CAPSTEAD

1998 ANNUAL REPORT

Stockholders' Letter

1

Report of Independent Auditors

3

Consolidated Statement of Operations

4

Consolidated Balance Sheet

5

Consolidated Statement of Stockholders' Equity

6

Consolidated Statement of Cash Flows

7

Notes to Consolidated Financial Statements

8

Selected Financial Data

29

Management's Discussion and Analysis

30

Directors

43

Officers

44

STOCKHOLDERS' LETTER

The decline and volatility of long-term interest rates in 1998 created one of the most difficult times for financing mortgage security investments in decades. For reasons that even now are not entirely clear, the market for certain mortgage assets owned by Capstead became very illiquid and the financing for these investments difficult. In addition, interest rate hedges that had been productive for years did not always perform as expected, particularly in the second quarter. This under-performance of the interest rate hedges contributed to the loss on the sale of the Company's investment in interest-only mortgage securities and the deteriorating performance of the mortgage servicing portfolio.

In the late summer and early fall of 1998, long-term interest rates declined dramatically and severe dislocations occurred in the stock market and financial markets for certain fixed-income securities. A number of commercial banks and investment banking firms suffered sizable trading losses. A larger number of specialty real estate finance companies suffered comparable losses to the Company's and several have entered bankruptcy. Some hedge funds investing in mortgage securities, other fixed-income securities and derivative securities suffered severe losses. The Federal Reserve, fearing a collapse and meltdown in the financial markets, engineered a bailout of the largest of the hedge funds.

The prospect of continuing declines in mortgage interest rates and further increases in homeowner prepayments, and the failure of our interest rate hedges to perform as expected, led us to make a number of very painful decisions. Faced with these most extraordinary circumstances, in June the Company sold a $1.0 billion investment in interest-only mortgage securities at a loss of $252 million. Also during the second quarter, we took an impairment charge of $45 million on the mortgage servicing portfolio.

Faced with a significant reduction in capital as a result of these losses and increasing challenges in financing our mortgage investments, we began reducing the Company's mortgage investment portfolios, which consisted primarily of Fannie Mae, Freddie Mac or Ginnie Mae mortgage-backed securities ("Agency Securities"). From a peak investment of $7.5 billion in May, these portfolios were reduced to $2.4 billion at December 31, 1998, a reduction of $5.1 billion. Related short-term indebtedness, which peaked at $7.4 billion in May, declined to $1.8 billion at year-end. The very substantial reduction in Agency Securities and the retirement of related indebtedness is a testament of the liquidity of Agency Securities despite an illiquid market.

In the third quarter, we began considering that it may be prudent to sell the mortgage banking operations. This despite the introduction of a profitable refinance center which captured a sizable number of our homeowners' refinancings and the exceptional third quarter performance of increased holdings of U.S. Treasury-based interest rate hedges. In the third quarter $146 million of gains on hedges were recorded, more than offsetting an additional $144 million decline in value of the mortgage servicing portfolio. Unfortunately, the prepayment risk associated with the mortgage servicing portfolio, the volatility of U.S. Treasury-based hedges and the diminished prospect of securing financing to grow the mortgage servicing portfolio were deemed too great of an ongoing risk to the stability of the Company given the difficult market conditions.

In December the Company closed the sale of its mortgage banking operations to two affiliates of GMAC Mortgage Group, Inc., which is a wholly-owned subsidiary of General Motors Acceptance Corporation. The sale of the mortgage banking operations generated more than $500 million in cash after the retirement of directly related indebtedness and transaction costs. In addition, this transaction produced a small gain of $2.9 million after providing for reserves for possible indemnities.

The damage to Capstead of all that occurred in 1998 was substantial. The Company incurred a net loss of $235 million, or $4.22 per share. After paying common stock dividends of 50 cents per share in each of the first and second quarters, the common stock dividend was eliminated in the third quarter. Stockholders' equity declined from $889 million to $680 million and book value per share declined from $11.42 to $7.56. The Company's common stock price of $20.00 on January 1, 1998 ended the year at $4.125.

In the face of difficult challenges in 1998, we did what we thought was necessary to maintain the viability of the Company and its value to stockholders. Robert Rubin, Secretary of the U.S. Treasury, described the period as the "worst financial crisis in 50 years." A number of specialty finance companies and financial institutions incurred large losses and several failed. Nevertheless, Capstead did not perform at the level of the first twelve years of our existence.

However, we ended the year with $680 million of stockholders' equity and, with the completion of the sale of the mortgage banking operations, significant liquidity. Short-term indebtedness was only $1.8 billion at year-end compared to $7.1 billion on January 1, 1998. We substantially reduced our exposure to increasing homeowner prepayments through the sale of interest-only mortgage securities and our mortgage servicing portfolio. Our remaining mortgage investments at year-end were virtually all Agency Securities.

In the early months of 1999, we employed a portion of the Company's cash liquidity to increase our portfolios of Agency Securities. Although Agency Securities have no foreclosure risk, the Company is subject to reduced net interest margins in periods of rising short-term interest rates or increasing prepayment rates. In addition, we are evaluating a number of opportunities to acquire or make strategic investments in a variety of real estate-related investments and entities. Also, we have continued to repurchase shares of Capstead common stock and $1.26 Cumulative Convertible Preferred Stock, Series B, in the open market. During the first quarter of 1999, the Company repurchased 1,759,600 shares of its common stock at an average price of $5.09 and 118,600 shares of its Series B Preferred at an average price of $11.99. As our common stock continues to sell well below book value per share of $7.56, such repurchases may continue, subject to the price of our securities and alternative investment opportunities. Acquiring common stock at prices below book value results in a modest increase in book value and net income per share, which in turn benefits our stockholders.

We have announced that we expect to resume the payment of a quarterly common stock dividend after first quarter operating results are available on April 22, 1999.

As we progress into 1999, we may well conclude that it is prudent to substantially limit the Company's activities to investing in Agency Securities. We believe we can generate adequate but not exceptional returns from these investments over a period of time.

These have been difficult times for you, our stockholders. Better times are ahead. We look forward to much improved results in 1999. Thank you for your continuing investment and support.

Sincerely,

Ronn K. Lytle
Chairman and Chief Executive Officer

April 7, 1999

REPORT OF INDEPENDENT AUDITORS

Stockholders and Board of Directors
Capstead Mortgage Corporation

We have audited the accompanying consolidated balance sheet of Capstead Mortgage Corporation and subsidiaries as of December 31, 1998 and 1997, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Capstead Mortgage Corporation and subsidiaries at December 31, 1998 and 1997, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 1998, in conformity with generally accepted accounting principles.

ERNST & YOUNG LLP

Dallas, Texas
February 4, 1999

CONSOLIDATED STATEMENT OF OPERATIONS

(In thousands, except per share amounts)

	Year Ended December 31		
	1998	*1997*	*1996*
Interest income:			
Mortgage securities and other investments	$ 311,807	$339,980	$303,212
CMO collateral and investments	355,391	354,279	359,752
Total interest income	667,198	694,259	662,964
Interest and related expense:			
Short-term borrowings:			
Mortgage securities and other investments	291,125	300,391	255,481
CMO investments	22,733	29,244	12,044
Collateralized mortgage obligations	340,248	281,497	314,338
Mortgage insurance and other	5,469	5,155	7,743
Total interest and related expense	659,575	616,287	589,606
Net margin on mortgage assets and other investments	7,623	77,972	73,358
Mortgage banking revenue	206,089	172,916	130,553
Mortgage servicing expense:			
Servicing expense	28,679	25,889	20,187
Amortization and impairment of mortgage servicing rights and related expense	319,886	64,892	44,795
Gain on financial instruments held to offset the effects of impairment	(173,424)	–	–
Interest	19,127	22,713	16,449
Total mortgage servicing expense	194,268	113,494	81,431
Net margin on mortgage banking operations	11,821	59,422	49,122
Other operating revenue (expense):			
Gain (loss) on sale of mortgage assets and related derivative financial instruments	(245,261)	27,737	15,991
Impairment on CMO investments	(4,051)	–	–
CMO administration and other	4,598	4,000	3,730
Other operating expense	(9,494)	(9,205)	(14,973)
Total other operating revenue (expense)	(254,208)	22,532	4,748
Net income (loss)	$(234,764)	$159,926	$127,228
Net income (loss)	$(234,764)	$159,926	$127,228
Less cash dividends on preferred stock	(22,342)	(25,457)	(36,356)
Net income available (loss attributable) to common stockholders	$(257,106)	$134,469	$ 90,872
Net income (loss) per common share:			
Basic	$(4.22)	$2.62	$2.37
Diluted	(4.22)	2.35	2.07
Average number of common shares outstanding:			
Basic	60,948	51,257	38,317
Diluted	60,948	68,023	61,501

See accompanying notes to consolidated financial statements.

CONSOLIDATED BALANCE SHEET

(In thousands, except per share amounts)

	December 31	
	1998	*1997*
Assets		
Mortgage securities and other investments	$2,369,602	$ 6,114,130
CMO collateral and investments	4,571,274	5,195,436
	6,940,876	11,309,566
Mortgage servicing rights	–	669,062
Prepaids, receivables and other	59,526	361,510
Cash and cash equivalents	73,385	17,377
Restricted cash and cash equivalents	26,500	–
	$7,100,287	$12,357,515
Liabilities		
Short-term borrowings	$1,839,868	$ 7,099,706
Collateralized mortgage obligations	4,521,324	4,309,455
Accounts payable and accrued expenses	58,894	59,746
	6,420,086	11,468,907
Stockholders' Equity		
Preferred stock - $0.10 par value; 100,000 shares authorized:		
$1.60 Cumulative Preferred Stock, Series A, 374 and 408 shares issued and outstanding ($6,134 aggregate liquidation preference)	5,228	5,698
$1.26 Cumulative Convertible Preferred Stock, Series B, 17,298 and 17,081 shares issued and outstanding ($196,851 aggregate liquidation preference)	193,196	189,800
Common stock - $0.01 par value; 100,000 shares authorized; 60,546 and 58,541 shares issued and outstanding	605	585
Paid-in capital	787,677	732,295
Undistributed income (loss)	(305,287)	12,676
Accumulated other comprehensive income (loss)	(1,218)	(52,446)
	680,201	888,608
	$7,100,287	$12,357,515

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(In thousands, except per share amounts)

	Three Years Ended December 31, 1998					
	Preferred Stock	*Common Stock*	*Paid-in Capital*	*Undistributed Income (Loss)*	*Accumulated Other Comprehensive Income (Loss)*	*Total*
Balance at January 1, 1996	$337,750	$353	$321,222	$ (2,503)	$ 7,902	$ 664,724
Comprehensive income:						
Net income	–	–	–	127,228	–	127,228
Other comprehensive income (loss):						
Change in unrealized loss on debt securities, net of reclassification amount	–	–	–	–	(13,503)	(13,503)
Total comprehensive income						113,725
Cash dividends:						
Common ($2.11½ per share)	–	–	–	(83,787)	–	(83,787)
Preferred:						
Series A ($1.60 per share)	–	–	–	(804)	–	(804)
Series B ($1.26 per share)	–	–	–	(35,552)	–	(35,552)
Conversion of preferred stock	(80,490)	54	80,412	–	–	(24)
Additions to capital	9,136	40	59,411	–	–	68,587
Balance at December 31, 1996	266,396	447	461,045	4,582	(5,601)	726,869
Comprehensive income:						
Net income	–	–	–	159,926	–	159,926
Other comprehensive income (loss):						
Change in unrealized loss on debt securities, net of reclassification amount	–	–	–	–	(46,845)	(46,845)
Total comprehensive income						113,081
Cash dividends:						
Common ($2.40 per share)	–	–	–	(126,375)	–	(126,375)
Preferred:						
Series A ($1.60 per share)	–	–	–	(683)	–	(683)
Series B ($1.26 per share)	–	–	–	(24,774)	–	(24,774)
Conversion of preferred stock	(85,097)	57	85,040	–	–	–
Additions to capital	14,199	81	186,210	–	–	200,490
Balance at December 31, 1997	195,498	585	732,295	12,676	(52,446)	888,608
Comprehensive loss:						
Net loss	–	–	–	(234,764)	–	(234,764)
Other comprehensive income (loss):						
Change in unrealized loss on debt securities, net of reclassification amount	–	–	–	–	51,228	51,228
Total comprehensive loss						(183,536)
Cash dividends:						
Common ($1.00 per share)	–	–	–	(60,857)	–	(60,857)
Preferred:						
Series A ($1.60 per share)	–	–	–	(610)	–	(610)
Series B ($1.26 per share)	–	–	–	(21,732)	–	(21,732)
Conversion of preferred stock	(1,111)	1	1,110	–	–	–
Net additions to capital	4,037	19	54,272	–	–	58,328
Balance at December 31, 1998	$198,424	$605	$787,677	$(305,287)	$ (1,218)	$ 680,201

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENT OF CASH FLOWS

(In thousands)

	Year Ended December 31		
	1998	*1997*	*1996*
Operating activities:			
Net income (loss)	$ (234,764)	$ 159,926	$ 127,228
Noncash items:			
Impairment on CMO investments	4,051	–	–
Amortization and impairment of mortgage servicing rights and related costs	319,886	64,892	44,795
Amortization of discount and premium	134,693	114,603	61,520
Depreciation and other amortization	5,010	3,585	3,670
Gain on sale of financial instruments held to offset the effects of impairment of mortgage servicing rights	(173,424)	–	–
Gain on sale of mortgage servicing rights and mortgage banking operations	(2,877)	–	–
Loss (gain) on sale of mortgage assets and related derivative financial instruments	245,261	(27,737)	(15,991)
Net change in prepaids, receivables, other assets, accounts payable and accrued expenses	112,183	(26,994)	8,364
Net cash provided by operating activities	410,019	288,275	229,586
Investing activities:			
Purchases of mortgage securities and other investments	(4,797,684)	(4,467,187)	(1,813,735)
Purchases of CMO collateral and investments	(1,305,865)	(1,684,295)	(521,539)
Purchases of mortgage servicing rights	(106,498)	(139,997)	(251,505)
Purchases of derivative financial instruments	(78,396)	(112,417)	(49,301)
Principal collections on mortgage investments	2,112,469	1,459,956	975,640
Proceeds from sales of mortgage assets	6,924,038	2,020,450	730,807
Proceeds from sales and settlement of derivative financial instruments	239,481	34,191	6,782
Proceeds from sale of mortgage servicing rights and mortgage banking operations	582,772	–	–
CMO collateral:			
Principal collections	1,187,988	537,817	552,430
Decrease in accrued interest receivable	8,367	4,724	5,119
Decrease (increase) in short-term investments	721	(4,546)	13,650
Net cash provided (used) by investing activities	4,767,393	(2,351,304)	(351,652)
Financing activities:			
Increase (decrease) in short-term borrowings	(5,259,838)	1,636,850	834,074
Increase (decrease) in mortgage servicing acquisitions payable	(8,363)	(63,374)	23,899
Collateralized mortgage obligations:			
Issuances of securities	1,494,853	1,109,411	41,323
Principal payments on securities	(1,299,115)	(673,119)	(723,881)
Increase (decrease) in accrued interest payable	(11,977)	2,253	1,383
Capital stock transactions	46,235	199,214	67,712
Dividends paid	(83,199)	(151,832)	(120,143)
Net cash provided (used) by financing activities	(5,121,404)	2,059,403	124,367
Net change in cash and cash equivalents	56,008	(3,626)	2,301
Cash and cash equivalents at beginning of year	17,377	21,003	18,702
Cash and cash equivalents at end of year	$ 73,385	$ 17,377	$ 21,003

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1998

NOTE 1 ¾ BUSINESS

Capstead Mortgage Corporation, a mortgage investment firm, earns income from investing in mortgage assets on a leveraged basis and from other investment strategies. Declining long-term interest rates throughout much of 1998 kept long-term interest rates at or below short-term interest rates for most of the year. This unfavorable interest rate environment led to significantly higher mortgage prepayment rates, which negatively impacted yields and asset valuations on most of the Company's mortgage assets, particularly on the Company's mortgage servicing and interest-only mortgage-backed securities portfolios. These market conditions contributed to liquidity issues for the mortgage finance industry as the availability of financing diminished for all but the highest quality mortgage assets. In response to these market conditions, the Company reduced its mortgage asset portfolios, which included the disposition of a large portfolio of interest-only mortgage-backed securities at a substantial loss, and in December 1998 completed the sale of its mortgage banking operations for a modest gain (see NOTE 3 and 5).

The Company entered 1999 with substantial liquidity but diminished earning capacity. In early 1999, the Company began to increase holdings of high quality mortgage-backed securities and may continue to do so. The Company also announced a common and preferred stock repurchase program (see NOTE 10), and that it is evaluating a number of opportunities to acquire or make strategic investments in a variety of real estate-related investments and entities, although there can be no assurance that the Company will make any such investments.

NOTE 2 ¾ ACCOUNTING POLICIES

Principles of Consolidation

The consolidated financial statements include the accounts of Capstead Mortgage Corporation ("Capstead"), its special-purpose finance subsidiaries and certain other entities (collectively, the "Company"). Intercompany balances and transactions have been eliminated. Substantially all of the assets of the special-purpose finance subsidiaries are pledged to secure collateralized mortgage obligations ("CMOs") and are not available for the satisfaction of general claims of Capstead. Capstead has no responsibility for CMOs beyond the assets pledged as collateral.

Use of Estimates

The use of estimates is inherent in the preparation of financial statements in conformity with generally accepted accounting principles. The amortization of premiums and discounts on mortgage assets and CMOs, as well as the amortization of mortgage servicing rights (see NOTE 3), is based on estimates of future movements in interest rates and of how resulting

rates will impact prepayments on underlying mortgage loans. Actual results could differ from those estimates. As was the case in 1998, prepayments could rise to levels that could adversely affect profitability.

Mortgage Assets

Mortgage assets held in the form of mortgage-backed securities are debt securities. Management determines the appropriate classification of debt securities at the time of purchase and periodically reevaluates such designation. Debt securities are classified as held-to-maturity when the Company has the positive intent and ability to hold the securities to maturity. Held-to-maturity securities are stated at amortized cost. Debt securities not classified as held-to-maturity are classified as available-for-sale. Available-for-sale securities are stated at fair value with unrealized gains (losses) reported as a separate component of *Accumulated other comprehensive income (loss)* in stockholders' equity. Mortgage loans are carried at the lower of cost or market determined on an aggregate basis.

Interest income is recorded as income when earned. Any premium or discount is recognized as an adjustment to interest income by the interest method over the life of the related mortgage asset. Realized gains (losses) are included in *Other operating revenue (expense)*. The cost of assets sold is based on the specific identification method.

Cash and Cash Equivalents

Cash and cash equivalents include unrestricted cash on hand and highly liquid investments with original maturities of three months or less.

Restricted Cash and Cash Equivalents

Restricted cash and cash equivalents represents cash and highly liquid investments held in escrow in connection with the sale of the mortgage banking operations. These funds are scheduled to be released from escrow over an 18-month period ending July 1, 2000 provided the acquirers of the mortgage banking operations have not made claims against these funds under the terms of the related sale agreements (see NOTE 3).

Mortgage Servicing Rights

Prior to the December 1998 sale of the mortgage banking operations (see NOTE 3), the cost of acquiring mortgage servicing rights was capitalized and amortized in proportion to and over the period of estimated net servicing income. Estimated net servicing income was evaluated periodically and adjustments were made to the rate of amortization. Mortgage servicing rights were evaluated for impairment on a disaggregated basis by predominant risk characteristics. A valuation allowance was established through a charge to operating results to the extent that the recorded amount for servicing rights within an individual stratum exceeded fair value. Fair values were established through use of a discounted cash flow valuation model that incorporated assumptions the Company believed market participants used in estimating the fair value of future net servicing income including assumptions regarding prepayment speeds, discount rates and servicing costs. For impairment evaluation purposes, the Company stratified its servicing portfolio based on term, interest rate and loan type (fixed-rate versus adjustable-rate).

Derivative Financial Instruments

The Company may acquire derivative financial instruments ("Derivatives") for risk management purposes. Derivatives acquired from time to time may include interest rate floors and caps; U.S. Treasury futures contracts and options; written options on mortgage assets or various other Derivatives available in the market place that are compatible with the Company's risk management objectives. Realized and unrealized gains (losses) on Derivatives not designated as hedges are taken directly to operating results as a component of either *Gain on financial instruments held to offset the effects of impairment* or *Gain (loss) on sale of mortgage assets and related derivative financial instruments*. Realized and unrealized gains (losses) on Derivatives designated as hedges reduce (increase) the carrying amount of the assets hedged. Ongoing correlation and effectiveness of such Derivatives are measured by comparing the change in value of the hedges with the change in value of the assets hedged. Should a hedge prove ineffective, hedge accounting would cease and the change in value of the hedge instruments would be taken to operating results.

Prior to selling nearly all of its investments in interest-only mortgage securities and its investment in mortgage servicing rights in June 1998 and December 1998, respectively, the Company held interest rate floors to help offset the effects of falling mortgage interest rates on the value of designated portions of these investments. Beginning in July 1998, the Company supplemented the floor positions with 10-year U.S. Treasury note futures contracts ("Treasury Note Futures") to help mitigate the effects of further declines in mortgage interest rates on the value of mortgage servicing rights (see NOTE 3 and 5). Interest rate floors generally increase in value when interest rates decline. Because interest rate floors are one-sided options, a holder of such instruments has exposure to loss that is limited to the current basis in the instruments. A holder may receive cash payments from counterparties should certain specified interest rates fall below specified levels. Any such payments received by the Company are accrued and taken directly to operating results as indicated above or, for Derivatives designated as hedges, as a component of interest income on CMO investments or amortization expense of mortgage servicing rights. Treasury Note Futures generally increase in value when interest rates decline and decrease in value when interest rates rise. Unlike interest rate floors, Treasury Note Futures are two-sided options where the holder has unlimited exposure to changes in interest rates and is subject to daily margin calls.

To a limited extent, the Company has used interest rate caps to partially protect against rising interest rates on short-term borrowings. Interest rate caps generally increase in value when interest rates rise. Like interest rate floors, interest rate caps are one-sided options where the holder's exposure is limited to the current basis in the instruments. A holder may receive cash payments from counterparties should certain specific interest rates rise above specified levels. Any such payments, if received by the Company, will be accrued and taken to operating results, or for hedges, as a separate component of interest expense on short-term borrowings.

The cost of acquiring Derivatives designated as hedges is taken as a charge to operating results as a component of the related hedged item over the contractual lives of these instruments. The fair value of Derivatives are included in *Prepaids, receivables and other* on the balance sheet. The Company has credit risk associated with the counterparties to Derivatives. The Company manages credit risk by dealing only with large, financially sound investment banking firms.

Borrowings

CMOs and short-term borrowings are carried at their unpaid principal balances, net of unamortized discount or premium. Any discount or premium is recognized as an adjustment to interest expense by the interest method over the expected term of the related borrowings.

Mortgage Banking Revenue

Prior to the December 1998 sale of the mortgage banking operations (see NOTE 3), the Company earned mortgage banking revenue for servicing and, to a lesser extent, originating single-family residential mortgage loans. Mortgage banking revenue represents fees received for servicing mortgage loans, interest earned on temporarily-held cash balances, income earned from originating and selling mortgage loans and other ancillary income customary to mortgage banking operations. Also included in mortgage banking revenue in 1998 is the gain on the sale of this operation (see NOTE 3). Servicing fees were calculated based on a contractual percentage of the outstanding monthly principal balance of mortgage loans serviced and recognized as income when collected. Other mortgage revenue was recorded on the accrual basis.

Income Taxes

Income taxes are accounted for using the liability method, and deferred income tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using enacted tax rates and laws that will be in effect when the differences are expected to reverse.

Capstead and its qualified real estate investment trust ("REIT") subsidiaries have elected to be taxed as a REIT and intend to continue to do so. As a result of this election, Capstead is not taxed on taxable income distributed to stockholders if certain REIT qualification tests are met. It is Capstead's policy to distribute 100 percent of taxable income of the REIT within the time limits prescribed by the Internal Revenue Code (the "Code"), which may extend into the subsequent taxable year. Accordingly, no provision has been made for income taxes for Capstead and its qualified REIT subsidiaries. Capstead's non-REIT subsidiaries file a separate consolidated federal income tax return and are subject to income taxes.

Stock-Based Compensation

Compensation cost for stock-based awards is generally measured as the excess, if any, of the quoted market price of the Company's stock at the date of the grant over the amount an employee must pay to acquire the stock and is recognized as compensation expense as the awards vest and restrictions lapse.

Net Income (Loss) per Common Share

Basic net income (loss) per common share is computed by dividing net income (loss), after deducting preferred stock dividends, by the weighted average number of common shares outstanding after retroactively giving effect to stock splits. Diluted net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of

common shares and common stock equivalents outstanding, after retroactively giving effect to stock splits, and assuming conversion of the $1.60 Cumulative Preferred Stock, Series A ("Series A Preferred Stock") and the $1.26 Cumulative Convertible Preferred Stock, Series B ("Series B Preferred Stock") if the effects of conversion are dilutive. The Series A and B Preferred Stock was not considered convertible for purposes of calculating diluted net loss per common share in 1998 because the effects of conversion were antidilutive.

Reclassification and Stock Splits

Certain amounts for prior years have been reclassified to conform to the 1998 presentation. On October 30, 1995 and July 31, 1996, the Company completed 3-for-2 common stock splits. The affected capital accounts as well as all references to the number of common shares and share amounts in the accompanying consolidated financial statements and related notes have been restated to reflect the stock splits.

Recent Accounting Pronouncements

On January 1, 1998 the Company adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" ("SFAS 130"). SFAS 130 establishes standards for the reporting of comprehensive income and its components in financial statements. As the term currently relates to the Company, comprehensive income (loss) consists of net income (loss) plus the change in unrealized gain (loss) on debt securities classified as available-for-sale (see NOTE 8). The adoption of SFAS 130 has not had any impact on the results of operations or financial position of the Company.

In June 1998 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). SFAS 133 establishes accounting and reporting standards for Derivatives and hedging activities. It requires that an entity recognizes all Derivatives as either assets or liabilities in the statement of financial position and measures those instruments at fair value. If certain conditions are met, a Derivative may be specifically designated as (i) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; (ii) a hedge of the exposure to variable cash flows of a forecasted transaction; or (iii) in certain circumstances, a hedge of a foreign currency exposure. This statement will become effective for the Company's fiscal year ending December 31, 2000. The adoption of SFAS 133 is not expected to have a material impact on the financial position of the Company.

NOTE 3 ¾ SALE OF MORTGAGE BANKING OPERATIONS

On December 21, 1998 the Company's subsidiary Capstead Inc. closed the sale of its investment in mortgage servicing rights to GMAC Mortgage Corporation ("GMACMC"), an affiliate of GMAC Mortgage Group, Inc., (a wholly-owned subsidiary of General Motors Acceptance Corporation ("GMAC")). Under the terms of the sale, the Company subserviced this mortgage servicing portfolio for GMACMC for the month of December 1998. On December 31, 1998 Capstead Inc. closed the sale of its mortgage banking operations to another GMAC affiliate, Homecomings Financial Network, Inc. ("Homecomings"). A gain of $2.9 million on these transactions was recorded as a component of *Mortgage banking*

revenue. Homecomings is a wholly-owned subsidiary of Residential Funding Corporation ("RFC"). Capstead Inc. has had a long-term subservicing relationship with RFC, subservicing approximately $19 billion of RFC's single-family mortgage loans just prior to the sale.

After retiring indebtedness related to the primary mortgage servicing portfolio, related hedge instruments and loan production financing, and after certain transaction costs, these transactions generated net cash proceeds of approximately $500 million. Of these proceeds, $26.5 million is being held in escrow for a period of up to 18 months to secure related indemnifications. Pursuant to the servicing portfolio sale agreement, a prepayment protection settlement payment of $16 million was remitted to GMACMC in February 1999. This prepayment protection settlement was provided for in the determination of the gain on these transactions, along with (i) other contract settlement provisions (principally concerned with pricing adjustments on mortgage servicing rights acquisition agreements and final settlement on operating assets acquired and obligations assumed by the buyers), (ii) anticipated costs associated with exiting the mortgage banking operations (see below), and (iii) transaction-related expenses including costs associated with the acceleration of benefits of restricted stock grants to employees (see NOTE 11).

In addition to the $16 million accrual for prepayment protection settlement, included in *Accounts payable and accrued expenses* at December 31, 1998 is an accrual of approximately $7.2 million for other contract settlement provisions and anticipated costs associated with mortgage servicing and mortgage loan origination related contractual obligations incurred prior to the sale. These costs include (i) completing trailing document work associated with the primary mortgage servicing portfolio, (ii) completing payoff processing for loans paid off prior to the sale, (iii) providing tax information to mortgagors and vendors for calendar year 1998 and (iv) indemnifying GMACMC for costs of mortgage loan buyback requests by investors in excess of existing indemnifications by the originators of the loans. The Company is unaware of any other material indemnification-related claims that may arise prior to the release of the funds held in escrow.

The following table provides information regarding the primary mortgage servicing portfolio (which excludes subservicing) and the related investment in mortgage servicing rights (dollars in thousands):

	Unpaid Principal Balance	*Number of Loans*	*Mortgage Servicing Rights*
Loans serviced at December 31, 1996	$ 35,562,597	366,373	$ 626,094
Additions	11,479,030	113,530	134,388
Results of hedging activity	–	–	(33,387)
Runoff/amortization*	(4,982,600)	(38,626)	(58,033)
Loans serviced at December 31, 1997	42,059,027	441,277	669,062
Additions:			
Purchases	4,409,143	37,877	91,640
Loan production	995,927	9,447	14,858
Runoff/amortization*	(9,370,200)	(80,584)	(88,040)
Impairment reserve (see below)	–	–	(224,733)
Results of hedging activity (see below)	–	–	(1,141)
Sale of mortgage servicing portfolio	(38,093,897)	(408,017)	(461,646)
Loans serviced at December 31, 1998	$ –	–	$ –

* *Excludes related amortization expense associated with loan setup and hedging activities.*

During 1998 the Company recorded impairment charges totaling $224.7 million reflecting the loss in value of its investment in mortgage servicing rights caused by increasingly high rates of current and anticipated future mortgage prepayments. Derivatives, specifically interest rate floors, were held to offset the effects of falling mortgage interest rates on the value of a designated portion of the servicing portfolio and were accorded hedge accounting treatment through May of 1998. Early in 1998, and particularly in the second quarter, these instruments under-performed relative to the loss in value of the servicing rights they were intended to hedge due primarily to an overabundance of other Derivatives in the marketplace, which effectively limited fair value increases for the interest rate floors held by the Company. As a result, these Derivatives no longer met hedge accounting criteria requiring high ongoing correlation and, beginning in June 1998, changes in value of these instruments were included in operating results rather than recorded as an adjustment to the carrying amount of the servicing asset.

In response to unfavorable market conditions (see NOTE 1), in July 1998 the Company began to actively manage an expanded portfolio of U.S. Treasury-based financial instruments that included interest rate floors, Treasury Note Futures and 10-year U.S. Treasury notes to help mitigate the effects of further declines in mortgage interest rates on the value of the mortgage servicing rights. Substantially all of these instruments were sold by year-end, including approximately $80 million in interest rate floors and Treasury Note Futures positions sold to GMACMC. During 1998 the Company realized gains of $119.5 million on interest rate floors and Treasury Note Futures and $53.9 million on the sale of U.S. Treasury notes, net of related taxes of $1.6 million. These gains are recorded as *Gain on financial instruments held to offset the effects of impairment* of mortgage servicing rights.

Prior to the sale of the mortgage banking operations, the Company maintained segregated escrow deposits that were held in bank trust accounts. At December 31, 1997 escrow and

fiduciary funds for loans serviced totaled $725 million, which were excluded from the accompanying 1997 consolidated balance sheet.

NOTE 4 ¾ MORTGAGE SECURITIES AND OTHER INVESTMENTS

Mortgage securities and other investments and the related average effective interest rates (calculated for the indicated year including mortgage insurance costs on non-agency securities and excluding unrealized gains and losses) were as follows (dollars in thousands):

	Principal Balance	*Premium (Discount)*	*Cost Basis*	*Carrying Amount*	*Average Coupon*	*Average Effective Rate*
				*	**	**
December 31, 1998						
Agency and U.S. Treasury securities:						
U.S. Treasury notes	$ –	$ –	$ –	$ –	–%	5.40%
Fixed-rate	397,648	(731)	396,917	400,345	6.50	6.51
Medium-term	313,947	3,597	317,544	318,033	6.60	5.94
Adjustable-rate	1,487,582	30,985	1,518,567	1,509,807	7.06	5.55
Non-agency securities:						
Fixed-rate	34,826	(11)	34,815	35,671	8.57	7.86
Medium-term	–	–	–	–	–	6.29
Adjustable-rate	–	–	–	–	–	6.81
Mortgage loans held for sale***	105,892	(146)	105,746	105,746	6.77	6.78
	$2,339,895	$33,694	$2,373,589	$2,369,602		
December 31, 1997						
Agency securities:						
Fixed-rate	$ 880,298	$(4,370)	$ 875,928	$ 871,377	6.51%	6.55%
Medium-term	607,858	7,502	615,360	616,992	6.67	6.34
Adjustable-rate	3,937,013	80,096	4,017,109	4,030,460	7.02	6.12
Non-agency securities:						
Fixed-rate	81,608	467	82,075	82,954	8.67	8.59
Medium-term	346,961	441	347,402	347,772	6.78	6.58
Adjustable-rate	159,947	1,169	161,116	164,575	7.79	7.12
	$6,013,685	$85,305	$6,098,990	$6,114,130		

* *Includes mark-to-market, if applicable (see NOTE 8).*
** *Average Coupon is calculated as of the indicated balance sheet date. Average Effective Rate is calculated for the year then ended.*
*** *Represents loans originated prior to the sale of the mortgage banking operations in December 1998. All such loans have been subsequently sold.*

The Company classifies its mortgage securities by interest rate characteristics of the underlying single-family residential mortgage loans. Fixed-rate mortgage securities either (i) have fixed rates of interest for their entire terms, (ii) have an initial fixed-rate period of 10 years after origination and then adjust annually based on a specified margin over 1-year U.S. Treasury Securities ("1-year Treasuries"), or (iii) were previously classified as medium-term and have adjusted to a fixed rate for the remainder of their terms. Medium-term mortgage securities either (i) have an initial fixed-rate period of 3 or 5 years after origination and then adjust annually based on a specified margin over 1-year Treasuries, (ii) have initial

interest rates that adjust one time, approximately 5 years following origination of the mortgage loan, based on a specified margin over Fannie Mae yields for 30-year, fixed-rate commitments at the time of adjustment, or (iii) fixed-rate mortgage securities that have expected weighted average lives of 5 years or less. Adjustable-rate mortgage securities either (i) adjust semiannually based on a specified margin over the 6-month London Interbank Offered Rate ("LIBOR"), (ii) adjust annually based on a specified margin over 1-year Treasuries, or (iii) were previously classified as medium-term and have begun adjusting annually based on a specified margin over 1-year Treasuries.

Agency and U.S. Treasury securities consist of mortgage-backed securities issued by government-sponsored entities, either Fannie Mae, Freddie Mac or Ginnie Mae ("Agency Securities"), and U.S. government-issued fixed-rate securities, commonly referred to as U.S. Treasury notes or bonds (collectively, "Agency and U.S. Treasury Securities"). Agency Securities have no foreclosure risk. Non-agency securities consist of (i) private mortgage pass-through securities whereby the related credit risk of the underlying loans is borne by AAA-rated private mortgage insurers, (ii) other AAA-rated private mortgage securities, or (iii) single-family residential mortgage loans held for sale in connection with loan production activities (collectively, "Non-agency Securities"). The maturity of mortgage-backed securities is directly affected by the rate of principal prepayments on the underlying loans.

NOTE 5 ¾ CMO COLLATERAL AND INVESTMENTS

CMO collateral consists of (i) fixed-rate, medium-term and adjustable-rate mortgage-backed securities collateralized by single-family residential mortgage loans and (ii) related investments, both pledged to secure CMO borrowings ("Pledged CMO Collateral"). CMO investments have included investments in Agency Trust interest-only mortgage securities and investments in other CMO securities such as other agency and private-issue interest-only and principal-only mortgage securities. Agency Trust interest-only mortgage securities are entitled to receive 100 percent of coupon interest stripped from pools of Agency Securities. The components of CMO collateral and investments are summarized as follows (in thousands):

	December 31	
	1998	*1997*
Pledged CMO Collateral:		
Pledged mortgage securities	$4,507,337	$4,326,696
Short-term investments	14,879	15,600
Accrued interest receivable	27,361	26,760
	4,549,577	4,369,056
Unamortized premium	11,830	2,752
	4,561,407	4,371,808
CMO investments:		
Agency Trust interest-only mortgage securities	–	809,757
Other CMO investments	9,867	13,871
	$4,571,274	$5,195,436

All principal and interest on pledged mortgage securities is remitted directly to a collection account maintained by a trustee. The trustee is responsible for reinvesting those funds in short-term investments. All collections on the pledged mortgage securities and the

reinvestment income earned thereon are available for the payment of principal and interest on CMO borrowings. Pledged mortgage securities are private mortgage pass-through securities whereby the related credit risk of the underlying loans is borne by AAA-rated private mortgage insurers or subordinated bonds within the related CMO series to which the collateral is pledged. The Company has retained only $1.3 million of credit risk in the form of subordinated bonds associated with these securities. The weighted average effective interest rate for total Pledged CMO Collateral was 7.27 percent and 7.38 percent during 1998 and 1997, respectively.

The value of interest-only mortgage securities, which trade in a market with relatively few participants, was significantly depressed in 1998 by increasingly high rates of current and anticipated future mortgage prepayments and sales of such securities by a number of large market participants. Late in the second quarter of 1998, the Company committed to the sale of its entire $1.0 billion Agency Trust interest-only mortgage securities portfolio at a loss of $251.9 million, net of related gains on Derivatives, and during the third quarter of 1998 the Company wrote down to fair value its remaining investment in interest-only mortgage securities through an other-than-temporary impairment charge of $4.1 million. Derivatives, specifically interest rate floors, were held to help offset the effects of falling mortgage interest rates on the value of interest-only mortgage securities and were accorded hedge accounting treatment through March of 1998. Early in 1998, and particularly in the second quarter, these instruments under-performed relative to the loss in value of the assets they were intended to hedge due primarily to an overabundance of other Derivatives in the marketplace, which effectively limited fair value increases for the interest rate floors held by the Company. As a result, these Derivatives no longer met hedge accounting criteria requiring high ongoing correlation and, beginning in April 1998, changes in value of these instruments were included in operating results rather than recorded as an adjustment to the carrying amount of the hedged assets. Such changes in value totaled $28.3 million during the second quarter of 1998 prior to the sale of the Agency Trust interest-only mortgage securities portfolio and are included in *Gain (loss) from sale of mortgage assets and related derivative financial instruments*.

NOTE 6 ¾ SHORT-TERM BORROWINGS

Short-term borrowings are primarily made under uncommitted repurchase arrangements with investment banking firms pursuant to which the Company pledges mortgage assets as collateral. The terms and conditions of these arrangements, including interest rates, are negotiated on a transaction-by-transaction basis.

Repurchase arrangements, all of which had maturities of less than 31 days, and the related average effective interest rates are classified by type of collateral as follows (dollars in thousands):

	December 31, 1998		*December 31, 1997*	
	Borrowings Outstanding	*Weighted Average Rate*	*Borrowings Outstanding*	*Weighted Average Rate*
Agency Securities	$1,839,868	5.47%	$5,419,261	5.84%
Non-agency Securities	–	–	582,823	6.12
CMO investments	–	–	870,816	5.98
	$1,839,868		$6,872,900	

With the December 1998 sale of the mortgage banking operations, Capstead Inc. canceled its revolving line of credit agreement with an investment banking firm that was secured by mortgage servicing rights. Interest rates on borrowings under this facility were based on LIBOR with interest due monthly. At December 31, 1997, borrowings under this facility totaled $179,600,000 at 7.50 percent. In addition, the Company borrowed against Derivative positions on an overnight basis from the counterparties to these instruments. Borrowings under such arrangements totaled $47,206,000 at a weighted average rate of 5.90 percent at December 31, 1997.

The weighted average effective interest rate on short-term borrowings secured by mortgage assets was 5.55 percent and 5.53 percent during 1998 and 1997, respectively. Interest paid on short-term borrowings totaled $347,633,000, $339,077,000 and $279,160,000 during 1998, 1997 and 1996, respectively. As of December 31, 1998, $1.9 billion of Agency Securities were pledged as collateral under repurchase arrangements.

NOTE 7 ¾ COLLATERALIZED MORTGAGE OBLIGATIONS

Each series of CMOs issued consists of various classes of bonds, most of which have fixed rates of interest. Interest is payable monthly or quarterly at specified rates for all classes. Typically, principal payments on each series are made to each class in the order of their stated maturities so that no payment of principal will be made on any class of bonds until all classes having an earlier stated maturity have been paid in full. The components of CMOs along with selected other information are summarized as follows (dollars in thousands):

	December 31	
	1998	*1997*
CMOs	$4,513,522	$4,332,409
Accrued interest payable	25,609	28,417
Total obligation	4,539,131	4,360,826
Unamortized discount	(17,807)	(51,371)
	$4,521,324	$4,309,455
Range of average interest rates	5.22% to 9.45%	5.60% to 9.95%
Range of stated maturities	2007 to 2028	2007 to 2027
Number of series	31	33

The maturity of each CMO series is directly affected by the rate of principal prepayments on the related Pledged CMO Collateral. Each series is also subject to redemption, generally at the Company's option, provided that certain requirements specified in the related indenture have been met (referred to as "Clean-up Calls"); therefore, the actual maturity of any series is likely to occur earlier than its stated maturity. The average effective interest rate for all CMOs was 7.85 percent and 7.63 percent during 1998 and 1997, respectively. Interest paid on CMOs totaled $352,627,000, $263,151,000 and $304,670,000 during 1998, 1997 and 1996, respectively.

NOTE 8 ¾ DISCLOSURES REGARDING FAIR VALUES OF FINANCIAL INSTRUMENTS

Estimated fair values of debt securities have been determined using available market information and appropriate valuation methodologies; however, considerable judgment is required in interpreting market data to develop these estimates. In addition, fair values fluctuate on a daily basis. Accordingly, estimates presented herein are not necessarily indicative of the amounts that could be realized in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on estimated fair values.

The carrying amounts of cash and cash equivalents, receivables, payables and short-term borrowings approximate fair value. The fair value of Agency and U.S. Treasury Securities, Non-agency Securities (excluding mortgage loans held for sale), CMO investments and Derivatives were estimated using either (i) quoted market prices when available, including quotes made by lenders in connection with designating collateral for repurchase arrangements, or (ii) offer prices for similar assets or market positions. The fair value of Pledged CMO Collateral was based on projected cash flows, after payment on the related CMOs, determined using market discount rates and prepayment assumptions. The fair value of CMOs was based on the same method used for determining fair value for Pledged CMO collateral adjusted for credit enhancements. The maturity of mortgage assets is directly affected by the rate of principal payments on the underlying mortgage loans and, for Pledged CMO Collateral, Clean-up Calls of the remaining CMOs outstanding. The following table summarizes fair value disclosures for financial instruments (in thousands):

	December 31, 1998		*December 31, 1997*	
	Carrying Amount	*Fair Value*	*Carrying Amount*	*Fair Value*
Assets:				
Cash and cash equivalents	$ 73,385	$ 73,385	$ 17,377	$ 17,377
Restricted cash and cash equivalents	26,500	26,500	–	–
Receivables	41,717	41,717	120,542	120,542
Mortgage investments	2,263,856	2,263,856	6,114,130	6,115,048
CMO collateral and investments	4,571,274	4,641,641	5,195,436	5,253,299
Derivatives*	12,618	12,618	207,343	203,375
Liabilities:				
Payables	58,894	58,894	59,746	59,746
Short-term borrowings	1,839,868	1,839,868	7,099,706	7,099,706
CMOs	4,521,324	4,614,764	4,309,455	4,413,285

* *Average fair values of Derivatives held by the Company and not accorded hedge accounting treatment during 1998 and 1997 were $81.1 million and $2.9 million, respectively.*

The following table summarizes fair value disclosures for available-for-sale debt securities (in thousands):

	Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Fair Value*
As of December 31, 1998				
Mortgage investments:				
Agency Securities:				
Fixed-rate	$ 396,917	$ 3,466	$ 38	$ 400,345
Medium-term	317,544	862	373	318,033
Adjustable-rate	1,518,567	1,486	10,246	1,509,807
Non-agency Securities:				
Fixed-rate	34,815	856	–	35,671
CMO collateral and investments	190,916	2,927	158	193,685
	$2,458,759	$ 9,597	$10,815	$2,457,541
As of December 31, 1997				
Mortgage investments:				
Agency Securities:				
Fixed-rate	$ 875,928	$ 2,903	$ 7,454	$ 871,377
Medium-term	615,360	1,678	46	616,992
Adjustable-rate	4,017,109	19,850	6,499	4,030,460
Non-agency Securities:				
Fixed-rate	39,416	878	–	40,294
Medium-term	222,054	398	28	222,424
Adjustable-rate	161,116	3,459	–	164,575
CMO collateral and investments	891,213	332	67,917	823,628
	$6,822,196	$29,498	$81,944	$6,769,750

The Company currently has the ability to hold mortgage assets for the foreseeable future and, therefore, does not expect to realize losses on security sales.

Held-to-maturity debt securities consist of Pledged CMO Collateral and collateral released from the related CMO indentures pursuant to Clean-up Calls and held as Non-agency Securities. The following tables summarize fair value disclosures for debt securities held-to-maturity (in thousands):

	Cost	*Gross Unrealized Gains*	*Gross Unrealized Losses*	*Fair Value*
As of December 31, 1998				
Pledged CMO Collateral	$4,377,589	$3,286	$26,359	$4,354,516
As of December 31, 1997				
Pledged CMO Collateral	$4,371,808	$2,988	$48,955	$4,325,841
Non-agency Securities	168,008	918	–	168,926
	$4,539,816	$3,906	$48,955	$4,494,767

Sales of released CMO collateral occasionally occur provided the collateral has paid down to within 15 percent of its original issuance amounts. The following table summarizes disclosures related to the disposition of debt securities (in thousands):

	Year Ended December 31		
	1998	*1997*	*1996*
Sale of securities held available-for-sale:			
Amortized cost	$6,233,622	$1,920,097	$624,151
Gains (losses)*	(223,959)	24,043	13,936
Redemption of callable agency notes and sale of released CMO collateral held-to-maturity:			
Amortized cost	5,022	73,324	64,753
Gains	471	2,986	1,098

* *Represents the reclassification amounts included in other comprehensive income (loss) as a component of the change in unrealized gains (losses) on debt securities held available-for-sale.*

NOTE 9 ¾ INCOME TAXES

Capstead and its qualified REIT subsidiaries file a separate federal income tax return that does not include the operations of the non-REIT subsidiaries. Provided all taxable income of Capstead and its qualified REIT subsidiaries is distributed to stockholders within time limits prescribed by the Code, no income taxes are due on this income. Taxable income of the non-REIT subsidiaries is fully taxable. Income taxes paid during 1998 totaled $1,600,000. No income taxes were paid during 1997 or 1996. Effective tax rates will differ substantially from statutory federal income tax rates because of the effect of the following items (in thousands):

	Year Ended December 31		
	1998	*1997*	*1996*
Income taxes computed at the federal statutory rate	$(82,167)	$ 55,974	$ 44,530
Nondeductible capital loss	83,651	–	–
Benefit of REIT status	(3,650)	(46,893)	(35,384)
Income taxes computed on income of non-REIT subsidiaries	(2,166)	9,081	9,146
Benefit of previously unrecognized deferred income tax asset	(667)	(10,889)	(8,308)
Tax effect of capital contributions to non-REIT subsidiaries	3,783	–	–
Other	650	1,808	(838)
	$ 1,600*	$ –	$ –

* *The 1998 provision for income taxes is reflected in the statement of operations as an offset to gains realized on financial instruments held to offset the effects of impairment of mortgage servicing rights.*

Significant components of deferred income tax assets and liabilities are as follows (in thousands):

	December 31	
	1998	1997
Deferred income tax assets:		
Alternative minimum tax credit	$1,915	$ 313
Net operating loss carryforwards	–	31,762
Hedging transactions	–	6,660
Other	864	1,630
	2,779	40,365
Deferred income tax liabilities:		
Mortgage servicing rights	–	37,276
Other	357	–
	357	37,276
Net deferred tax assets	$2,422	$ 3,089
Valuation allowance	$2,422	$ 3,089

At December 31, 1998 Capstead and its qualified REIT subsidiaries had capital loss carryforwards for tax purposes of approximately $243 million, which expire in the year 2004. At December 31, 1998 the non-REIT subsidiaries had net operating loss carryforwards for tax purposes of approximately $5 million, which expire in the year 2013.

NOTE 10 ¾ STOCKHOLDERS' EQUITY

The Series A Preferred Stock is entitled to a cumulative fixed dividend at an annual rate of $1.60, is eligible for conversion into 2.1707 shares of common stock and is nonvoting. The Series A Preferred Stock is currently redeemable at the Company's option at a redemption price of $16.40 per share and has a liquidation preference of $16.40 per share. During 1998, 33,682 shares of the Series A Preferred Stock were converted into 69,124 shares of common stock.

The Series B Preferred Stock is entitled to a cumulative fixed dividend at an annual rate of $1.26, is eligible for conversion into 0.7537 of 1 share of common stock and is nonvoting. The Series B Preferred Stock is currently redeemable at the Company's option at a redemption price of $12.50 per share and has a liquidation preference of $11.38 per share. During 1998, 57,512 shares of the Series B Preferred Stock were converted into 41,657 shares of common stock.

The weighted average shares used to calculate diluted net income per common share in 1997 and 1996 differs from weighted average common shares outstanding because of the dilutive effects of stock options and the potential conversion of preferred stock into common stock in those years. In 1998 stock options and preferred share conversions were anti-dilutive in calculating net loss per common share; therefore, diluted net loss per common share was the same as basic net loss per common share. Dilutive options increased weighted average shares by 1,101,000 and 960,000 shares in 1997 and 1996, respectively. The assumed conversion of the Series A and B Preferred Stock increased weighted average shares by 15,665,000 and 22,224,000 shares during 1997 and 1996, respectively.

On February 4, 1999 the Board of Directors authorized the repurchase of up to 6 million shares of its common stock and up to 2 million shares of its Series B Preferred Stock. This program calls for the repurchase of shares in open market transactions from time to time subject to the price of its securities and alternative investment opportunities. In December 1998 the Company completed a previously authorized repurchase of 1 million shares of common stock at an average price of $4.10 per share.

Through May 1998 the Company used several programs designed to raise new equity capital at favorable prices. These programs were indefinitely suspended when the prices of the Company's equity issues declined during the second quarter of 1998. The following tables summarize capital raised through these programs (dollars in thousands):

	1998		*1997*		*1996*	
	Shares	*Net Proceeds*	*Shares*	*Net Proceeds*	*Shares*	*Net Proceeds*
Common Stock:						
Dividend reinvestments	149,267	$ 2,901	810,791	$ 18,195	413,030	$ 8,326
Direct stock purchases	426,458	8,155	2,565,434	63,121	647,289	12,091
Structured equity shelf	1,751,500	33,349	4,108,900	97,938	1,954,550	37,443
	2,327,225	44,405	7,485,125	179,254	3,014,869	57,860
Series B Preferred Stock:						
Dividend reinvestments	74,376	1,085	185,523	3,120	310,434	4,259
Structured equity shelf	199,600	2,952	646,500	11,079	309,200	4,877
	273,976	4,037	832,023	14,199	619,634	9,136
		$48,442		$193,453		$66,996

Dividend reinvestments allow existing stockholders to convert cash dividends into newly issued shares. Similarly, direct stock purchases allow investors the opportunity to acquire additional shares directly from the Company, subject to certain limitations. Structured equity shelf issuances represent new shares issued by the Company on a daily basis either directly into the market or in larger blocks to qualified buyers, subject to certain limitations.

Option exercises by employees during 1998, 1997 and 1996 resulted in net additions to capital of $1,897,000, $5,761,000 and $7,246,000, respectively.

The Company's Charter provides that if the Board of Directors determines in good faith that the direct or indirect ownership of stock of Capstead has become concentrated to an extent which would cause Capstead to fail to qualify as a REIT, the Company may redeem or repurchase, at fair market value, any number of shares of common stock and/or preferred stock sufficient to maintain or bring such ownership into conformity with the Code. In addition, the Company may refuse to transfer or issue shares of common stock and/or preferred stock to any person whose acquisition would result in Capstead being unable to comply with the requirements of the Code. Finally, the Charter provides that the Company may redeem or refuse to transfer any shares of capital stock of Capstead necessary to prevent the imposition of a penalty tax as a result of ownership of such shares by certain disqualified organizations, including governmental bodies and tax-exempt entities that are not subject to tax on unrelated business taxable income.

NOTE 11 ¾ EMPLOYEE BENEFIT PLANS

The Company sponsors stock plans for directors and employees to provide for the issuance of stock options and other incentive-based stock awards (collectively, the "Plans"). The Plans provide for the issuance of up to an aggregate of 7,512,500 shares of common stock. Options granted have terms and vesting requirements at the grant date of up to ten years. Prior to a restructuring of long-term incentive compensation for key officers on January 2, 1998 which eliminated this feature, most of the outstanding stock options provided for the annual granting of dividend equivalent rights ("DERs") that permitted the option holder to obtain additional shares of common stock based upon formulas set forth in the Plans. The following table provides information regarding stock option activity for the periods indicated:

	Number of Shares	*Weighted Average Exercise Price*
As of December 31, 1995 (1,293,221 exercisable)	2,059,423	$12.41
Granted (average fair value: $2.03 per share)	821,250	15.42
Exercised	(563,230)	12.23
Canceled	(17,559)	12.01
DERs granted (average fair value: $15.25 per share)	70,686	–
As of December 31, 1996 (1,716,334 exercisable)	2,370,570	13.12
Granted (average fair value: $3.07 per share)	622,250	23.51
Exercised	(431,568)	11.00
Canceled	(1,125)	12.00
DERs granted (average fair value: $24.00 per share)	188,328	–
As of December 31, 1997 (1,878,421 exercisable)	2,748,455	14.91
Granted (average fair value: $1.48 per share)	1,814,250	20.00
Exercised	(161,546)	11.75
Canceled	(690,127)	6.97
DERs granted (average fair value: $20.00 per share)	237,743	–
As of December 31, 1998 (3,948,775 exercisable)*	3,948,775	17.87

* *With the December 1998 sale of the mortgage banking operations, all outstanding stock option awards became 100 percent vested. On June 30, 1999 unexercised options held by former employees of Capstead Inc. (totaling 2,080,072 shares as of December 31, 1998) will be forfeited under the terms of the Plans.*

Weighted average exercise price and remaining life information for significant option grants outstanding at December 31, 1998 were as follows:

	Options Outstanding	*Options Exercisable*	*Weighted Average Exercise Price*	*Remaining Life (Years)*
Options granted January 1998	1,648,232	1,648,232	$19.92	9
Options granted January 1997	582,147	582,147	23.35	8
Options granted January 1996	752,061	752,061	15.37	7
Options granted April 1994	854,015	854,015	12.83	5

In connection with the January 2, 1998 restructuring of long-term incentive compensation for key officers, the Company canceled existing DER option grants totaling 452,627 shares and eliminated the right to receive future DER award grants in exchange for cash settlements aggregating $10,524,000 and 452,627 shares of restricted common stock. The cash settlements were fully accrued for at December 31, 1997. The restricted stock had a grant date fair value of $20 per share and was granted subject to certain restrictions, including continuous employment, which generally lapsed over 5 years.

During 1998 the Company also issued restricted stock grants for an aggregate of 35,000 shares of common stock to employees completing their first year of employment with the Company at grant date fair values averaging $11.18 per share. These grants were subject to certain restrictions, including continuous employment, which generally lapsed over 10 years. Similar grants to all qualifying employees were made in 1997 and 1996 for 201,000 and 144,000 shares of common stock at grant date fair values averaging $24.35 and $21.50 per share, respectively. Additionally, in 1996 the Company issued restricted stock grants for 262,500 shares of common stock to key officers at a grant date fair value of $15.42 per share, also subject to restrictions as to continuous employment which generally lapsed over 4 years from the date of grant.

Costs associated with restricted stock grants (generally measured by the fair value of the Company's common stock on the date of grant multiplied by the number of shares granted) have been recognized as compensation expense over the period restricted. However, with the December 1998 sale of the mortgage banking operations, all remaining restrictions lapsed under the terms of the Plans. Therefore, the gain on sale of the mortgage banking operations includes a $11,043,000 charge to eliminate all deferred compensation related to restricted stock grants.

The Company applies Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations in accounting for stock awards. Accordingly, no compensation expense has been recognized for stock awards other than for DERs and restricted stock grants. Related compensation costs, excluding the charge mentioned above, totaled $2,398,000, $6,323,000 and $6,032,000 in 1998, 1997 and 1996, respectively. The effect of determining compensation cost for stock options granted since the beginning of 1995, based upon the estimated fair value at the grant date consistent with the methodology prescribed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," would have been 3 cents per share or less on diluted net income (loss) per common share for each of the last 3 years. This effect on diluted net income (loss) per common share was determined using a Black-Scholes option pricing model and, depending upon each individual option grant during the last three years, dividend yields of 10 to 12 percent, volatility factors of 27.8 to 32.5 percent, expected life assumptions of 3 to 5 years and risk-free rates of 5 percent to over 7 percent. This effect may not be representative of the pro forma effect on future operating results.

The Company also sponsors a qualified defined contribution retirement plan for all employees. The Company matches up to 50 percent of a participant's voluntary contribution up to a maximum of 6 percent of a participant's compensation and may make additional contributions of up to another 3 percent of a participant's compensation. All Company contributions are subject to certain vesting requirements. Contribution expenses were $709,000, $634,000 and $677,000 in 1998, 1997 and 1996, respectively.

NOTE 12 ¾ STOCKHOLDER LITIGATION

During 1998 twenty-four purported class action lawsuits were filed against the Company and certain of its officers alleging, among other things, that the defendants violated federal securities laws by publicly issuing false and misleading statements and omitting disclosure of material adverse information regarding the Company's business during various periods between January 28, 1997 and July 24, 1998. The complaints claim that as a result of such alleged improper actions, the market price of the Company's equity securities were artificially inflated during that time period. The complaints seek monetary damages in an undetermined amount. In March 1999 these actions were consolidated. The date by which the Company is to respond has not yet run. The Company believes it has meritorious defenses to the claims and intends to vigorously defend the actions. Based on available information, management believes the resolution of these suits will not have a material adverse effect on the financial position of the Company.

NOTE 13 ¾ NET INTEREST INCOME ANALYSIS (UNAUDITED)

The following table summarizes interest income and interest expense and average effective interest rates for the periods indicated (dollars in thousands):

	1998		*1997*		*1996*	
	Amount	*Average Rate*	*Amount*	*Average Rate*	*Amount*	*Average Rate*
Interest income:						
Mortgage securities and other investments	$311,807	5.89%	$339,980	6.28%	$303,212	6.41%
CMO collateral and investments	355,391	7.28	354,279	7.84	359,752	7.73
Total interest income	667,198		694,259		662,964	
Interest expense:						
Short-term borrowings	313,858	5.55	329,635	5.53	267,525	5.53
CMOs	340,248	7.85	281,497	7.63	314,338	7.53
Total interest expense	654,106		611,132		581,863	
Net interest	$ 13,092		$ 83,127		$ 81,101	

The following tables summarize the changes in interest income and interest expense due to changes in interest rates versus changes in volume for the periods indicated (in thousands):

	*1998/1997**		
	Rate	*Volume*	*Total*
Interest income:			
Mortgage securities and other investments	$(20,988)	$ (7,185)	$(28,173)
CMO collateral and investments	(26,168)	27,280	1,112
Total interest income	(47,156)	20,095	(27,061)
Interest expense:			
Short-term borrowings	1,010	(16,787)	(15,777)
CMOs	8,591	50,160	58,751
Total interest expense	9,601	33,373	42,974
Net interest	$(56,757)	$(13,278)	$(70,035)

	1997/1996*		
	Rate	*Volume*	*Total*
Interest income:			
Mortgage securities and other investments	$(6,163)	$ 42,931	$ 36,768
CMO collateral and investments	5,117	(10,590)	(5,473)
Total interest income	(1,046)	32,341	31,295
Interest expense:			
Short-term borrowings	–	62,110	62,110
CMOs	4,002	(36,843)	(32,841)
Total interest expense	4,002	25,267	29,269
Net interest	$(5,048)	$ 7,074	$ 2,026

* *The change in interest due to both volume and rate has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.*

NOTE 14 ¾ QUARTERLY RESULTS (UNAUDITED)

The following is a summary of quarterly results of operations (in thousands, except percentages and per share amounts). See NOTE 1 for discussion of significant changes to the Company's operations during 1998 that have impacted 1998 quarterly operating results and are expected to impact future operations.

	Year Ended December 31, 1998			
	First Quarter	*Second Quarter*	*Third Quarter*	*Fourth Quarter*
Interest income	$193,019	$ 201,871	$144,683	$127,625
Interest and related expenses	178,652	191,358	162,891	126,674
Net margin on mortgage assets and other investments	14,367	10,513	(18,208)	951
Net margin on mortgage banking operations	14,845	(27,153)	13,215	10,914
Other operating revenue (expense)	5,858	(251,492)	(6,832)	(1,742)
Net income (loss)	$ 35,070	$(268,132)	$(11,825)	$ 10,123
Net income (loss) per common share:				
Basic	0.50	(4.47)	(0.28)	0.07
Diluted	0.48	(4.47)	(0.28)	0.07
Return on average stockholders' equity	14.59%	(117.53%)	(7.00%)	5.97%

	Year Ended December 31, 1997			
	First Quarter	*Second Quarter*	*Third Quarter*	*Fourth Quarter*
Interest income	$165,281	$163,015	$175,915	$190,048
Interest and related expenses	143,015	142,902	154,865	175,505
Net margin on mortgage assets and other investments	22,266	20,113	21,050	14,543
Net margin on mortgage banking operations	14,042	13,565	16,253	15,563
Other operating revenue (expense)	1,080	5,993	4,564	10,894
Net income	$ 37,388	$ 39,671	$ 41,867	$ 41,000
Net income per common share:				
Basic	0.65	0.67	0.68	0.63
Diluted	0.58	0.60	0.61	0.57
Return on average stockholders' equity	19.76%	19.79%	19.58%	17.81%

NOTE 15 ¾ MARKET AND DIVIDEND INFORMATION (UNAUDITED)

The New York Stock Exchange trading symbol for the Company's common stock is CMO. There were 6,248 holders of record of the Company's common stock at December 31, 1998. In addition, depository companies held stock for 44,608 beneficial owners. The high and low stock sales prices and dividends declared on common stock for the periods indicated were as follows:

	Year Ended December 31, 1998			*Year Ended December 31, 1997*		
	Stock Prices		*Dividends*	*Stock Prices*		*Dividends*
	High	*Low*	*Declared*	*High*	*Low*	*Declared*
First quarter	$21 11/16	$18 1/2	$0.50	$25 3/8	$19 1/2	$0.58
Second quarter	21 1/2	7 15/16	0.50	25 1/4	19 7/8	0.59 1/2
Third quarter	8 3/8	2 3/16	–	27 13/16	24 1/2	0.61
Fourth quarter	4 5/8	2 1/8	–	27 1/4	17 5/16	0.61 1/2

SELECTED FINANCIAL DATA

(In thousands, except percentages and per share amounts)

	Year Ended December 31				
	1998	*1997*	*1996*	*1995*	*1994*
Selected consolidated statement of operations data:					
Interest income	$ 667,198	$ 694,259	$ 662,964	$ 623,160	$ 557,001
Interest and related expense	659,575	616,287	589,606	588,421	488,224
Net margin on mortgage assets and other investments	7,623	77,972	73,358	34,739	68,777
Net margin on mortgage banking operations*	11,821	59,422	49,122	41,253	21,019
Other operating revenue (expense)**	(254,208)	22,532	4,748	1,367	(4,217)
Net income (loss)	$ (234,764)	$ 159,926	$ 127,228	$ 77,359	$ 85,579
Net income (loss) per common share:***					
Basic	$ (4.22)	$ 2.62	$ 2.37	$ 1.10	$ 1.36
Diluted	(4.22)	2.35	2.07	1.09	1.34
Return on average stockholders' equity	(28.83%)	19.12%	18.41%	11.91%	13.27%
Cash dividends paid per share:					
Common	$ 1.00	$ 2.40	$ 2.11 ½	$ 1.09 ⅓	$ 1.42 ⅔
Series A Preferred	1.60	1.60	1.60	1.60	1.60
Series B Preferred	1.26	1.26	1.26	1.26	1.26
Average number of common shares outstanding:***					
Basic	60,948	51,257	38,317	34,631	34,316
Diluted	60,948	68,023	61,501	35,883	35,720
Selected consolidated balance sheet data:					
Mortgage securities and other investments	$2,369,602	$ 6,114,130	$ 4,840,417	$ 4,556,049	$ 3,310,629
CMO collateral and investments	4,571,274	5,195,436	4,501,646	4,796,925	5,265,458
Mortgage servicing rights*	–	669,062	626,094	418,794	281,032
Total assets	7,100,287	12,357,515	10,157,338	9,903,606	8,943,858
Short-term borrowings	1,839,868	7,099,706	5,462,856	4,628,782	3,190,582
Collateralized mortgage obligations	4,521,324	4,309,455	3,861,892	4,538,863	5,102,145
Stockholders' equity	680,201	888,608	726,869	664,724	563,675
Mortgage banking data:*					
Primary servicing portfolio	$ –	$42,059,027	$35,562,597	$25,557,629	$14,392,182
Subservicing portfolio	–	11,834,091	2,155,873	–	–

NOTE: See management's discussion and analysis of financial condition and the notes to consolidated financial statement for discussion of changes t o the Company's operations in 1998 that are expected to impact future operating results.

* *The Company's mortgage banking operations, including related mortgage servicing rights, were sold in December 1998.*

** *Included in other operating revenue (expense) in 1998 were substantial losses incurred from the sale of mortgage assets, principally interest-only mortgage securities.*

*** *Net income (loss) per common share and average number of common shares outstanding amounts prior to 1997 have been restated as re quired to comply with Statement of Financial Accounting Standards No. 128, "Earnings per Share." For further discussion of net income (loss) per common share, see the notes to the consolidated financial statements. Amounts have been adjusted for 3 -for-2 common stock splits effective October 30, 1995 and July 31, 1996.*

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FINANCIAL CONDITION

Overview

Capstead Mortgage Corporation, a mortgage investment firm, earns income from investing in mortgage assets on a leveraged basis and from other investment strategies. Declining long-term interest rates throughout much of 1998 kept long-term interest rates at or below short-term interest rates for most of the year. This unfavorable interest rate environment led to significantly higher mortgage prepayment rates, which negatively impacted yields and asset valuations on most of the Company's mortgage assets, particularly on the Company's mortgage servicing and interest-only mortgage-backed securities portfolios. These market conditions contributed to liquidity issues for the mortgage finance industry as the availability of financing diminished for all but the highest quality mortgage assets. In response to these market conditions, the Company reduced its mortgage asset portfolios, which included the disposition of a large portfolio of interest-only mortgage-backed securities at a substantial loss, and sold its mortgage banking operations for a modest gain. Combined with the temporary use of the proceeds from the sale of the mortgage banking operations, these reductions in mortgage assets contributed to lowering the Company's leverage ratio (short-term borrowings to equity, before other comprehensive income adjustments) from its peak of 8.7:1 at June 30, 1998 to 2.7:1 at December 31, 1998.

With the December 1998 sale of its mortgage banking operations, and reduced mortgage asset holdings, the Company entered 1999 with substantial liquidity but diminished earning capacity. Since year-end, the mortgage finance markets have generally improved and the Company's borrowing rates have declined; however, yields on mortgage assets continue to be depressed because of high mortgage prepayments and the resetting of underlying adjustable-rate mortgage loans to lower interest rate levels.

In early 1999, the Company began redeploying a portion of the proceeds from the sale of its mortgage banking operations to increase holdings of high quality mortgage-backed securities and may continue to do so. The Company also announced a common and preferred stock repurchase program and that it is evaluating a number of opportunities to acquire or make strategic investments in a variety of real estate-related investments and entities, although there can be no assurance that the Company will make any such investments.

Sale of Mortgage Banking Operations

On December 21, 1998 the Company's subsidiary Capstead Inc. closed the sale of its $38 billion mortgage servicing portfolio to GMAC Mortgage Corporation ("GMACMC"), an affiliate of GMAC Mortgage Group, Inc., (a wholly-owned subsidiary of General Motors Acceptance Corporation ("GMAC")). On December 31, 1998 Capstead Inc. closed the sale of its mortgage banking operations to another GMAC affiliate, Homecomings Financial Network, Inc. ("Homecomings"). A gain of $2.9 million on these transactions was recorded as a component of *Mortgage banking revenue* in the 1998 consolidated financial statements. Homecomings is a wholly-owned subsidiary of Residential Funding Corporation ("RFC").

Capstead Inc. has had a long-term subservicing relationship with RFC, subservicing approximately $19 billion of RFC's single-family mortgage loans just prior to the sale.

After retiring indebtedness related to the primary mortgage servicing portfolio, related hedge instruments and loan production financing, and after certain transaction costs, these transactions generated net cash proceeds of approximately $500 million. Of these proceeds, $26.5 million is being held in escrow for a period of up to 18 months to secure related indemnifications. Included in the determination of the gain on these transactions was a prepayment protection settlement payment of $16 million remitted to GMACMC in February 1999 pursuant to the servicing portfolio sale agreement, and an accrual of approximately $7.2 million established for other contract settlement provisions (principally concerned with pricing adjustments on mortgage servicing rights acquisition agreements and final settlement on operating assets acquired and obligations assumed by the buyers), and anticipated costs associated with mortgage servicing and mortgage loan origination related contractual obligations incurred prior to the sale. These costs include (i) completing trailing document work associated with the primary mortgage servicing portfolio, (ii) completing payoff processing for loans paid off prior to the sale, (iii) providing tax information to mortgagors and vendors for calendar year 1998 and (iv) indemnifying GMACMC for costs of mortgage loan buyback requests by investors in excess of existing indemnifications by the originators of the loans. The Company is unaware of any other material indemnification-related claims that may arise prior to the release of the funds held in escrow.

Mortgage Securities and Other Investments

Mortgage securities and other investments consist of high quality single-family residential mortgage-backed securities, most of which are issued by government-sponsored entities, either Fannie Mae, Freddie Mac or Ginnie Mae ("Agency Securities"). The Company may also invest in government-issued securities, commonly referred to as U.S. Treasury notes or bonds. Agency Securities have no foreclosure risk. Non-agency securities consist of (i) private mortgage pass-through securities whereby the related credit risk of the underlying loans is borne by AAA-rated private mortgage insurers, (ii) other AAA-rated private mortgage securities, or (iii) single-family residential mortgage loans held for sale in connection with loan production activities (together, "Non-agency Securities"). The Company classifies its mortgage securities and other investments by interest rate characteristics of the underlying loans (see NOTE 4 to the 1998 consolidated financial statements). Mortgage securities and other investments are financed under repurchase arrangements with investment banking firms pursuant to which the portfolios are pledged as collateral (see "Liquidity and Capital Resources").

In response to market conditions discussed above, in the second quarter of 1998 the Company began reducing these portfolios in order to reduce short-term borrowings and improve its credit profile by focusing almost exclusively on Agency Securities. Sales of mortgage securities held in these portfolios totaled $3.4 billion during the second, third and fourth quarters. In addition, the Company sold U.S. Treasury notes held principally to help offset the effects of impairment on the Company's investment in mortgage servicing rights.

The following table depicts certain characteristics of mortgage securities and other investments as of December 31, 1998. Note that acquisitions of securities subsequent to year-end are not reflected.

Mortgage Securities and Other Investments	*Principal Balance*	*Purchase Premium (Discount)*	*Basis*	*Weighted Average Coupon*	*Fourth Quarter Runoff*	*Net Margin Over Index*	*Maximum Annual Reset*	*Months to Roll*
			*		*(Annualized)*	**		**
Agency Securities:								
Fixed-rate	$ 397,648	$ (731)	$ 396,917	6.50%	14.59%	–%	–%	
Medium-term	313,947	3,597	317,544	6.60	40.55	2.23	–	34
FNMA/FHLMC ARMs:								
6-Month LIBOR	113,414	3,020	116,434	7.63	50.53	2.03	2.00	3
1-Year CMT	502,860	13,330	516,190	7.46	50.50	2.20	2.00	7
GNMA ARMs	871,308	14,635	885,943	6.75	37.24	1.50	1.00	6
	2,199,177	33,851	2,233,028	6.89	37.63			
Non-agency Securities:								
Fixed-rate	34,826	(11)	34,815	8.57	56.28	–	–	–
Mortgage loans held for sale***	105,892	(146)	105,746	6.77	1.52	–	–	–
	$2,339,895	$33,694	$2,373,589	6.91%	36.27%	1.86%	0.94%	11

* *Recorded amount before mark to market, if applicable.*
** *Calculated excluding fixed-rate securities.*
*** *Represents loans originated by the mortgage banking operations prior to its sale in December 1998. All such loans have been subsequently sold.*

During 1998 adjustable-rate ("ARM") mortgage securities were particularly hard hit by higher mortgage prepayments because homeowners found it increasingly advantageous to refinance into fixed-rate mortgage loans with lower interest rates. Expectations for future mortgage prepayments on ARM mortgage securities peaked in early October 1998 when the 10-year U.S. Treasury rate reached a low of 4.16 percent. Consequently, in the third quarter the Company wrote-off an additional $5.3 million of the purchase premiums through premium amortization adjustments. These write-offs and asset sales have decreased but not eliminated the Company's exposure to future increases in prepayments relative to remaining purchase premiums. Should future prepayments be realized at levels above the Company's current expectations, additional write-offs of remaining premiums may be necessary (see "Effects of Interest Rate Changes").

CMO Collateral and Investments

Prior to 1995 the Company had been an active issuer of CMOs and other securities backed by single-family residential mortgage loans. The related credit risk of the underlying loans is borne by AAA-rated private mortgage insurers or by subordinated bonds within the related CMO series to which the collateral is pledged. The Company has retained only $1.3 million of credit risk in the form of subordinated bonds associated with these securities. The Company also retained residual interests in these securitizations primarily with the characteristics of interest-only mortgage securities. Interest-only mortgage securities are entitled to receive all or some portion of the interest stripped from the single-family

residential mortgage loans underlying the securities. Other than occasional CMO issuances (see below) the Company has not been an active issuer of CMOs since 1994.

In lieu of issuing CMOs, the Company had increased its CMO investments (defined as CMO collateral and investments, net of related bonds) by acquiring interest-only mortgage securities issued by other issuers, primarily Fannie Mae and Freddie Mac. The value of interest-only mortgage securities, which trade in a market with relatively few participants, was significantly depressed in 1998 by increasingly high rates of current and anticipated future mortgage prepayments and sales of such securities by a number of other large market participants. Derivative financial instruments ("Derivatives"), specifically interest rate floors, held to help offset the effects of falling interest rates on the value of these securities, under-performed relative to the loss in value of the interest-only mortgage securities due primarily to an overabundance of other Derivatives in the marketplace, which effectively limited fair value increases for the interest rate floors held by the Company. These value declines and the prospect for further deterioration, compounded by the poor performance of these Derivatives, led to the Company's decision to dispose of a $1.0 billion interest-only mortgage securities portfolio in the second quarter for a loss of $251.9 million, net of $28.3 million in gains on Derivatives. Remaining investments in interest-only mortgage securities issued by others totaled $6.3 million at December 31, 1998.

With further increases in the third quarter of 1998 in mortgage prepayment rates and expectations for future mortgage prepayments, the Company wrote off a significant portion of remaining CMO investments through CMO bond discount amortization adjustments aggregating $15.7 million and recorded a $4.1 million other-than-temporary impairment charge to write down remaining investments in interest-only mortgage securities to fair value. These write-offs have decreased but not eliminated the Company's exposure to future increases in prepayments relative to remaining CMO investments. Should future prepayments increase beyond the Company's current expectations, additional write-downs of remaining CMO collateral premiums and bond discounts may be necessary (see "Effects of Interest Rate Changes"). As of December 31, 1998, the Company's CMO investments had been reduced to $50.0 million, down from $886.0 million at December 31, 1997. Included in this net investment are $11.8 million and $17.8 million of remaining CMO collateral premiums and bond discounts, respectively.

Since the Company exited the mortgage loan conduit business in 1995, it has maintained several finance subsidiaries with remaining capacity to issue CMOs and other securitizations ("securitization shelves"). In an effort to recover costs associated with these securitization shelves, and to potentially add to the Company's CMO administration activities, the Company may, from time to time, purchase mortgage loans from originators or conduits and issue CMOs or other securities backed by these loans. The Company may or may not retain a significant residual economic interest in these securitizations. In the latter half of 1997, the Company completed two such CMO transactions totaling $1.1 billion and during 1998 issued two additional such CMOs totaling $1.1 billion. Additionally, in the third quarter of 1998, the Company issued a $345.4 million CMO backed by Non-agency Securities, retaining a $6.1 million residual interest.

Mortgage Banking Operations

The Company commenced mortgage servicing operations in 1993 and grew the operation into one of the 20 largest mortgage servicers in the country with a total mortgage servicing

portfolio (including primary servicing and subservicing) of $57 billion prior to its sale in December 1998. In February 1998 the Company entered the mortgage production business, which was also sold.

Because of the increasingly high rates of current and anticipated future mortgage prepayments experienced during 1998, expectations for future cash flows from the mortgage servicing portfolio continued to deteriorate during 1998. As a result, substantially higher amortization expense and substantial impairment charges were recorded, which could not be offset by the Company's risk management strategies and startup mortgage production business. In the past the Company attempted to help offset the effects of falling interest rates on the value of its investment in mortgage servicing rights with Derivatives, specifically interest rate floors. These instruments under-performed during the first half of 1998 relative to the decline in the value of the mortgage servicing portfolio due primarily to the interest rate floor market conditions mentioned above. In July 1998 the Company began managing an expanded portfolio of U.S. Treasury-based financial instruments that included interest rate floors, 10-year U.S. Treasury note futures contracts and 10-year U.S. Treasury notes to help mitigate the effects of further declines in mortgage interest rates on the value of mortgage servicing rights. These instruments performed well in the second half of 1998 relative to declines in value of the servicing portfolio because of significant declines in U.S. Treasury rates caused in part by global market instability and because mortgage interest rates did not decline to the same extent as U.S. Treasury rates (see "Results of Operations" and "Effects of Interest Rate Changes").

Utilization of Capital and Potential Liquidity

The following table summarizes the Company's utilization of capital and potential liquidity as of December 31, 1998 (in thousands):

	Assets	*Borrowings*	*Capital Employed*	*Potential Liquidity* *
Agency securities:				
Fixed-rate	$ 400,345	$ 388,668	$ 11,677	$ 349
Medium-term	318,033	119,339	198,694	187,705
Adjustable-rate	1,509,807	1,303,023	206,784	152,743
Non-agency Securities:				
Fixed-rate	35,671	–	35,671	34,215
Production warehouse	105,746	28,838	76,908	74,608
CMO collateral and investments	4,571,274	4,521,324	49,950	12,500
	$6,940,876	$6,361,192	579,684	462,120
Other assets, net of other liabilities			100,517	73,385**
			$680,201	$535,505

* *Based on maximum borrowings available under existing uncommitted repurchase arrangements considering the fair value of related collateral as of December 31, 1998 (see "Liquidity and Capital Resources").*

** *Represents unrestricted cash and cash equivalents (see NOTE 2 to the consolidated financial statements).*

The Company raised $51.9 million of new capital earlier in 1998 through the issuance of stock (i) directly to investors pursuant to its direct stock purchase and dividend reinvestment programs, (ii) daily sales of stock into the open market and (iii) stock compensation

programs. Effective early in June 1998, the Company suspended its stock purchase program and open market sales until further notice and in December 1998 repurchased 1 million shares of common stock for $4.1 million. Due primarily to losses incurred during the year, total stockholders' equity decreased $208.4 million to $680.2 million at December 31, 1998 compared to $888.6 million at December 31, 1997. Book values per common share outstanding at the respective balance sheet dates were as follows:

	December 31	
	1998	*1997*
Assuming liquidation of preferred stock*	$7.88	$11.74
Assuming redemption of preferred stock**	7.56	11.42

* *The Series A and B Preferred Stock have liquidation preferences of $16.40 and $11.38 per share, respectively.*
** *The Series A and B Preferred Stock have redemption prices of $16.40 and $12.50 per share, respectively.*

RESULTS OF OPERATIONS

Comparative net operating results (interest income or fee revenues, net of related interest expense and, in the case of mortgage banking and CMO administration, related direct and indirect operating expenses) by source were as follows (in thousands, except per share amounts):

	Year Ended December 31		
	1998	*1997*	*1996*
Agency and U.S. Treasury Securities	$ 12,754	$ 31,892	$ 35,082
Non-agency Securities	4,947	5,867	9,867
CMO collateral and investments	(10,078)	40,213	28,409
Mortgage banking operations	11,821	59,422	49,122
CMO administration and other	4,598	4,000	3,730
Contribution to income	24,042	141,394	126,210
Gain (loss) on sale of mortgage assets and related Derivatives	(245,261)	27,737	15,991
Impairment on CMO investments	(4,051)	–	–
Other operating expense	(9,494)	(9,205)	(14,973)
Net income (loss)	$(234,764)	$159,926	$127,228
Net income (loss) per common share:			
Basic	$(4.22)	$2.62	$2.37
Diluted	(4.22)	2.35	2.07

1998 Compared to 1997

Operating results for the year ended December 31, 1998 reflect the impact on the Company of the unfavorable interest rate environment and market conditions experienced in 1998 and steps taken by the Company in response including reducing its mortgage asset portfolios and culminating in the sale of the mortgage banking operations in December 1998 for a gain of $2.9 million (see above, "Financial Condition"). In reducing its mortgage asset portfolios, the Company incurred losses of $245.3 million including a $251.9 million loss, net of related gains on Derivatives, on the disposition of a $1.0 billion portfolio of interest-

only mortgage securities in the second quarter. Net interest margins on the Company's mortgage asset portfolios were dramatically reduced by (i) the effects of high prepayments which reduced yields on mortgage assets and (ii) declining earning capacity due to reduced holdings. Mortgage banking results also reflect the effects of high prepayments through higher mortgage servicing amortization expenses and impairment charges that were not totally offset by this operation's risk management strategies and limited mortgage production capacity.

Since year-end, the mortgage finance markets have generally improved and the Company's borrowing rates have declined; however, yields on mortgage assets continue to be depressed because of high mortgage prepayments and the resetting of underlying adjustable-rate mortgage loans to lower interest rate levels. In early 1999 the Company began deploying a portion of the proceeds from the sale of its mortgage banking operations to increase holdings of high quality mortgage-backed securities and may continue to do so. The earning capacity of the Company's mortgage asset portfolios are largely dependent on the extent to which the Company increases these portfolios and the relationship between short- and long-term interest rates (the "yield curve"). A steepening of the yield curve, whether through higher long-term interest rates or lower short-term interest rates, should improve the performance of the Company's mortgage asset portfolios (see "Effects of Interest Rate Changes"). Additionally, the Company is evaluating a number of opportunities to acquire or make strategic investments in a variety of real estate-related investments and entities, although there can be no assurance that the Company will make any such investments.

Agency Securities contributed less to operating results during 1998 than in 1997 due primarily to a 38-basis point decrease in financing spreads. The average outstanding portfolio peaked at $6.5 billion in May 1998 before being reduced by asset sales and runoff to an average of $2.3 billion in December 1998. Average yields for this portfolio were 5.77 percent during 1998 compared to 6.18 percent during 1997, while average borrowing rates were slightly lower at 5.54 percent during 1998 compared to 5.57 percent during 1997. Lower yields reflect increased amortization of purchase premiums and investments in relatively low coupon 10-year U.S. Treasury notes. Additionally, lower 6-month LIBOR and 1-year U.S. Treasury rates have contributed to declining yields on ARM securities because underlying ARM loans reset periodically based on those indices.

Non-agency Securities contributed less to operating results during 1998 than in 1997 due primarily to a 22-basis point decrease in financing spreads. The average outstanding portfolio peaked at $705 million in March 1998 before being reduced by runoff, sales and a $345.4 million CMO issuance. Average yields for this portfolio (calculated including mortgage insurance costs) were 6.79 percent during 1998 compared to 6.96 percent during 1997, while average borrowing rates were marginally higher at 5.80 percent during 1998 compared to 5.75 percent during 1997.

CMO investments contributed substantially less to operating results in 1998 than in 1997 primarily because of the disposition of the Agency Trust interest-only mortgage securities in June 1998, which significantly diminished the earning capacity of this portfolio. With the increase in expectations for future mortgage prepayments as discussed above, the Company wrote off a significant portion of remaining CMO investments through CMO bond discount amortization adjustments aggregating $15.7 million and recorded a $4.1 million other-than-temporary impairment charge to write down remaining investments in interest-only mortgage securities to fair value. Average yields for this portfolio declined to 6.32 percent during

1998 from 10.24 percent during 1997. Yields were negatively impacted by the downsizing of this portfolio and the effects of high prepayments.

Mortgage banking revenues increased to $206.1 million in 1998 compared to $172.9 million in 1997 due to growth of the new mortgage production operation, higher earnings on temporarily-held cash balances and the $2.9 million gain on sale of this operation. Amortization expenses of $95.2 million and impairment charges of $224.7 million recorded in 1998 reflect the effects of high prepayments (including the prospect of continued high prepayments) on the value of the mortgage servicing portfolio. After recording an impairment charge of $45.0 million in the second quarter, net of related gains on Derivatives, the Company's decision in July 1998 to actively manage an expanded portfolio of U.S. Treasury-based financial instruments to more fully protect the value of the Company's investment in mortgage servicing rights substantially offset impairment charges recorded in the third and fourth quarters of 1998.

Operating expenses during 1998 were comparable to 1997 in total. Higher general and administrative costs and lower allocations of costs to the mortgage banking operations were all but offset by lower compensation-related accruals. With the sale of the mortgage banking operations, ongoing operating expenses are expected to be significantly lower.

Excluding the loss on sale of the Agency Trust interest-only mortgage securities and related gains on Derivatives, the Company recorded gains of $2.3 million on the sale of $3.8 billion of mortgage assets. In addition, the Company earned $3.8 million in 1998 from a strategy of writing call options on a portion of the Company's fixed-rate securities. During 1997 the Company sold $2.0 billion of mortgage assets for gains totaling $27.0 million. Derivatives not designated as hedges contributed $708,000 to operating results during 1997.

1997 Compared to 1996

Operating results for 1997 exceeded 1996 results due primarily to the benefit of larger holdings of mortgage assets, offset somewhat by a narrowing of financing spreads due to high levels of prepayments and higher short-term borrowing rates. Likewise, mortgage servicing results, while benefiting from significant growth in the servicing portfolio in 1996 and 1995, were hampered by higher amortization of mortgage servicing rights due to high prepayments.

Agency Securities contributed less to income during 1997 than in 1996. The benefit to operating results of an $891 million (22 percent) increase in average holdings of these securities to $4.9 billion during 1997 was offset by declining financing spreads primarily because of higher prepayments. Additionally, lower 6-month LIBOR and 1-year U.S. Treasury rates led to declining yields on ARM securities because underlying ARM loans reset periodically to those indices. Finally, yields on acquisitions of newly created ARM securities trended lower because many of those securities had initial mortgage interest rates below the referenced indices (referred to as "teaser-rate ARM securities"). During 1997 financing spreads averaged only 20 basis points lower at 61-basis points; however, financing spreads for the fourth quarter of 1997 of 28-basis points were 65-basis points lower than spreads achieved in the fourth quarter of 1996. Average yields for this portfolio were 6.18 percent during 1997 compared to 6.24 percent during 1996, while average borrowing rates were higher at 5.57 percent compared to 5.43 percent during 1996.

Non-agency Securities contributed less to income during 1997 than in 1996 due primarily to a 13-basis point decrease in financing spreads and a $206 million (30 percent) reduction in

the average holdings of those securities to $476 million. Average yields for this portfolio (calculated including mortgage insurance costs) were 6.96 percent during 1997 compared to 7.01 percent during 1996, while average borrowing rates were higher at 5.75 percent during 1997 compared to 5.67 percent during 1996.

CMO investments contributed substantially more to income in 1997 than in 1996 primarily because of investments made during 1996 and 1995 in interest-only mortgage securities. Average yields for this portfolio (after hedging costs) declined to 10.24 percent during 1997 from 11.85 percent during 1996. Yields were negatively impacted by higher prepayments and increased hedging costs.

Higher mortgage banking results reflected continued growth in this operation. Revenues increased to $173 million in 1997 compared to $131 million in 1996. Servicing expenses also increased, but not to the same extent as revenues, reflecting further efficiencies gained in the servicing process with continued growth in the servicing portfolio. Amortization of mortgage servicing rights of $65 million during 1997 was higher than the $45 million recorded in 1996 due to portfolio growth and higher levels of prepayments caused by lower prevailing mortgage interest rates. Greater use of external borrowings secured by the mortgage servicing portfolio to finance portfolio growth contributed to higher borrowing costs in 1997 compared to 1996.

Operating expenses during 1997 were lower than 1996 primarily because of lower compensation-related accruals.

During 1997 the Company sold $2.0 billion of mortgage assets for gains totaling $27.0 million. This compares to sales of mortgage assets totaling $667 million during 1996 for gains of $14.9 million. Derivatives not designated as hedges contributed $708,000 to operating results during 1997 compared to $1.1 million during 1996.

LIQUIDITY AND CAPITAL RESOURCES

The Company's primary sources of funds include monthly principal and interest payments on mortgage securities and other investments, short-term borrowings, excess cash flows on CMO investments and proceeds from sales of mortgage assets. In addition, the Company has substantial liquidity with the proceeds from the December 1998 sale of its mortgage banking operations (see above "Financial Condition"), which have been temporarily deployed to reduce short-term borrowings. The Company currently believes that these funds are sufficient for the acquisition of mortgage assets, repayments on short-term borrowings, the payment of cash dividends as required for Capstead's continued qualification as a Real Estate Investment Trust ("REIT") and common and preferred stock repurchases as described below. In addition, the liquidity provided by the sale of the mortgage banking operations affords the Company the opportunity to make strategic investments in a variety of real estate-related investments and entities. There can be no assurances, however, that the Company will make any such investments. It is the Company's policy to remain strongly capitalized and conservatively leveraged.

Short-term borrowings are primarily made under repurchase arrangements. The Company has uncommitted repurchase facilities with investment banking firms to finance mortgage assets, subject to certain conditions. Interest rates on borrowings under these facilities are based on overnight to 30-day London Interbank Offered Rate ("LIBOR") rates. The terms and conditions of these arrangements, including interest rates, are negotiated on a

transaction-by-transaction basis. Amounts available to be borrowed under these arrangements are dependent upon the fair value of the securities pledged as collateral which fluctuates with changes in interest rates and the securities' credit quality. Because of the credit-worthiness of securities issued by government-sponsored entities and the U.S. government, the Company has concentrated its remaining investments that it finances using repurchase arrangements on these securities.

In February 1999 the Company's board of directors authorized the repurchase of up to 6 million shares of common stock and up to 2 million shares of $1.26 Cumulative Convertible Preferred Stock, Series B. The Company may repurchase the shares in open market transactions from time to time subject to the price of its securities and alternative investment opportunities.

With the sale of the mortgage banking operations, the Company terminated a repurchase arrangement to fund a portion of its production warehouse, which was liquidated subsequent to year-end, and a revolving line of credit agreement with an investment banking firm which was collateralized by mortgage servicing rights.

EFFECTS OF INTEREST RATE CHANGES

Interest Rate Sensitivity on Operating Results

The Company performs earnings sensitivity analysis using an income simulation model to estimate the effects that specific interest rate changes will have on future earnings. All mortgage assets and any Derivatives held are included in this exercise. In addition, sensitivity of fee income to market interest rate levels, such as those related to CMO administration, are included as well. The model incorporates management assumptions regarding the level of prepayments on mortgage assets for a given level of market rate changes using industry estimates of prepayment speeds for various coupon segments. These assumptions are developed through a combination of historical analysis and future expected pricing behavior. As of December 31, 1998, the Company had the following estimated earnings sensitivity profile:

	Immediate Change In: (rates in basis points, dollars in thousands)			
30-day LIBOR rate	Down 100	Down 100	Flat	Up 100
10-year U.S. Treasury rate	Down 100	Flat	Up 100	Up 100
Projected 12-month earnings change*	$(424)	$12,757	$8,065	$(4,775)

* *Note that the impact of actual or planned acquisitions of mortgage assets subsequent to year-end and potential new business activities were not factored into the simulation model for purposes of this disclosure.*

Income simulation modeling is a primary tool used to assess the direction and magnitude of changes in net margins on mortgage assets resulting from changes in interest rates. Key assumptions in the model include prepayment rates on mortgage assets, cash flows and maturities of Derivatives and other financial instruments, changes in market conditions, and management's financial capital plans. These assumptions are inherently uncertain and, as a

result, the model cannot precisely estimate net margins or precisely predict the impact of higher or lower interest rates on net margins. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes and other changes in market conditions, management strategies and other factors.

General Discussion of Effects of Interest Rate Changes

Changes in interest rates may impact the Company's earnings in various ways. The Company's earnings depend, in part, on the difference between the interest received on mortgage securities and other investments, and the interest paid on related short-term borrowings. The resulting spread may be reduced in a rising short-term interest rate environment. Because a substantial portion of the Company's mortgage investments are ARM mortgage securities, the risk of rising short-term interest rates is offset to some extent by increases in the rates of interest earned on the underlying ARM loans. Since ARM loans generally limit the amount of such increase during any single interest rate adjustment period and over the life of the loan, interest rates on borrowings can rise to levels that may exceed the interest rates on the underlying ARM loans resulting in a negative financing spread. The Company may invest in Derivatives from time to time, specifically interest rate caps, as a hedge against rising interest rates on a portion of its short-term borrowings. Interest rate caps generally increase in value as related interest rates rise and decline in value when such rates fall.

Another effect of changes in interest rates is that, as long-term interest rates decrease, the rate of prepayment of mortgage loans underlying mortgage investments generally increases. To the extent the proceeds of prepayments on mortgage investments cannot be reinvested at a rate of interest at least equal to the rate previously earned on such investments, earnings may be adversely affected. As seen in 1998 prolonged periods of high prepayments can significantly reduce the expected life of mortgage investments; therefore, the actual yields realized can be lower due to faster amortization of purchase premiums. In addition, the rates of interest earned on ARM investments generally will decline during periods of falling short-term interest rates as the underlying ARM loans reset at lower rates.

Changes in interest rates also impact earnings recognized from CMO investments, which have consisted primarily of interest-only mortgage securities and fixed-rate CMO residuals (see above "Financial Condition"). The amount of income that may be generated from interest-only mortgage securities is dependent upon the rate of principal prepayments on the underlying mortgage collateral. If mortgage interest rates fall significantly below interest rates on the collateral, principal prepayments will increase, reducing or eliminating the overall return on these investments. As seen in 1998 sustained periods of high prepayments can result in losses. Conversely, if mortgage interest rates rise, interest-only mortgage securities tend to perform favorably because underlying mortgage loans will generally prepay at slower rates, thereby increasing overall returns.

CMO residuals behave similarly to interest-only mortgage securities. As seen in 1998 if mortgage interest rates fall, prepayments on the underlying mortgage loans generally will be higher thereby reducing or even eliminating overall returns on these investments. This is due primarily to the acceleration of the amortization of bond discounts, a noncash item, as bond classes are repaid more rapidly than originally anticipated. Conversely, if mortgage interest rates rise significantly above interest rates on the collateral, principal prepayments will typically diminish, improving the overall return on an investment in a fixed-rate CMO

residual because of an increase in time over which the Company receives the larger positive interest spread.

The Company periodically sells mortgage assets. Such sales may become attractive as values of mortgage assets fluctuate with changes in interest rates. At other times, such as in 1998, it may become prudent to reposition investment portfolios, for example, to mitigate exposure to further declines in mortgage interest rates. In either case, sales of mortgage assets may increase income volatility because of the recognition of transactional gains or losses.

The above discussion regarding how changes in interest rates impact mortgage assets also applied to the Company's investment in mortgage servicing rights, which was sold in December 1998. When mortgage interest rates rise, periodic amortization of amounts paid for mortgage servicing rights is less since the average lives of the related mortgage loans tend to be longer. Under these conditions, mortgage servicing rights become more valuable. Conversely, lower mortgage interest rates will spur prepayments thus reducing the time the Company can service the related loans. As seen in 1998, sustained periods of high prepayments can result in losses on the Company's investment in mortgage servicing rights, particularly since this investment is evaluated for impairment on a disaggregated basis and impairment charges are necessary if the recorded amount for an individual servicing stratum exceeds its fair value.

The Company supplements its business plan from time to time with Derivatives held to help offset the effects of falling interest rates on the value of certain assets, such as interest-only mortgage securities and mortgage servicing rights. Historically, most Derivatives used by the Company have been interest rate floors that generally decrease in value when interest rates rise and increase in value when rates decline. The fair value of interest rate floors will erode over time and, as see in 1998, can also be impacted by other factors such as changes in market demand for these instruments. Other Derivatives acquired from time to time may include U.S. Treasury futures contracts and options, written options on mortgage assets or various other Derivatives available in the marketplace that are compatible with the Company's risk management objectives. In instances where such Derivatives are accorded hedge accounting treatment, changes in value adjust the basis of the assets hedged. In instances where Derivatives are not accorded hedge accounting treatment, changes in value are recorded in operating results as they occur, which can increase income volatility. With the sale of nearly all interest-only mortgage securities and the mortgage banking operations, the Company has significantly reduced its exposure to declining mortgage interest rates and therefore the use of Derivatives to manage this exposure has been curtailed.

OTHER

Impact of the Year 2000

Many existing computer software programs use only two digits to identify the year in date fields and, as such, could fail or create erroneous results by or at the Year 2000. The Company utilizes a number of software systems to administer securitizations and manage its mortgage assets. In addition, the Company utilizes vendors in various capacities and interfaces with various institutions. The Company is exposed to the risk that its systems and the systems of its vendors and institutions it interfaces with are not Year 2000 compliant.

State of Readiness. The Company has made and will continue to make investments in its software systems and applications to ensure the Company is Year 2000 compliant. The Company is also taking steps to ensure that the vendors it utilizes and institutions that it interfaces with are also taking the necessary steps to become Year 2000 compliant. This process is expected to be essentially complete by the end of the second quarter of 1999. In addition, with the sale of the mortgage banking operations in December 1998, the Company has built a completely new computer network that is considered to be Year 2000 compliant.

Costs. The financial costs of becoming Year 2000 compliant for the ongoing operations of the Company, including the construction of the Company's new computer network, have not and are not expected to exceed $300,000.

Risks and Contingency Planning. Although the Company expects that all its systems and applications will be Year 2000 compliant per the above schedule well prior to December 31, 1999, there can be no assurance that all of the vendors it utilizes and institutions that it interfaces with will complete their compliance efforts. The Company will continue to monitor their efforts in this regard and will take all prudent steps necessary to ensure operations are not disrupted including the use of other vendors or other methodologies and processes to transact the Company's business. The effect of any disruption to the Company's operations of any such instances of non-compliance is not presently determinable.

Forward Looking Statements

This document contains "forward-looking statements" (within the meaning of the Private Securities Litigation Reform Act of 1995) that inherently involve risks and uncertainties. The Company's actual results, changes in net asset value and liquidity can differ materially from those anticipated in these forward-looking statements as a result of unforeseen factors. These factors may include, but are not limited to, Year 2000 compliance failures, changes in general economic conditions, the availability of suitable investments, fluctuations in and market expectations for fluctuations in interest rates and levels of mortgage prepayments, the effectiveness of risk management strategies, the impact of leverage, liquidity of credit markets, increases in costs and other general competitive factors.

Recent Accounting Pronouncements

In June 1998 the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). SFAS 133 establishes accounting and reporting standards for Derivatives and hedging activities. It requires that an entity recognize all Derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a Derivative may be specifically designated as (i) a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment; (ii) a hedge of the exposure to variable cash flows of a forecasted transaction; or (iii) in certain circumstances, a hedge of a foreign currency exposure. This statement will become effective for the Company's fiscal year ending December 31, 2000. The adoption of SFAS 133 is not expected to have a material impact on the financial position of the Company.

DIRECTORS

Bevis Longstreth
Of Counsel,
Debevoise & Plimpton

Member: Audit and Compensation Committees

Paul M. Low
Chief Executive Officer,
Laureate Inc.

Chairman: Executive and Nominating Committees

Ronn K. Lytle
Chairman and Chief Executive Officer,
Capstead Mortgage Corporation

Member: Executive and Nominating Committees

Harriet E. Miers
Co-Managing Partner,
Locke Lidell & Sapp LLP

Chair: Audit Committee
Member: Nominating Committee

William R. Smith
Chairman of the Board and Chief Executive Officer,
Smith Capital Management

Chairman: Compensation Committee
Member: Audit Committee

John C. Tolleson
Chief Executive Officer,
The Tolleson Group

Member: Compensation and Executive Committees

OFFICERS

Ronn K. Lytle
Chairman and Chief Executive Officer

Andrew F. Jacobs
Executive Vice President – Finance,
Treasurer and Secretary

SENIOR VICE PRESIDENTS

Phillip A. Reinsch
Control

Robert R. Spears, Jr.
Asset and Liability Management

VICE PRESIDENTS

Neal E. Nix
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Amar R. Patel
Asset and Liability Management

D. Christopher Sieber
Control

Michael S. Taylor
Asset and Liability Management

Diane F. Wilson
Control

Tricia M. Zimmerman
Stockholder Relations

ASSISTANT VICE PRESIDENTS

Michael W. Brown
Asset and Liability Management

Jill A. Reed
Administration

Laura Catherine Doolittle
Control

CORPORATE INFORMATION

Transfer Agent and Registrar

Inquiries regarding stock, cash dividends or change of name or address should be direct to:
Shareowner Services
Norwest Bank of Minnesota, N.A.
Post Office Box 64863
St. Paul, Minnesota 55164-0863
(800) 468-9716

Series B Preferred Stock Conversions

Holders of Series B Preferred Stock may convert into common stock at any time. If conversion is requested after one or more monthly Series B Preferred Stock dividend record dates during a calendar quarter and on or before the record dates during a calendar quarter and on or before the record date for payment of the quarterly dividend on the common stock, the holder must pay over to the Company all such Series B Preferred Stock dividends declared and paid.

Form 10-K

A copy of the Company's Form 10-K for 1998 as filed with the Securities and Exchange Commission will be furnished upon written request to:
Capstead Mortgage Corporation
Attention: Stockholder Relations
2711 North Haskell Avenue, Suite 900
Dallas, Texas 75204-2915

Annual Meeting

The Annual Meeting of Stockholders will be held at 9:00 a.m. on May 27, 1999 at Cityplace Center East, 2711 North Haskell Avenue, Dallas, Texas.

CAPSTEAD

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