arlington is trading a P/E ratio of 4.4x vs. median comparables at 9.8x. Considering current and 3-year historical trading ranges of AI and comps, we believe using a P /E multiple range of 4.0x to 8.0x is reasonable. Using the range on our FY18 EPS estimate, we arrive at a valuation range of ~$9.28 to ~$18.56 with a mid-point of ~$13.92.

Dividend Yield

Currently, Arlington Asset Investment Corp. is trading a dividend yield of 14.5% vs. median comps at 11.9%. Most mortgage REITs typically trade on dividend yield expectations. The higher yield may indicate that investors are concerned with Arlington's dividend. We note that our FY18 core EPS of $2.32 supports the current annual dividend estimate of $1.68.

Precedent Transactions

We note that two significant agreements have been recently announced affecting our comps analysis. In April 2018, Two Harbors Investment Corp. announced a definitive agreement to acquire CYS Investments, Inc. Per current disclosures, CYS shareholders are receiving a P/BV of ~1.05x. We also note that the transaction includes a P/E valuation of ~9.5x for CYS investors.

Also, in May 2018, Annaly Capital Management, Inc. announced its intention to acquire MTGE Investment Corp., with shareholders receiving ~1.0x P/BV; however, once transaction fees and termination fees (to MGTE's manager) are paid on the deal, Annaly will be paying closer to a ~1.07x MTGE's book value. We also note that this transaction includes an approximate 14.7x P/E multiple.

Both transactions further demonstrate the discount at which Arlington currently trades relative to peer valuations.

INCOME STATEMENT

Arlington Asset Investment Corp. (NYSE: AI)
Consolidated Statements of Income (in thousands $, except per share amounts)
Fiscal Year: December

	FY 2015	FY 2016	FY 2017	FY 2018E
Interest Income				
Agency mortgage-backed securities	$ 105,914	$ 97,053	$ 120,968	$ 122,460
Private label mortgage backed securities	15,342	7,910	101	-
Other	7	373	179	250
Total Interest Income	**121,263**	**105,336**	**121,248**	**122,710**
Interest Expense				
Short-term debt	14,701	24,433	46,648	61,200
Long-term debt	4,188	4,789	4,866	4,876
Total Interest Expense	**18,889**	**29,222**	**51,514**	**66,076**
Net Interest Income	**102,374**	**76,114**	**69,734**	**56,634**
Investment loss, net				
Realized gain on sale of AFS, net	17,725	4,777	-	-
Other-than-temporary impairment charges	(2,417)	(1,737)	-	-
(Loss) gain on trading investments, net	(31,058)	(41,249)	2,424	(88,343)
Loss from derivative instruments, net	(104,743)	(31,660)	3,224	40,154
Other, net	2,064	551	226	50
Total investment loss, net	**(118,429)**	**(69,318)**	**5,874**	**(48,139)**
General and administrative expenses				
Compensation and benefits	9,719	11,526	13,203	13,000
Other general and administrative expenses	5,068	9,230	5,367	5,300
Total general and administrative expenses	**14,787**	**20,756**	**18,570**	**18,300**
(Loss) income before income taxes	**(30,842)**	**(13,960)**	**57,038**	**(9,805)**
Income tax provision (benefit)	38,561	27,387	39,603	25,000
Preferred stock dividend	-	-	251	498
Net (loss) income	**$ (69,403)**	**$ (41,347)**	**$ 17,184**	**$ (35,303)**
Basic EPS - GAAP	**$ (3.02)**	**$ (1.79)**	**$ 0.67**	**$ (1.24)**
Diluted EPS - GAAP	**$ (3.02)**	**$ (1.79)**	**$ 0.66**	**$ (1.24)**
Weighted average shares outstanding				
Basic	23,002	23,051	25,649	28,500
Diluted	23,002	23,051	26,011	28,500
Core Operating Income				
GAAP net interest income	102,374	76,114	69,734	56,634
TBA dollar roll income	6,743	19,261	21,291	26,866
Interest rate swap net interest expense	(1,282)	(17,825)	(17,334)	(1,710)
Economic net interest income	107,835	77,550	73,691	81,790
Core general and administrative expense	13,642	13,802	14,644	15,168
Preferred stock dividend	-	-	251	498
Core operating income	**$ 94,193**	**$ 63,748**	**$ 58,796**	**$ 66,124**
Core operating income/share	**$ 4.09**	**$ 2.75**	**$ 2.26**	**$ 2.32**
Weighted average diluted shares outstanding	23,088	23,202	26,011	28,500
Dividend per share	**$ 3.00**	**$ 2.50**	**$ 2.28**	**$ 1.68**

BALANCE SHEETS

Arlington Asset Investment Corp. (NYSE: AI)
Consolidated Balance Sheets (in thousands $, except per share amounts)
Fiscal Year: December

	FY 2015	FY 2016	FY 2017	Q1 FY18
Assets				
Cash and cash equivalents	$ 36,987	$ 54,794	$ 21,614	$ 15,219
Interest receivables	11,936	11,646	12,546	12,662
Sold securities receivable	-	-	-	447,102
Mortgage-backed securities, at fair value agency				
Agency	3,865,316	3,911,375	4,054,424	3,907,018
Private label	130,553	1,266	76	75
Derivative assets, at fair value	12,991	74,889	763	5,024
Deferred tax asset-net	72,927	48,829	800	-
Deposits	29,429	11,149	59,103	57,624
Other assets	18,197	3,003	11,203	15,795
Total Assets	**$ 4,178,336**	**$ 4,116,951**	**$ 4,160,529**	**$ 4,460,519**
Liabilities				
Repurchase agreements	$ 2,834,780	$ 3,649,102	$ 3,667,181	$ 3,583,358
Federal home loan bank advances	786,900	-	-	-
Interest payable	2,436	3,434	4,418	3,484
Accrued compensation and benefits	5,170	5,406	5,015	1,622
Dividend payable	14,504	15,739	17,550	17,836
Derivative liabilities, at fair value	553	9,554	4,833	2,039
Purchased securities payable	-	-	-	440,563
Deferred tax liabilities, net	-	-	-	17,518
Other liabilities	1,132	1,247	1,335	1,158
Long-term debt	73,433	73,656	73,880	73,936
Total Liabilities	**3,718,908**	**3,758,138**	**3,774,212**	**4,141,514**
Shareholders' Equity				
Preferred stock	-	-	7,108	7,567
Class A common stock - par value	229	236	281	281
Class B common stock - par value	1	-	-	-
Additional paid in capital	1,898,085	1,910,284	1,974,941	1,975,369
Accumulated other comprehensive income	12,371	-	-	-
Accumulated deficit/retained earnings	(1,451,258)	(1,551,707)	(1,596,013)	(1,664,212)
Total Shareholders Equity	**459,428**	**358,813**	**386,317**	**319,005**
Total Liabilities & Shareholders Equity	**$ 4,178,336**	**$ 4,116,951**	**$ 4,160,529**	**$ 4,460,519**
Book value per common share	$ 20.00	$ 15.19	$ 13.43	$ 11.03
Tangible book value per common share	$ 16.82	$ 13.12	$ 13.40	$ 11.65

RECENT EVENTS

June 14, 2018 – Arlington declares $0.375 dividend per common share for Q218

May 15, 2018 – Arlington declares a dividend of $0.4375 per share on its series B preferred stock for Q218.

May 2, 2018 – Arlington reports financial results for first quarter of 2018

March 15, 2018 – Arlington declares $0.55 dividend per common share for Q118

February 15, 2018 – Arlington declares a dividend of $0.4375 per share on its series B preferred stock for Q118.

February 6, 2018 – Arlington report fourth quarter and full year 2017 results.

December 14, 2017 - Arlington declares $0.55 per common share dividend for fourth quarter of 2017.

November 30, 2017 - Arlington declares dividend on its series B preferred stock for the fourth quarter of 2-17.

October 24, 2017 - Arlington reports third quarter 2017 financial results.

September 14, 2017 - Arlington declares $0.55 per common share dividend for the third quarter of 2017.

September 6, 2017 - Arlington declares dividend on its series B preferred stock for the third quarter 2017.

July 24, 2017 - Arlington reports second quarter 2017 financial results.

June 16, 2017 - Arlington declares $0.55 per common share dividend for the second quarter of 2017.

June 7, 2017 - Arlington declares initial dividend on its series B preferred stock.

April 25, 2017 - Arlington reports first quarter 2017 financial results.

March 14, 2017 - Arlington declares $0.625 per share dividend for the first quarter of 2017.

CORPORATE GOVERNANCE

Eric F. Billings, Executive Chairman – Mr. Billings co-founded the company in 1989, and established the company's principal investing unit as FBR Asset Investment Corp. in 1997. Mr. Billings served as Chairman of FBR & Co., a publicly-traded investment banking, institutional brokerage and asset management firm, a position he held since its formation in 2006 until his retirement in 2012. From 2006 to 2008, Mr. Billings also served as the Chief Executive Officer of FBR & Co. In addition, he concurrently holds the position of Senior Managing Partner and Co-Portfolio Manager of Billings Capital Management, LLC, an investment management company he runs with his sons. Mr. Billings began his 30-year investment career at Legg Mason, Inc. as an investment analyst and salesperson in the Institutional Brokerage division. In 1983 he joined Johnston Lemon Corp. where he built and managed their Washington, DC institutional brokerage group until 1989. He was born in Boston, MA and is a graduate of the University of Maryland with a B.A. in Economics and Finance.

J. Rock Tonkel, Jr., President, CEO, - Prior to his current position, he was the company's President and COO, a position he held since 2007. Prior to 2007, he was President and Head of Investment Banking at FBR Capital Markets & Co. Mr. Tonkel joined FBR Capital Markets & Co. in 1994 as Head of Investment Banking's Financial Institutions Group. Prior to joining FBR Capital Markets & Co., Mr. Tonkel served as Special Assistant to the Director of the Office of Thrift Supervision, the regulatory agency for the savings and loan industry. At the Office of Thrift Supervision, Mr. Tonkel oversaw the restructuring of many of the nation's largest troubled thrifts and savings banks. Mr. Tonkel received his Bachelor of Arts degree in economics from Amherst College.

Richard Konzmann, EVP, CFO – Prior to joining the Company in March 2015, Mr. Konzmann was employed by American Capital, Ltd., a publicly traded private equity firm and global asset manager, from 2002 until March 2015. In 2006, he became Senior Vice President, Accounting of American Capital, Ltd. where he was responsible for all accounting, financial reporting, loan servicing and tax compliance for the alternative asset management company and its funds under management, including publicly traded mortgage real estate investment trusts, publicly traded business development companies and private equity funds. Prior to joining American Capital, Ltd., Mr. Konzmann served in various controllership, finance and asset management roles with Crestline Capital Corporation and Host Marriott Corporation and began his career with the public accounting firm Deloitte and Touche LLP. Mr. Konzmann graduated from Pennsylvania State University with a Bachelor of Science in Accounting and is a Certified Public Accountant and Certified Valuation Analyst.

Brian J. Bowers, CIO, Portfolio Manager– Mr. Bowers is responsible for the principal investing activities of the firm's portfolio, overseeing the daily investing operations and the direction of the portfolio. Mr. Bowers joined the Company in 2000, and has over 20 years of fixed income experience, portfolio analysis and management. Previously, he was the Chief Portfolio Strategies for BB&T Capital Markets and the Portfolio Manager/Plan Sponsor of CareFirst, Inc. Mr. Bowers earned a Bachelor of Science in Finance from the University of Maryland and an M.B.A. from Loyola College.

Board of Directors:

Eric F. Billings – *Executive Chairman*

Anthony P. Nader, III - *Director*

Daniel J. Altobello – *Director*

Daniel E. Berce – *Director*

David W. Faeder – *Director*

J. Rock Tonkel, Jr. – *Director*

Peter A. Gallagher – *Director*

Ralph S. Michael, III – *Director*

KEY TERMS AND METRICS

Net interest income – This represents "revenue" and is the difference between the income generated from interest bearing assets less the financing costs associated with acquiring the assets.

Net interest margin – Measurement that represents how successful a firm is at investing its capital in comparison to the total amount of capital employed. It is calculated as net interest income divided by earning assets.

Economic net interest income – This is a non-GAAP financial measure. Arlington calculates the figure as GAAP net interest income plus TBA dollar roll income less net interest expenses from interest rate swap agreements.

Core operating income / EPS - Core EPS or core operating income is a non-GAAP figure that often excludes "non-core" items such as gains and losses from investments. Arlington calculates core operating income as economic net interest income less core G&A expenses. Core G&A expenses typically exclude stock option expense. Management uses this figure to evaluate the performance of the investment strategy and core business over time.

Book value – Book value is calculated as total equity less preferred stock.

Tangible book value – Mortgage REITS or other mortgage investing entities calculate tangible book value as book value less deferred tax asset.

Mortgage Backed Security (MBS) – A MBS is a type of asset backed bond that is secured by a mortgage or pool of mortgages. These mortgages are sold to entities that "package" the loans together into a security for investors to buy. The investor in a MBS security receives interest and principal payments that are "passed-through" when borrowers pay their mortgages.

Agency MBS – An agency MBS is issued by a government entity or government sponsored entity such as Federal National Mortgage (Fannie Mae or FNMA), Federal Home Loan Mortgage Corp. (Freddie Mac) and/or Government National Mortgage Association (Ginnie Mae or GNMA). GNMAs are backed by the full faith and credit of the US government. FNMA and Freddie Mac securities offer an implicit guarantee from the US Government. What this means is that investors believe that should something happen to FNMA or Freddie Mac, the US government would act and guarantee these securities. As the guarantee is "implicit" and not a direct guarantee of the US government, the securities offer higher yields than treasury securities.

Private label MBS – Private label MBS or non-agency MBS are mortgage backed securities that are issued by private entities such as a financial institution. Private label MBS have a higher credit risk than agency MBS as private label MBS are guaranteed by the private entity. As a result, private label MBS will typically offer a higher yield to compensate for higher risk.

TBA security – A TBA (to-be-announced) is a forward contract for the purchase or sale of a MBS security with predetermined features such as: (1) price, (2) face amount, (3) issuer, (4) coupon, and (5) stated maturity. However, the specific agency securities to be delivered against the forward contract are not identified until shortly before the settlement date. The Federal Reserve estimates that over 90% of MBS trading occurs in the TBA market.

TBA dollar roll – This is a form of short-term financing using the TBA market. A dollar roll transaction combines the sale of a TBA with current month settlement with a simultaneous purchase of a similar TBA with settlement in the next month. The purchase price is normally lower than the sale price and is referred to as dollar roll or drop. This dollar roll or price drop is the implied net interest income earned from TBA dollar roll transactions.

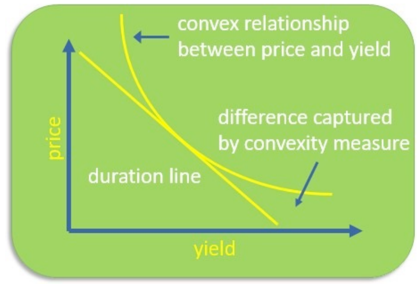
Interest rate swap – This is an agreement between two counterparties where one stream of future interest payments is swapped in exchange for another based on a specific principal amount (notional amount). Interest rate swaps typically involve the exchange of a variable interest rate for a fixed interest rate or vice versa. Entities enter into swaps to help reduce or increase exposure to fluctuations in interest rates.

Notional amount – The notional amount is the total value of a contract or financial instrument that is used to calculate payments made on that contract or financial instrument. The amount used does not change.

Repurchase agreement - This is a form of short-term borrowing and is also known as a repo. In a repo, one party sells a security (aka collateral) to another party in exchange for cash and a promise to repurchase the exact same security in the future. The cash received will typically have a "hair-cut" to the actual value of the security being sold. The size of the haircut is dependent on the collateral and the perceived risk of the collateral falling in value.

Constant prepayment rate (CPR) - This measure is an annualized estimate of mortgage prepayments that is expected over the next year. The measurement helps model the risk of prepayments. A CPR of 10% means that 10% of the MBS pool of loans is likely to prepay in the next year.

Duration – Duration is a measure of the sensitivity of the price of a bond to a change in interest rates. Duration is measured in years and is a linear measure. The higher the duration number, the larger the potential the swing in the price of the bond. For example, if a bond has a duration of 8.0, then this means if interest rates drop by 1.0%, the price of the bond will increase 8.0%. While duration is a linear measure, the actual changes to the bond price is unlikely to change in a linear manner.



Convexity – Convexity measures the curvature of a bond price and yield relationship. It is a “second derivative”, which essentially means it measures the rate of change in change. While duration is a linear measure, convexity is a non-linear measure and when used along with duration, helps investors better understand an approximate change in bond price given the change in interest rates. The higher the convexity of a bond, the more sensitive it is to interest rate fluctuations.

Prepayment risk – This is the risk that borrowers will repay a loan before its maturity. While this provides higher payments that are passed through to the investors of mortgage backed securities, it also presents a risk. First, prepayments are generally higher when interest rates are dropping as borrowers are more apt to refinance and the volume of home sales/purchases is likely to increase as well. As a result, the owner of a MBS will receive more income that will likely need to be reinvested at lower interest rates. Additionally, GAAP requires investors to amortize premium and/or discounts paid for MBS into the income statement over time. The amortization of a premium reduces net income. Therefore, if prepayments accelerate, net income will experience pressure.

Interest rate risk – Bond values move inversely to interest rate changes. Thus, if interest rates increase, bond prices decline and vice versa. How sensitive a bond is to fluctuating interest rates is dependent on numerous factors such the maturity date of the bond and the coupon rate.

Spread risk – This is also referred to as basis risk and is the risk of an increase in the spread between US treasury bonds and a debt security (i.e. MBS) with similar maturity. When spreads increase, this is typically a sign that investors are demanding a higher risk premium vs. risk free securities. As such a widening of spreads could send MBS securities down in value.

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