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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended September 30, 2004

OR

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

For the transition period from to \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 000-50230

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**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**

(Exact name of Registrant as specified in its charter)

**Virginia**  
(State or other jurisdiction of  
incorporation or organization)

**54-1873198**  
(I.R.S. Employer  
Identification No.)

**1001 Nineteenth Street North**  
**Arlington, VA 22209**  
(Address of principal executive offices)  
(Zip code)

**(703) 312-9500**  
(Registrant's telephone number including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date:

<u>Title</u>	<u>Outstanding</u>
Class A Common Stock	143,715,720 shares as of October 26, 2004
Class B Common Stock	24,979,599 shares as of October 26, 2004

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**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**FORM 10-Q**  
**FOR THE QUARTER ENDED SEPTEMBER 30, 2004**  
**INDEX**

	<u>Page</u>
<b>Part I. FINANCIAL INFORMATION<sup>1</sup></b>	
Item 1. Financial Statements — (unaudited)	
Consolidated Balance Sheets — September 30, 2004 and December 31, 2003 . . . . .	3
Consolidated Statements of Operations — Three Months Ended September 30, 2004 and 2003 . . . .	4
Consolidated Statements of Operations — Nine Months Ended September 30, 2004 and 2003 . . . .	5
Consolidated Statements of Changes in Shareholders' Equity — Nine Months Ended September 30, 2004 and Year Ended December 31, 2003 . . . . .	6
Consolidated Statements of Cash Flows — Nine Months Ended September 30, 2004 and 2003 . . . .	7
Notes to Consolidated Financial Statements . . . . .	8
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations . . . . .	22
Item 3. Quantitative and Qualitative Disclosures about Market Risk . . . . .	32
Item 4. Controls and Procedures . . . . .	35
<b>Part II. OTHER INFORMATION</b>	
Item 1. Legal Proceedings . . . . .	36
Item 4. Submission of Matters to a Vote of Security Holders . . . . .	37
Item 6. Exhibits and Reports on Form 8-K . . . . .	37
Signatures . . . . .	39

<sup>1</sup> On March 31, 2003, Friedman, Billings, Ramsey Group, Inc. ("the Company" or "FBR") completed its merger with FBR Asset Investment Corporation ("FBR Asset") and one of its wholly owned subsidiaries, Forest Merger Corporation, created to effect the merger (the "merger") of FBR and FBR Asset. The merger was accounted for as a purchase of FBR Asset by FBR using the purchase method of accounting. For the period from January 1, 2003 through March 30, 2003, and prior periods the Company accounted for its investment in FBR Asset using the equity method of accounting. See Note 2 to the Consolidated Financial Statements at page 8.

**PART I — FINANCIAL INFORMATION**

**Item 1. Consolidated Financial Statements and Notes — (unaudited)**

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED BALANCE SHEETS**  
(Dollars in thousands)  
(Unaudited)

	<u>September 30, 2004</u>	<u>December 31, 2003</u>
<b>ASSETS</b>		
Cash and cash equivalents .....	\$ 173,535	\$ 92,688
Receivables:		
Interest .....	44,953	44,674
Asset management fees .....	5,777	5,517
Investment banking .....	15,954	8,464
Affiliates .....	4,098	4,861
Securities sold .....	164,078	—
Other .....	3,370	3,779
Investments:		
Mortgage-backed securities, at fair value .....	10,918,664	10,551,570
Long-term investments .....	341,942	379,002
Reverse repurchase agreements .....	162,095	—
Trading securities, at fair value .....	54,373	4,932
Due from clearing broker .....	227,282	89,940
Management contract intangible .....	14,755	16,090
Goodwill .....	108,013	108,013
Furniture, equipment, software and leasehold improvements, net of accumulated depreciation and amortization of \$24,786 and \$24,852, respectively .....	11,315	6,969
Prepaid expenses and other assets .....	33,361	12,086
<b>Total assets</b> .....	<b><u>\$12,283,565</u></b>	<b><u>\$11,328,585</u></b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Liabilities:</b>		
Trading account securities sold but not yet purchased, at fair value .....	\$ 147,965	\$ 9,525
Repurchase agreements .....	4,784,967	5,095,676
Commercial paper .....	5,346,318	4,392,965
Securities purchased .....	119,494	—
Dividends payable .....	57,359	56,744
Interest payable .....	9,639	6,188
Accrued compensation and benefits .....	93,508	100,901
Accounts payable, accrued expenses and other liabilities .....	72,779	58,058
Long-term debt .....	108,175	54,189
<b>Total liabilities</b> .....	<b><u>10,740,204</u></b>	<b><u>9,774,246</u></b>
<b>Commitments and Contingencies (Note 10)</b>		
<b>Shareholders' equity:</b>		
Preferred Stock .....	—	—
Class A Common Stock, \$0.01 par value, 450,000,000 shares authorized, 143,710,720 and 141,021,320 shares issued and outstanding, respectively .....	1,437	1,410
Class B Common Stock, \$0.01 par value, 100,000,000 shares authorized, 24,979,599 and 25,872,099 shares issued and outstanding, respectively .....	250	259
Additional paid-in capital .....	1,477,413	1,443,228
Employee stock loan receivable (717 and 1,290 shares) .....	(4,821)	(8,277)
Deferred compensation .....	(17,492)	(2,203)
Accumulated other comprehensive (loss) income, net .....	(44,949)	60,505
Retained earnings .....	131,523	59,417
<b>Total shareholders' equity</b> .....	<b><u>1,543,361</u></b>	<b><u>1,554,339</u></b>
<b>Total liabilities and shareholders' equity</b> .....	<b><u>\$12,283,565</u></b>	<b><u>\$11,328,585</u></b>

See notes to consolidated financial statements.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Dollars in thousands, except per share data)  
(Unaudited)

	Three Months Ended September 30,	
	2004	2003
<b>Revenues:</b>		
Investment banking:		
Underwriting .....	\$ 65,990	\$ 37,518
Corporate finance .....	75,631	51,637
Institutional brokerage:		
Principal transactions .....	4,241	6,549
Agency commissions .....	18,505	13,145
Asset management:		
Base management fees .....	7,044	5,602
Incentive allocations and fees .....	1,737	1,549
Principal investment:		
Interest .....	88,035	46,849
Net investment income .....	19,090	18,178
Dividends .....	5,820	1,258
Other .....	1,827	2,675
Total revenues .....	287,920	184,960
Interest expense .....	44,265	22,972
Revenues, net of interest expense .....	243,655	161,988
<b>Non-Interest Expenses:</b>		
Compensation and benefits .....	95,824	67,505
Professional services .....	13,421	6,508
Business development .....	8,284	4,820
Clearing and brokerage fees .....	1,556	2,057
Occupancy and equipment .....	3,898	2,426
Communications .....	3,348	2,969
Other operating expenses .....	4,846	4,259
Total non-interest expenses .....	131,177	90,544
Net income before taxes .....	112,478	71,444
Income tax provision .....	20,329	14,483
<b>Net income</b> .....	<b>\$ 92,149</b>	<b>\$ 56,961</b>
Basic earnings per share .....	\$ 0.55	\$ 0.42
Diluted earnings per share .....	\$ 0.55	\$ 0.41
Dividends declared per share .....	\$ 0.34	\$ 0.34
<b>Weighted average shares outstanding:</b>		
Basic .....	167,593	135,670
Diluted .....	168,800	138,269

See notes to consolidated financial statements.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Dollars in thousands, except per share data)  
(Unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
<b>Revenues:</b>		
Investment banking:		
Underwriting .....	\$166,240	\$ 70,281
Corporate finance .....	128,482	70,739
Institutional brokerage:		
Principal transactions .....	15,686	16,876
Agency commissions .....	68,702	33,731
Asset management:		
Base management fees .....	19,963	18,662
Incentive allocations and fees .....	2,958	8,535
Principal investment:		
Interest .....	264,141	98,432
Net investment income .....	74,531	55,489
Dividends .....	8,475	3,741
Other .....	4,824	6,452
Total revenues .....	754,002	382,938
Interest expense .....	111,188	44,339
Revenues, net of interest expense .....	642,814	338,599
<b>Non-Interest Expenses:</b>		
Compensation and benefits .....	228,411	135,150
Professional services .....	38,635	13,059
Business development .....	33,707	14,826
Clearing and brokerage fees .....	6,937	5,037
Occupancy and equipment .....	10,128	6,842
Communications .....	9,732	7,406
Other operating expenses .....	16,168	11,316
Total non-interest expenses .....	343,718	193,636
Net income before taxes .....	299,096	144,963
Income tax provision .....	36,129	23,507
<b>Net income</b> .....	<b>\$262,967</b>	<b>\$121,456</b>
Basic earnings per share .....	\$ 1.57	\$ 1.14
Diluted earnings per share .....	\$ 1.56	\$ 1.11
Dividends declared per share .....	\$ 1.14	\$ 1.02
<b>Weighted average shares outstanding:</b>		
Basic .....	166,975	106,279
Diluted .....	168,500	109,103

See notes to consolidated financial statements.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
(Dollars in thousands)  
(Unaudited)

	Class A Number of Shares	Class A Amount	Class B Number of Shares	Class B Amount	Addi- tional Paid- In Capital	Employee Stock Loan Receivable	Deferred Compensation, net	Accumu- lated Other Compre- hensive Income (Loss)	Retained Earnings	Total	Comprehensive Income (Loss)
<b>Balances, December 31, 2002</b> . . .	24,480,092	\$ 245	25,975,449	\$260	\$ 211,724	\$(24,182)	\$ —	\$ 4,345	\$ 52,773	\$ 245,165	
Net Income . . . . .									201,414	201,414	\$201,414
Repurchase of Class A shares . . . . .	(976,600)	(10)			(8,173)					(8,183)	
Conversion of Class B shares to Class A shares . . . . .	103,350	1	(103,350)	(1)						—	
Issuance of Class A common shares . . . . .	117,414,478	1,174			1,238,137		(2,203)			1,237,108	
Repayment of employee stock purchase and loan plan receivable . . . . .						17,445				17,445	
Interest on employee stock purchase and loan plan . . . . .					1,540	(1,540)					
Other comprehensive income: Net change in unrealized gain (loss) on available-for-sale investment securities, net of taxes . . . . .								55,045		55,045	55,045
Net change in unrealized gain (loss) on cash flow hedges . . . . .								1,115		1,115	1,115
Comprehensive income . . . . .											<u>\$257,574</u>
Dividends . . . . .									(194,770)	(194,770)	
<b>Balances, December 31, 2003</b> . . .	141,021,320	\$1,410	25,872,099	\$259	\$1,443,228	\$(8,277)	\$(2,203)	\$ 60,505	\$ 59,417	\$1,554,339	
Net Income . . . . .									262,967	262,967	\$262,967
Conversion of Class B shares to Class A shares . . . . .	892,500	9	(892,500)	(9)						—	
Issuance of Class A common shares . . . . .	1,796,900	18			33,886		(15,289)			18,615	
Repayment of employee stock purchase and loan plan receivable . . . . .						3,755				3,755	
Interest on employee stock purchase and loan plan . . . . .					299	(299)					
Other comprehensive income: Net change in unrealized gain (loss) on available-for-sale investment securities, net of taxes . . . . .								(80,668)		(80,668)	(80,668)
Net change in unrealized gain (loss) on cash flow hedges . . . . .								(24,786)		(24,786)	(24,786)
Comprehensive income . . . . .											<u>\$157,513</u>
Dividends . . . . .									(190,861)	(190,861)	
<b>Balances, September 30, 2004</b> . .	143,710,720	\$1,437	24,979,599	\$250	\$1,477,413	\$(4,821)	\$(17,492)	\$(44,949)	\$ 131,523	\$1,543,361	

See notes to consolidated financial statements.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Dollars in thousands)  
(Unaudited)

	Nine Months Ended September 30,	
	2004	2003
<b>Cash flows from operating activities:</b>		
Net income	\$ 262,967	\$ 121,456
Non-cash items included in earnings:		
Incentive allocations and fees and net investment income from long-term investments	(76,526)	(45,787)
Premium amortization on mortgage-backed securities	60,959	64,016
Derivative contracts marked-to-market	4,316	(9,142)
Depreciation and amortization	4,241	3,138
Other	(490)	2,129
Changes in operating assets:		
Receivables:		
Investment banking	(7,490)	(9,382)
Asset management fees	(260)	8,080
Affiliates	763	3,972
Other	409	(7,171)
Due from clearing broker	(137,342)	(40,916)
Marketable and trading securities	(49,441)	1,553
Prepaid expenses and other assets	(14,103)	(22,331)
Changes in operating liabilities:		
Trading account securities sold but not yet purchased	138,440	4,070
Accounts payable, accrued expenses and other liabilities	9,869	17,357
Accrued compensation and benefits	(7,393)	12,257
Net cash provided by operating activities	188,919	103,299
<b>Cash flows from investment activities:</b>		
Purchases of mortgage-backed securities	(5,075,794)	(7,768,346)
Receipt of principal payments on mortgage-backed securities	3,227,861	2,222,023
Proceeds from sales of mortgage-backed securities	1,298,721	1,771,971
Purchases of reverse repurchase agreements, net	(162,095)	—
Purchases of long-term investments	(71,825)	(33,036)
Proceeds from sales of long-term investments	155,865	56,219
Purchases of fixed assets	(7,274)	(2,481)
Proceeds from disposals of fixed assets	22	5,114
FBR Asset cash acquired	—	11,258
Bank loans, net of allowances	—	15,052
Net cash used in investing activities	(634,519)	(3,722,226)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of long-term debt	52,500	40,000
Repayments of long-term debt	—	(970)
Proceeds from repurchase agreements, net	(310,709)	(168,310)
Proceeds from issuances of commercial paper, net	953,353	4,039,888
Dividends paid	(191,056)	(90,617)
Proceeds from issuance of common stock	18,605	29,176
Proceeds from repayments of employee stock loan receivable	3,754	871
Repayments of short-term borrowings	—	(9,618)
Net (decrease) in bank deposits	—	(51,215)
Repurchases of Class A common shares	—	(8,183)
Net cash provided by financing activities	526,447	3,781,022
Net increase in cash and cash equivalents	80,847	162,095
Cash and cash equivalents, beginning of period	92,688	90,007
Cash and cash equivalents, end of period	\$ 173,535	\$ 252,102
<b>Supplemental Cash Flow Information:</b>		
Cash payments for interest	\$ 96,981	\$ 47,300
Cash payments for taxes	\$ 48,264	\$ 14,600

Note: The Company's merger with FBR Asset was a non-cash transaction see Note 2.

See notes to consolidated financial statements.

**FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Dollars in thousands)**  
**(Unaudited)**

**1. Basis of Presentation:**

The consolidated financial statements of Friedman, Billings, Ramsey Group, Inc. and subsidiaries (“FBR Group,” “FBR,” or the “Company”) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q. Therefore, they do not include all information required by accounting principles generally accepted in the United States of America for complete financial statements. The interim financial statements reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair statement of the results for the periods presented. All significant intercompany accounts and transactions have been eliminated in consolidation. The results of operations for interim periods are not necessarily indicative of the results for the entire year. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2003 included on Form 10-K filed by the Company under the Securities Exchange Act of 1934.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Certain amounts in the consolidated financial statements and notes for prior periods have been reclassified to conform to the current period presentation.

**2. FBR Asset Investment Corporation:**

*Merger With FBR Asset Investment Corporation*

In June 2001, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 141, “Business Combinations,” which provides that all business combinations initiated after June 30, 2001 be accounted for using the purchase method. Under the purchase method, net assets and results of operations of acquired companies are included in the consolidated financial statements from the date of acquisition. In addition, SFAS 141 provides that the cost of an acquired entity must be allocated to the assets acquired, including identifiable intangible assets, and the liabilities assumed based on their estimated fair values at the date of acquisition. The excess of cost over the fair value of the net assets acquired must be recognized as goodwill.

On November 15, 2002, the Company announced that it had entered into a merger agreement with FBR Asset Investment Corporation (“FBR Asset”) and one of its wholly owned subsidiaries, Forest Merger Corporation (“New FBR”), created to effect the merger (the “merger”) of FBR and FBR Asset. At separate special meetings of FBR and FBR Asset shareholders held on March 28, 2003, shareholders of both companies voted to approve the merger. The merger closed before the opening of business on March 31, 2003. The merger was accounted for as a purchase of FBR Asset by FBR Group using the purchase method of accounting. During the period from January 1, 2003 through March 30, 2003, the Company accounted for its investment in FBR Asset using the equity method of accounting.

Upon completion of the merger, pursuant to the merger agreement, FBR Asset merged with and into New FBR, and, immediately following that merger, FBR Group merged with and into New FBR, with New FBR continuing as the surviving company to each merger, and subsequently assuming the name Friedman, Billings, Ramsey Group, Inc. At the time of the merger, each outstanding share of FBR Group Class A common stock was converted into the right to receive one share of New FBR Class A common stock, each outstanding share of FBR Group Class B common stock was converted into the right to receive one share of New FBR Class B common stock, and each outstanding share of FBR Asset common stock was converted into the right to receive 3.65 shares of New FBR Class A common stock.

Upon completion of the merger, the Company elected Real Estate Investment Trust (“REIT”) status for U.S. federal income tax purposes. The Company conducts its mortgage-backed securities and merchant banking investments at the parent company REIT level. To qualify for tax treatment as a REIT, the parent company must meet certain income and asset tests and distribution requirements. The parent company generally will not be subject to federal income tax at the corporate level to the extent that it distributes at least 90 percent of its taxable income to its shareholders and complies with certain other requirements.

Also upon completion of the merger, the Company created FBR TRS Holdings, Inc., a taxable REIT subsidiary holding company, under which the Company conducts its investment banking, institutional brokerage and asset management business in taxable REIT subsidiaries. The taxable REIT subsidiaries are fully subject to corporate income tax. Income from the taxable REIT subsidiaries may be retained by the subsidiaries or distributed to the parent REIT company.

FBR Group’s purchase price of \$776,862 is calculated using the number of shares of New FBR Class A common stock issued in the merger of 85,973,312 (determined as the number of shares of FBR Asset common stock outstanding immediately prior to completion of the merger multiplied by the exchange ratio of 3.65) and an \$8.91 per share average trading price of FBR Group common stock for a period of two days before and after the terms of the merger agreement were agreed to and announced and direct merger costs of \$10,840. A summary of the fair values of the net assets acquired is as follows:

Cash .....	\$ 11,258
Mortgage-backed securities .....	4,658,407
Equity investments .....	97,555
Interest receivable .....	30,207
Other assets .....	1,535
Repurchase agreements .....	(4,032,746)
Interest rate swaps .....	(10,481)
Interest payable .....	(13,892)
Other liabilities .....	(3,408)
Adjustment to eliminate FBR Group investment in FBR Asset .....	(67,786)
Goodwill .....	106,213
Total purchase price, including acquisition costs .....	<u>\$ 776,862</u>

The total amount of goodwill represents the cost of FBR Asset in excess of the fair value of the net assets acquired and is not deductible for tax purposes. Under SFAS No. 142, “Goodwill and Other Intangible Assets,” goodwill is not amortized. Instead, this asset is required to be tested at least annually for impairment.

The following presents unaudited pro forma consolidated results for the nine months ended September 30, 2003.

	Nine Months Ended September 30,	
	Actual 2004	2003
Gross revenues, as reported . . . . .	\$754,002	\$382,938
Revenues, net of interest expense, as reported . . . . .	642,814	338,599
Net earnings, as reported . . . . .	262,967	121,456
Gross revenues, pro forma . . . . .	n/a	430,182
Revenues, net of interest expense, pro forma . . . . .	n/a	364,917
Net earnings, pro forma . . . . .	n/a	147,282
Earnings per common share:		
Basic, as reported . . . . .	\$ 1.57	\$ 1.14
Diluted, as reported . . . . .	\$ 1.56	\$ 1.11
Basic, pro forma . . . . .	n/a	\$ 1.10
Diluted, pro forma . . . . .	n/a	\$ 1.08

***Investment in FBR Asset***

As of March 30, 2003, and during the period from January 1, 2003 through March 30, 2003, as well as at December 31, 2002, the Company and its affiliated entities owned 2,844,700 shares or 10.88% percent of the outstanding common stock of FBR Asset.

During the period from January 1, 2003 through March 30, 2003, the Company accounted for its investment in FBR Asset using the equity method of accounting and recorded \$2,860 of net investment income in the statements of operations for its proportionate share of FBR Asset’s net income during the period.

Prior to its merger with FBR Asset, the Company had a management agreement with FBR Asset under which the Company performed portfolio management services on behalf of FBR Asset. These services included, but were not limited to, making investment purchases and sales, collecting market information, submitting reports pertaining to FBR Asset’s assets, interest rates, and general economic conditions, and periodic review and evaluation of the performance of FBR Asset’s portfolio of assets.

Under this management agreement the Company received a quarterly “base” management fee equal to the sum of (1) 0.20 percent per annum (adjusted to reflect a quarterly period) of the average book value of the mortgage assets of FBR Asset during each calendar quarter and (2) 0.75 percent per annum (adjusted to reflect a quarterly period) of the average book value of the remainder of FBR Asset’s invested assets during each calendar quarter. During the period January 1, 2003 through March 30, 2003, the Company recorded \$2,762 in base management fees.

In addition, under the management agreement the Company was also entitled to receive incentive fees based on the performance of FBR Asset during the preceding four quarters, calculated: funds from operations, plus net realized gains or losses from asset sales, less the threshold amount (all computed on a weighted average share outstanding basis), multiplied by 25 percent. The threshold amount was calculated as the weighted average issuance price per share of all shares of FBR Asset, multiplied by a rate equal to the average of the weekly closing rate of the ten-year U.S. Treasury during the previous 52-week period plus five percent per annum. During the period January 1, 2003 through March 30, 2003, the Company recorded \$5,617 in incentive fees.

The Company entered into an agreement in August 2001 with FBR Asset and its registered broker-dealer subsidiary, Pegasus, regarding FBR Asset's extension of credit to or investment in entities that are or may be the Company's investment banking clients. During the period January 1, 2003 through March 30, 2003, pursuant to this agreement, the Company paid \$353 in fees to FBR Asset in connection with investment banking transactions.

### 3. Stock Compensation:

The Company accounts for stock-based compensation in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," as amended. Pursuant to SFAS 123, the Company continues to apply the provisions of Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees." Under APB 25, compensation expense is recorded for the difference, if any, between the fair market value of the common stock on the date of grant and the exercise price of the option. For certain option grants made during 2003 and 2004, the exercise prices of options granted were below the market prices on the dates of grants. The total compensation recorded for these grants was less than \$100 for the three and nine months ended September 30, 2004 and 2003. All outstanding stock options at March 30, 2003 vested as a result of the merger with FBR Asset. The following pro forma financial information reflects the application of SFAS 123's fair value approach to recording stock compensation.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net income, as reported	\$92,149	\$56,961	\$262,967	\$121,456
Stock based employee compensation	143	28	198	1,708
Pro forma net income	\$92,006	\$56,933	\$262,769	\$119,748
Basic earnings per share—as reported	\$ 0.55	\$ 0.42	\$ 1.57	\$ 1.14
Basic earnings per share—pro forma	\$ 0.55	\$ 0.42	\$ 1.56	\$ 1.13
Diluted earnings per share—as reported	\$ 0.55	\$ 0.41	\$ 1.57	\$ 1.11
Diluted earnings per share—pro forma	\$ 0.55	\$ 0.41	\$ 1.56	\$ 1.10

### 4. Investments:

#### *Institutional Brokerage Trading Securities*

Trading securities owned and trading account securities sold but not yet purchased consisted of securities at fair values as of September 30, 2004 and December 31, 2003:

	September 30, 2004		December 31, 2003	
	Owned	Sold But Not Yet Purchased	Owned	Sold But Not Yet Purchased
Corporate stocks	\$52,378	\$142,013	\$3,754	\$9,524
Corporate bonds	1,996	5,952	1,178	1
	\$54,374	\$147,965	\$4,932	\$9,525

Trading account securities sold but not yet purchased represent obligations of the Company to deliver the specified security at the contracted price, and thereby, create a liability to purchase the security in the market at prevailing prices. However, these obligations relate primarily to over-allotments associated with the Company's underwriting activities. As of September 30, 2004 and December 31, 2003, for \$131,375 and \$8,900 respectively, of securities sold but not yet purchased, the Company maintains an option to purchase additional shares from the

issuer at the applicable offering price less the underwriter discount to cover these short positions. Accordingly, these transactions when unrelated to over-allotments result in off-balance-sheet risk as the Company's ultimate obligation to satisfy the sale of securities sold but not yet purchased may exceed the current value recorded in the consolidated balance sheets.

### ***Principal Investments***

The Company's investments as principal consisted of the following as of September 30, 2004 and December 31, 2003:

	<u>September 30, 2004</u>	<u>December 31, 2003</u>
Mortgage-backed securities .....	\$10,918,664	\$10,551,570
Reverse repurchase agreements .....	162,095	—
Long-term Investments		
Merchant Banking:		
Marketable equity securities .....	139,656	178,550
Non-public equity securities .....	124,078	83,400
Private debt investment .....	5,000	7,500
Equity method investments .....	58,937	67,756
Cost method and other investments .....	9,024	15,195
Investment securities—marked to market .....	5,247	26,601
Total long-term investments .....	<u>341,942</u>	<u>379,002</u>
Total principal investments .....	<u>\$11,422,701</u>	<u>\$10,930,572</u>

### ***Mortgage-Backed Securities and Long-Term Investments***

The Company's principal investments consist primarily of mortgage-backed securities and equity investments in publicly traded companies. In accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," these securities are classified as either available-for-sale (carried at fair value with resulting unrealized gains and losses reflected as other comprehensive income or loss) or trading (carried at fair value with unrealized gains and losses recorded to net investment income).

The Company's investments in mortgage-backed securities and marketable equity securities as of September 30, 2004 and December 31, 2003 were:

	<u>September 30, 2004</u>			<u>Fair Value</u>
	<u>Amortized Cost</u>	<u>Unrealized</u>		
		<u>Gains</u>	<u>Losses</u>	
Mortgage-backed securities <sup>(1)</sup>				
Available-for-sale .....	\$10,917,408	\$ 6,257	\$(84,410)	\$10,839,255
Trading .....	79,250	159	—	79,409
	<u>10,996,658</u>	<u>6,416</u>	<u>(84,410)</u>	<u>10,918,664</u>
Marketable equity securities – Available-for sale .....	116,215	30,161	(6,720)	139,656
Total .....	<u>\$11,112,873</u>	<u>\$36,577</u>	<u>\$(91,130)</u>	<u>\$11,058,320</u>

<sup>(1)</sup> As of September 30, 2004, the mortgage-backed securities portfolio had a net premium of \$192,511. This net premium includes \$17,683 of remaining premium related to the increase in the basis of the securities acquired from FBR Asset based on the values of the securities at the time of the merger.

	December 31, 2003			
	Amortized Cost	Unrealized		Fair Value
		Gains	Losses	
Mortgage-backed securities – Available-for sale . . . . .	\$10,590,540	\$ 15,535	\$(54,505)	\$10,551,570
Marketable equity securities – Available-for sale . . . . .	82,607	96,323	(380)	178,550
Total . . . . .	<u>\$10,673,147</u>	<u>\$111,858</u>	<u>\$(54,885)</u>	<u>\$10,730,120</u>

The Company's mortgage-backed securities portfolio is comprised of agency-backed adjustable-rate mortgage-backed securities, most of which are Hybrid ARM securities in which the coupon is fixed for three or five years before adjusting. The weighted-average coupon of the portfolio at September 30, 2004 and December 31, 2003 was 3.90% and 4.42%, respectively.

During the three months ended September 30, 2004, the Company sold mortgage-backed securities resulting in gross gains and losses of \$4,825 and \$(2,983), respectively, and sold marketable equity securities resulting in gross gains and losses of \$13,194 and \$-0-, respectively. During the same period in 2003, sales of mortgage-backed securities resulted in gross gains and losses of \$727 and \$(256), respectively, while sales of marketable equity securities resulted in gross gains and losses of \$13,887 and \$-0-, respectively.

During the nine months ended September 30, 2004, the Company sold mortgage-backed securities resulting in gross gains and losses of \$4,994 and \$(3,820), respectively, and sold marketable equity securities resulting in gross gains and losses of \$66,785 and \$-0-, respectively. During the same period in 2003, sales of mortgage-backed securities resulted in gross gains and losses of \$6,273 and \$(331), respectively, while sales of marketable equity securities resulted in gross gains and losses of \$24,398 and \$-0-, respectively.

The following table shows the gross unrealized losses and fair value of the Company's available for sale securities at September 30, 2004 with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by length of time the individual securities have been in a continuous loss position.

	Continuous Unrealized Loss Position for					
	Less Than 12 Months			12 Months or More		
	Amortized Cost	Unrealized Losses	Fair Value	Amortized Cost	Unrealized Losses	Fair Value
Mortgage-backed securities . . . . .	\$7,414,716	\$(54,100)	\$7,360,616	\$1,829,215	\$(30,310)	\$1,798,905
Marketable equity securities . . . . .	58,330	(6,720)	51,610	—	—	—
Total . . . . .	<u>\$7,473,046</u>	<u>\$(60,820)</u>	<u>\$7,412,226</u>	<u>\$1,829,215</u>	<u>\$(30,310)</u>	<u>\$1,798,905</u>

The unrealized losses on mortgage-backed securities are due to interest rate increases and are not related to credit quality issues. All of the mortgage-backed securities held by the Company are guaranteed as to principal and interest by Fannie Mae, Freddie Mac or Ginnie Mae. The Company does not deem these investments to be other-than-temporarily impaired based on the severity of the decline, because the decline in market value is attributable to interest rate increases and because the Company has the intent and ability to hold these investments until a recovery of fair value occurs, which may be maturity. The Company has also evaluated its portfolio of marketable equity securities for impairment. Based on the limited severity and duration of these losses and the Company's ability and intent to hold these investments for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider these investments to be other-than-temporarily impaired. For investments in equity securities carried at cost and other cost method investments, except as noted in the following sentence, the Company did not identify any events or changes in circumstances that may have had a significant adverse effect on the fair value of those investments. The Company recorded a \$2,500 impairment loss during the third quarter of 2004 that is included in net investment income reflecting the Company's evaluation of the estimated fair value of a private debt investment as of September 30, 2004. This impairment loss was due to circumstances arising during the quarter that had an adverse effect on the fair value of the security.

As of September 30, 2004, \$10,257,540 (fair value excluding principal receivable) of the mortgage-backed securities were pledged as collateral for repurchase agreements, commercial paper borrowings and interest rate swap agreements. In addition, \$47,511 of principal and interest receivables related to the securities collateralizing commercial paper borrowings have also been pledged as collateral for those borrowings.

***Reverse Repurchase Agreements***

In May 2004 the Company entered into one year Master Repurchase Agreement with a mortgage loan originator under which the Company provides warehouse financing to the mortgage originator. As of September 30, 2004, the outstanding balance was \$162,095 and the weighted average coupon was 2.38%. The Company funds its advances under the agreement through repurchase agreement borrowings. Both the reverse repurchase agreement and repurchase agreement borrowings reset daily and mature within the next six months.

**5. Borrowings:**

***Commercial Paper and Repurchase Agreements***

The Company issues commercial paper and enters into repurchase agreements to fund its investments in mortgage-backed securities and reverse repurchase agreements. Commercial paper issuances are conducted through Georgetown Funding Company, LLC (“Georgetown Funding”), a special purpose Delaware limited liability company organized for the purpose of issuing extendable commercial paper notes in the asset-backed commercial paper market and entering into reverse repurchase agreements with the Company and its affiliates. The Company serves as administrator for Georgetown Funding’s commercial paper program. Through its administration agreement, the Company maintains effective control over Georgetown Funding. The Company consolidates Georgetown Funding for financial reporting purposes. The commercial paper notes issued by Georgetown Funding are rated A1+/P1 by Standard & Poor’s and Moody’s Investors Service, respectively. The Company’s Master Repurchase Agreement with Georgetown Funding enables the Company to finance up to \$12,000,000 of mortgage-backed securities. Prior to August 31, 2004, financing capacity through Georgetown Funding was \$5,000,000.

The following table provides information regarding the Company’s outstanding commercial paper and repurchase agreement borrowings as of September 30, 2004 and December 31, 2003.

	September 30, 2004		December 31, 2003	
	Commercial Paper	Repurchase Agreements	Commercial Paper	Repurchase Agreements
Outstanding balance . . . . .	\$5,346,318	\$4,784,967	\$4,392,965	\$5,095,676
Weighted-average rate . . . . .	1.83%	1.72%	1.18%	1.14%
Weighted-average term to maturity . . . . .	38.9 days	30.2 days	37.3 days	25.6 days

The following table provides information regarding the Company’s commercial paper and repurchase agreement borrowings outstanding during the three and nine months ended September 30, 2004 and 2003.

	September 30, 2004		September 30, 2003	
	Commercial Paper	Repurchase Agreements	Commercial Paper	Repurchase Agreements
Weighted-average outstanding balance during the three months ended . . . . .	\$4,775,182	\$6,310,166	\$965,227	\$6,787,821
Weighted-average rate during the three months ended . . . . .	1.56%	1.52%	1.18%	1.12%
Weighted-average outstanding balance during the nine months ended . . . . .	\$4,659,973	\$5,762,767	\$325,278	\$4,370,136
Weighted-average rate during the nine months ended . . . . .	1.27%	1.29%	1.18%	1.20%

See also Note 6 for information regarding the effects of interest rate swaps and Eurodollar futures on the Company’s borrowing costs.

### ***Long Term Debt***

During 2003, and through September 30, 2004, the Company through its taxable REIT subsidiary FBR TRS Holdings, Inc. (“TRS Holdings”) issued a total of \$102,500 in long-term debentures. The long term debt securities accrue and require payments of interest quarterly at annual rates of three month LIBOR plus 2.50%-3.25%, mature in thirty years, and are redeemable, in whole or in part, without penalty after five years.

### **6. Derivative Financial Instruments and Hedging Activities:**

In the normal course of its operations, the Company is a party to financial instruments that are accounted for as derivative financial instruments in accordance with SFAS No. 133, “Accounting for Derivative Instruments and for Hedging Activities,” as amended. These instruments include interest rate swap agreements, Eurodollar futures contracts, forward commitments to purchase and sell mortgaged-backed securities and warrants to purchase common stock.

#### ***Interest Rate Swaps and Eurodollar Futures Contracts***

The Company utilizes interest rate swap agreements and Eurodollar futures to hedge the interest rate risk associated with its repurchase agreement and commercial paper borrowings. In the third quarter of 2004, the Company also began using derivatives to economically hedge certain positions in mortgage-backed securities. The counterparties to the interest rate swap agreements and Eurodollar futures contracts are U.S. financial institutions. Under the interest rate swap agreements, the Company receives a floating rate based on three-month LIBOR and pays a fixed rate, as summarized below. Eurodollar futures contracts are a proxy for the forward AA/AAA LIBOR-based credit curve and allow the Company the ability to lock in three month LIBOR forward rates.

When hedging the variability in interest payments associated with the Company’s borrowing activities, the notional amount of each interest rate swap agreement and Eurodollar futures contract is matched against a like amount of current and/or anticipated borrowings under repurchase agreements or commercial paper. These instruments are highly effective hedges and qualify as cash flow hedges under SFAS 133. Accordingly, changes in the fair value of these derivatives are reported in other comprehensive income to the extent the hedge was perfectly effective, while changes in value attributable to hedge ineffectiveness are reported in earnings. The gains and losses on cash flow hedge transactions that are reported in other comprehensive income are reclassified to earnings in the periods in which the earnings are affected by the hedged cash flows.

The Company also uses Eurodollar futures contracts to economically hedge the fair value of certain mortgage-backed security positions, which were comprised of mortgage-backed securities classified as trading and certain commitments to purchase mortgage-backed securities. The Company has not designated these Eurodollar futures contracts as hedges under SFAS 133. The total notional amount of these contracts, which have maturity dates ranging from December 2004 to September 2011, was \$4,860,000 as of September 30, 2004. The market value of these contracts at September 30, 2004 was \$(3,157). The gains and losses on these derivatives are recorded to net investment income along with the gains and losses on the mortgage-backed security positions being hedged. For the three and nine months ended September 30, 2004, the Company recorded a net loss of \$6,561 on these derivatives. During the same periods, the Company recorded a net gain of \$7,619 on the related mortgage-backed security positions (see Note 4 disclosures relating to mortgage-backed securities designated as trading, and discussion of dollar roll forward commitments below for further information regarding this net gain).

The net effect of the Company’s interest rate swap agreements, including purchase accounting basis adjustments and hedge ineffectiveness, and Eurodollar futures contracts accounted for as cash flow hedges was to decrease (increase) interest expense by \$876 and \$(6,187) for the three and nine months ended September 30, 2004, respectively. The total gain deferred in accumulated other comprehensive income relating to these

derivatives was \$7,807 at September 30, 2004. All of these amounts are expected to flow through the Company's statement of operations over the next twelve months. The Company held the following interest rate swaps at September 30, 2004 and December 31, 2003.

<u>Notional Amount</u>	<u>Pay Rate<sup>(1)</sup></u>	<u>Receive Rate on September 30, 2004</u>	<u>Receive Rate on December 31, 2003</u>	<u>Termination Date</u>	<u>September 30, 2004 Fair Value</u>	<u>December 31, 2003 Fair Value</u>
\$ 50,000	4.97%	n/a	1.16%	July 27, 2004	\$ —	\$(2,009)
2,000,000	1.31% <sup>(2)</sup>	1.62%	1.16%	October 15, 2004	1,505	(678)
500,000	1.31%	1.62%	1.16%	October 17, 2004	393	(139)
500,000	1.59%	1.88%	1.14%	December 18, 2004	358	(1,198)
500,000	1.60%	1.89%	1.14%	December 22, 2004	356	(1,206)
500,000	1.41%	1.95%	1.13%	December 30, 2004	858	(136)
<u>1,000,000</u>	<u>1.68%</u>	<u>1.66%</u>	<u>n/a</u>	<u>July 28, 2005</u>	<u>5,383</u>	<u>n/a</u>
<u>\$5,050,000</u>					<u>\$8,853</u>	<u>\$(5,366)</u>

(1) The weighted average fixed rate of the Company's interest rate swap agreements is 1.45% as of September 30, 2004.

(2) Average of two, one billion dollar notional interest rate swaps.

The notional amount of Eurodollar futures contracts accounted for as cash flow hedges totaled \$1,000,000 as of September 30, 2004. These contracts mature in December 2004 and March 2005, and their fair value was \$1,091 as of September 30, 2004.

### ***Forward Commitments***

As of September 30, 2004, the Company had made forward commitments to purchase \$405,000 in Hybrid ARM securities. These commitments to purchase mortgage-backed securities are designated as cash flow hedges of the anticipated purchases, and as of September 30, 2004 were valued at \$293, which was deferred as a gain to accumulated other comprehensive income. Gains and losses on commitments deferred to other comprehensive income are transferred from accumulated other comprehensive income to earnings over the life of the hedged item after settlement of the forward purchase. Gains and losses on forward commitments that are net settled in a pair-off transaction are recognized immediately. During the three and nine months ended September 30, 2004, the Company recorded losses of \$(788) and \$(638), respectively, on paired-off commitments. The Company recorded gains of \$1,848 on paired-off commitments during the nine months ended September 30, 2003. No pair-off gains or losses were recorded in the three months ended September 30, 2003.

The Company also made commitments to purchase Hybrid ARM securities in dollar roll transactions. The notional amount of such commitments was \$500,000 as of September 30, 2004 with a fair value of \$1,484. During the three and nine months ended September 30, 2004, the Company recorded \$7,460 in gains on these dollar roll transactions that is included in net investment income.

### ***Stock Warrants***

In connection with its capital raising activities, the Company may receive warrants to acquire equity securities. These instruments are accounted for as derivatives with changes in the fair value recorded to net investment income under SFAS 133. During the three and nine months ended September 30, 2004, the Company recorded net gains of \$4,380 and \$5,513, respectively, related to these securities. The Company recorded net gains of \$207 and \$5,414, respectively, for the same periods in 2003. As of September 30, 2004, the Company held stock warrants with a fair value of \$455.

## 7. Income Taxes:

In connection with the Company's merger with FBR Asset effective March 31, 2003, the parent company, FBR Group elected REIT status under the Internal Revenue Code. As a REIT, FBR Group is not subject to Federal income tax on earnings distributed to its shareholders. Most states recognize REIT status as well. Since FBR Group intends to distribute 100% of its REIT taxable income to shareholders, the Company has recognized no income tax expense on its REIT income.

To maintain tax qualification as a REIT, FBR Group must meet certain income and asset tests and distribution requirements. The REIT must distribute to shareholders at least 90% of its (parent company) taxable income. A predominance of the REIT's gross income must come from real estate sources and other portfolio-type income. A significant portion of the REIT's assets must consist of real estate and similar portfolio investments, including mortgage-backed securities. Beginning in 2001, the tax law changed to allow REITs to hold a certain percentage of their assets in taxable REIT subsidiaries. The income generated from the Company's taxable REIT subsidiaries is taxed at normal corporate rates and will generally not be distributed to the Company's shareholders. Failure to maintain REIT qualification would subject FBR Group to Federal and state corporate income taxes at regular corporate rates.

During the three and nine months ended September 30, 2004, the Company recorded \$20,329 and \$36,129 respectively, of income tax expense for income attributable to taxable REIT subsidiaries. The Company's effective tax rate at its taxable REIT subsidiaries was 39% for the three and nine months ended September 30, 2004. During the three and nine months ended September 30, 2003, the Company recorded \$14,483 and \$23,507, respectively, of income tax expense for the period prior to the effective date of the merger with FBR Asset as well as for income generated subsequently that was attributable to taxable REIT subsidiaries. The Company's effective tax rate applicable to this 2003 income also was 39%.

## 8. Net Capital Requirements:

The Company's U.S. broker-dealer subsidiaries, Friedman, Billings, Ramsey & Co., Inc. ("FBR & Co."), FBR Investment Services, Inc. ("FBRIS"), and Pegasus Capital Corporation ("Pegasus") are subject to the Securities and Exchange Commission's Uniform Net Capital Rule ("the rule"), which requires the maintenance of minimum net capital and requires the ratio of aggregate indebtedness to net capital, both as defined by the rule, not to exceed 15 to 1. As of September 30, 2004, FBR & Co. had regulatory net capital as defined of \$76,297, which exceeded its required net capital of \$10,366 by \$65,931. In addition, as of September 30, 2004, FBRIS and Pegasus each had regulatory net capital as defined in excess of amounts required.

The Company's U.K. broker-dealer subsidiary, Friedman, Billings, Ramsey International, Ltd. ("FBRIL") is subject to the net capital rules of the Financial Services Authority. As of September 30, 2004, FBRIL had regulatory net capital as defined in excess of amounts required.

## 9. Earnings Per Share:

The following tables present the computations of basic and diluted earnings per share for the three and nine months ended September 30, 2004 and 2003:

	Three Months Ended September 30, 2004		Three Months Ended September 30, 2003	
	Basic	Diluted	Basic	Diluted
Weighted average shares outstanding:				
Common stock . . . . .	167,593	167,593	135,670	135,670
Stock options and restricted stock . . . . .	—	1,207	—	2,599
Weighted average common and common equivalent shares outstanding . . . . .	<u>167,593</u>	<u>168,800</u>	<u>135,670</u>	<u>138,269</u>
Net earnings applicable to common stock . . . . .	<u>\$ 92,149</u>	<u>\$ 92,149</u>	<u>\$ 56,961</u>	<u>\$ 56,961</u>
Earnings per common share . . . . .	<u>\$ 0.55</u>	<u>\$ 0.55</u>	<u>\$ 0.42</u>	<u>\$ 0.41</u>

	Nine Months Ended September 30, 2004		Nine Months Ended September 30, 2003	
	Basic	Diluted	Basic	Diluted
Weighted average shares outstanding:				
Common stock . . . . .	166,975	166,975	106,279	106,279
Stock options and restricted stock . . . . .	—	1,525	—	2,824
Weighted average common and common equivalent shares outstanding . . . . .	<u>166,975</u>	<u>168,500</u>	<u>106,279</u>	<u>109,103</u>
Net earnings applicable to common stock . . . . .	<u>\$262,967</u>	<u>\$262,967</u>	<u>\$121,456</u>	<u>\$121,456</u>
Earnings per common share . . . . .	<u>\$ 1.57</u>	<u>\$ 1.56</u>	<u>\$ 1.14</u>	<u>\$ 1.11</u>

As of September 30, 2004 and 2003, respectively, 4,031,675 and 7,622,453 options to purchase shares of common stock were outstanding (both including shares associated with the Employee Stock Purchase and Loan Plan that are treated as options). As of September 30, 2004 and 2003, respectively, 3,174,175 and 7,582,453 of the total outstanding options were exercisable and 2,632,300 and 2,396,900 were anti-dilutive. In addition, the 1,219,290 restricted common shares granted to employees (see Note 11) are also included in the calculation of weighted average common equivalent diluted shares outstanding for the three and nine months ended September 30, 2004.

## 10. Commitments and Contingencies:

### *Contractual Obligations*

The Company has contractual obligations to make future payments in connection with non-cancelable lease agreements and other contractual commitments as well as uncalled capital commitments to various investment partnerships that may be called over the next ten years. The following table sets forth these contractual obligations by fiscal year:

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>Thereafter</u>	<u>Total</u>
Long-term debt . . . . .	\$ —	\$ 970	\$ 970	\$ 970	\$ 970	\$104,295	\$108,175
Minimum rental and other contractual commitments <sup>(1)</sup> . . . . .	1,323	12,802	9,738	6,764	6,913	49,672	87,212
Capital commitments <sup>(2)</sup> . . . . .	—	—	—	—	—	—	—
Total Contractual Obligations . . . . .	<u>\$1,323</u>	<u>\$13,772</u>	<u>\$10,708</u>	<u>\$7,734</u>	<u>\$7,883</u>	<u>\$153,967</u>	<u>\$195,387</u>

<sup>(1)</sup> The table above excludes obligations related to the Company's repurchase agreement and commercial paper borrowings as well as derivative financial instruments, which are described in Note 5 and Note 6.

<sup>(2)</sup> The table above excludes \$7,733 of uncalled capital commitments to various investment partnerships that may be called over the next ten years. This amount was excluded because the Company cannot currently determine when, if ever, the commitments will be called.

### *Litigation*

As of September 30, 2004, the Company was not a defendant or plaintiff in any lawsuits or arbitrations, nor involved in any governmental or self-regulatory organization ("SRO") matters that are expected to have a material adverse effect on the Company's financial condition or statements of operations. The Company is a defendant in a small number of civil lawsuits and arbitrations (together, litigation) relating to its various businesses. In addition, the Company is subject to various reviews, examinations, investigations and other inquiries by governmental agencies and SROs.

There can be no assurance that the current litigation, investigations and regulatory matters, individually or in aggregate, will not have a material adverse effect on the Company's financial condition or results of operations in a future period. However, based on management's review with counsel, resolution of these matters is not expected to have a material adverse effect on the Company's financial condition or results of operations.

Many aspects of the Company's business involve substantial risks of liability and litigation. Underwriters, broker-dealers and investment advisers are exposed to liability under Federal and state securities laws, other Federal and state laws and court decisions, including decisions with respect to underwriters' liability and limitations on indemnification, as well as with respect to the handling of customer accounts. For example, underwriters may be held liable for material misstatements or omissions of fact in a prospectus used in connection with the securities being offered and broker-dealers may be held liable for statements made by their securities analysts or other personnel. In certain circumstances, broker-dealers and asset managers may also be held liable by customers and clients for losses sustained on investments. In recent years, there has been an increasing incidence of litigation and actions by government agencies and SROs involving the securities industry, including class actions that seek substantial damages. The Company is also subject to the risk of litigation, including litigation that may be without merit. As the Company intends to actively defend such litigation, significant legal expenses could be incurred. An adverse resolution of any future litigation against the Company could materially affect the Company's operating results and financial condition.

### ***Incentive Fees***

The Company recognizes incentive income from the partnerships it manages based on what would be due to the Company if the partnership terminated on the balance sheet date. Incentive allocations may be based on unrealized gains and losses, and could vary significantly based on the ultimate realization of the gains or losses. We may therefore reverse previously recorded incentive allocations in future periods relating to the Company's managed partnerships. As of September 30, 2004, \$3,562 of such fees was subject to such potential future reversal.

## **11. Shareholders' Equity:**

### ***Dividends***

The Company declared the following distributions during the nine months ended September 30, 2004 and the year ended December 31, 2003:

<u>Declaration Date</u>	<u>Record Date</u>	<u>Payment Date</u>	<u>Dividends Per Share</u>
<b>2004</b>			
September 9, 2004	September 30, 2004	October 29, 2004	\$0.34
June 10, 2004	June 30, 2004	July 30, 2004	\$0.46 <sup>(1)</sup>
March 10, 2004	March 31, 2004	April 30, 2004	\$0.34
<b>2003</b>			
December 11, 2003	December 31, 2003	January 30, 2004	\$0.34
September 10, 2003	September 30, 2003	October 31, 2003	\$0.34
June 12, 2003	July 1, 2003	July 31, 2003	\$0.34
April 1, 2003	April 15, 2003	April 30, 2003	\$0.34

<sup>(1)</sup> Includes a special dividend of \$0.12 per share.

### ***Restricted Stock***

During the nine months ended September 30, 2004, the Company granted 551,490 shares of restricted Class A common stock valued at \$14,506 to employees in lieu of cash payments for incentive compensation accrued during 2003 under the Company's Stock and Annual Incentive Plans. As of September 30, 2004, a total of 1,219,290 shares of restricted Class A common stock had been granted. The unamortized value of restricted stock granted to employees totaled \$17,247 and \$2,203, as of September 30, 2004 and December 31, 2003, respectively, and is reflected as deferred compensation in stockholders' equity.

### ***Employee Stock Purchase and Loan Plan***

In connection with the Employee Stock Purchase and Loan Plan, in July and August 2001, the Company issued stock and received five-year, limited recourse promissory notes from employees with interest accruing at 6.5 percent accreting to principal for the remaining purchase price. The notes are collateralized by the shares of stock purchased under the plan. As of September 30, 2004 and December 31, 2003, the balance outstanding on these loans was \$4,821 and \$8,277, respectively. During the three and nine months ended September 30, 2004, \$154 and \$577, respectively of compensation expense was recorded for dividends paid on the shares purchased with proceeds from the notes.

### ***Share Repurchases***

In April 2003, the Company's Board of Directors authorized a share repurchase program in which the Company may repurchase up to 14 million shares of the Company's Class A common stock from time to time. Under a previous share repurchase program, during the three months ended March 31, 2003, the Company repurchased 976,600 shares of its Class A common stock at a cost of \$8,200. There were no other share repurchases during 2003, and there have been no share repurchases during 2004.

## **12. Segment Information:**

The Company considers its capital markets, asset management, and principal investing operations to be three separately reportable segments. The capital markets segment includes the Company's investment banking and institutional brokerage operations. Asset management includes the Company's fee based asset management. The Company's principal investing segment was initiated subsequent to completing the merger with FBR Asset, and includes the Company's mortgage-backed security investment activities, substantially all of the Company's equity security investing activities and the Company's investments in managed investment funds. Accordingly, there is no comparable first quarter 2003 financial information for this segment. The Company has developed systems and methodologies to allocate overhead costs to its business units and, accordingly, presents segment information consistent with internal management reporting. There are no significant revenue transactions between the segments. The following table illustrates the financial information for the Company's segments for the periods presented:

	<u>Capital Markets</u>	<u>Asset Management</u>	<u>Principal Investing</u>	<u>Consolidated Totals</u>
Three Months Ended September 30, 2004				
Total revenues . . . . .	\$166,766	\$10,524	\$110,630	\$287,920
Pre-tax income . . . . .	53,315	1,704	57,459	112,478
Three Months Ended September 30, 2003				
Total revenues . . . . .	\$109,094	\$10,298	\$ 65,568	\$184,960
Pre-tax income . . . . .	32,697	1,640	37,107	71,444
Nine Months Ended September 30, 2004				
Total revenues . . . . .	\$384,053	\$27,766	\$342,183	\$754,002
Pre-tax income . . . . .	93,081	2,644	203,371	299,096
Nine Months Ended September 30, 2003				
Total revenues . . . . .	\$200,190	\$39,949	\$142,799	\$382,938
Pre-tax income . . . . .	43,957	12,749	88,257	144,963

**13. Management Contract Intangible:**

The Company's 2001 acquisition of MMA/Rushmore was accounted for using the purchase method of accounting under SFAS 141, and resulted in the recording of \$19,700 of management contracts on the balance sheet. These management contracts were previously unrecognized intangible assets of MMA. This intangible asset is being amortized on a straight-line basis over 15 years. As of September 30, 2004, \$5,174 of amortization has been recorded resulting in a net value of \$14,755. Approximately \$1,300 per year will be amortized over the remaining life of this intangible asset.

**14. Accounting Developments:**

FASB Interpretation No. 46, "Consolidation of Variable Interest Entities — an interpretation of APB No. 51," ("FIN 46") was issued in January 2003. FIN 46 explains how to identify variable interest entities and how an enterprise assesses its interests in a variable entity to decide whether to consolidate that entity. The FASB then issued FIN 46(R), "Consolidation of Variable Interest Entities an Interpretation of ARB No. 51," which replaced FIN 46. Application of FIN 46(R) is required in financial statements of public entities that have interests in variable interest entities or potential variable interest entities commonly referred to as special-purpose entities for periods ending after December 15, 2003. Adoption of FIN 46(R) did not have a material effect on the Company's results of operations and financial position.

In March 2004, the Emerging Issues Task Force ("EITF") of the FASB reached a consensus on Issue 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" ("EITF 03-1"). EITF 03-1 provides guidance with respect to the meaning of other-than-temporary impairment and its application to investments classified as either available-for-sale or held-to-maturity under SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and investments accounted for under the cost method or the equity method. In September 2004, the FASB issued a Staff Position, FSP EITF Issue 03-1-1, delaying the effective date for the measurement and recognition guidance included in EITF 03-1, and also issued an exposure draft, FSP EITF Issue 03-1a, which proposes guidance relating to debt securities that are impaired because of interest rate and/or sector spread increases. The delay in the effective date for the measurement and recognition guidance of EITF 03-1 did not suspend existing requirements for assessing whether investment impairments are other-than-temporary.

It is expected that the proposed guidance under FSP EITF Issue 03-1a will be finalized during the fourth quarter of 2004. Adoption of the effective elements of EITF 03-1 did not have a material effect on the Company's results of operations and financial position. The Company is monitoring the outcome of the EITF's consideration of the exposure draft FSP EITF Issue 03-1a.

**15. Subsequent Event:**

In October 2004, the Company formed Arlington Funding, LLC ("Arlington Funding"), a special purpose Delaware limited liability company organized for the purpose of issuing extendable commercial paper notes in the asset backed commercial paper market and entering into reverse repurchase agreements with mortgage originators. Arlington Funding allows the Company to fund warehouse lines of credit to asset-backed issuers. The Company's financing capacity through Arlington Funding is \$5,000,000. The Company serves as administrator for Arlington Funding's commercial paper program, and through its administration agreement maintains effective control over Arlington Funding. The Company anticipates that it will consolidate Arlington Funding for financial reporting purposes.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following analysis of the consolidated financial condition and results of operations of Friedman, Billings, Ramsey Group, Inc. (the "Company") should be read in conjunction with the unaudited Consolidated Financial Statements as of September 30, 2004 and 2003, and the Notes thereto and the Company's 2003 Annual Report on Form 10-K.

### **Business Environment**

The Company invests and plans to continue to invest in mortgage-backed securities ("MBS") that are guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae. In addition, subject to maintaining REIT qualification, the Company invests from time to time in real estate and non-real estate related assets, including but not limited to, purchasing equity securities and making senior secured, mezzanine, and other loans.

We constantly evaluate the rates of return that can be achieved in each investment category in which we participate. At this time, based on the interest rate environment and the shape of the yield curve, our mortgage-backed securities investments have provided us with higher relative rates of return than most other investment opportunities we have evaluated. (See discussion of "Interest Rate Risk" at *page 32*.) Consequently, we have maintained a high allocation of our assets and capital in this sector. We intend to continue to evaluate investment opportunities against the returns available in each of our investment alternatives and endeavor to allocate our assets and capital with an emphasis toward the highest risk-adjusted return available. This strategy will cause us to have different allocations of capital in different environments.

Our investment banking (capital raising, merger and acquisition, restructuring, and advisory services), institutional brokerage and asset management (including investments), are linked to the capital markets business activities. In addition, our business activities are focused in the financial services, real estate, technology, healthcare, energy and diversified industries sectors. Historically, we have focused on small and mid-cap stocks, although our research coverage and associated brokerage activities increasingly involve larger-cap stocks. By their nature, our business activities are highly competitive and are not only subject to general market conditions, volatile trading markets, and fluctuations in the volume of market activity, but also to the conditions affecting the companies and markets in our areas of focus. As a result, revenues can be subject to significant volatility from period to period.

Our investment banking and asset management revenues and net income are subject to substantial positive and negative fluctuations due to a variety of factors that cannot be predicted with great certainty. These factors include the overall condition of the economy and the securities markets as a whole and the sectors on which we focus. For example, a significant portion of the performance based or incentive revenues that we recognize from our venture capital, private equity, and other asset management activities is based on the value of securities held by the funds we manage. The value of these securities includes unrealized gains or losses that may change from one period to another. Although when market conditions permit, we may take steps to realize or lock-in gains on these securities, these securities are often illiquid, and therefore such steps may not be possible, and the value of these securities is subject to increased market risk. Similarly, investment banking activities and our market share are subject to significant market risk.

In order to compete in this increasingly competitive environment, we continually evaluate each of our businesses across varying market conditions for competitiveness, profitability, and alignment with our long-term strategic objectives, including the diversification of revenue sources. We believe that it is important to diversify and strengthen our revenue base by increasing the segments of our business that offer a recurring and more predictable source of revenue. We may choose, from time to time, to reallocate resources based on the opportunities for profitability and revenue growth for each of our businesses relative to our commitment of resources.

## Results of Operations

### *Three months ended September 30, 2004 compared to three months ended September 30, 2003*

Net income increased from \$57.0 million during the third quarter of 2003 to \$92.1 million during the third quarter of 2004. This increase is primarily due to increased net revenues in 2004 as compared to 2003 in our principal investment segment and increased capital markets revenues including underwriting, corporate finance and agency commissions. Our 2004 net income also includes \$20.3 million of income tax expenses as compared to \$14.5 million of income tax expenses being recorded in 2003.

The Company's net revenues increased 50% from \$162.0 million in 2003 to \$243.7 million in 2004 due primarily to increases in revenues net of interest expense associated with our principal investment activities and increases in revenues from investment banking and institutional brokerage activities. Within capital markets our investment banking revenue increased \$52.5 million and institutional brokerage revenue increased \$3.1 million in 2004 as compared to 2003.

Underwriting revenue increased 76% from \$37.5 million in 2003 to \$66.0 million in 2004. The increase is attributable to more managed transactions completed in 2004 as compared to 2003. During the third quarter of 2004, the Company managed nineteen public equity/debt offerings raising \$3.2 billion. During the third quarter of 2003, the Company managed eleven public offerings raising \$1.2 billion. The average size of underwritten equity/debt transactions for which we were a lead or co-manager increased from \$104.9 million in 2003 to \$168.4 million in 2004. The company also managed three asset-backed security offerings during the third quarter of 2004 totaling \$2.2 billion in transaction volume.

Corporate finance revenue increased 47% from \$51.6 million in 2003 to \$75.6 million in 2004. The Company completed two private placements in 2004 generating \$64.0 million in revenues compared to four in 2003 generating \$48.9 million in revenues. M&A and advisory fee revenue increased from \$2.7 million in 2003 to \$11.6 million in 2004 due to an increase in completed M&A transactions and advisory assignments.

Institutional brokerage revenue from principal transactions decreased 35% from \$6.5 million in 2003 to \$4.2 million in 2004 as a result of decreases in both trading gains and trading volume. Institutional brokerage agency commissions increased 41% from \$13.1 million in 2003 to \$18.5 million in 2004 as a result of increases in trading volume primarily due to increased customer trading. The Company believes that this increase is due to achieving greater penetration of institutional accounts through broader research coverage and sales and trading services.

Asset management base management fees increased 25% from \$5.6 million in 2003 to \$7.0 million in 2004 as a result of increases in assets under management. Asset management incentive allocations and fees increased 13% from \$1.5 million in 2003 to \$1.7 million in 2004 as a result of improved performance in the managed assets.

Revenues from our principal investment activities, net of interest expense, totaled \$68.7 million for the third quarter of 2004 compared to \$43.3 million for the third quarter of 2003. The primary source of principal investment revenues is interest income from investments in mortgage-backed securities, offset by interest expense from repurchase agreements and commercial paper. The following table summarizes the components of net interest income (dollars in thousands).

	Three Months Ended September 30, 2004			Three Months Ended September 30, 2003		
	Average Balance	Income / (Expense)	Yield / Cost	Average Balance	Income / (Expense)	Yield / Cost
Mortgage-backed securities . . . . .	<u>\$11,501,189</u>	\$ 86,116	3.00%	<u>\$7,906,232</u>	\$ 46,849	2.37%
Other <sup>(1)</sup> . . . . .		1,919			—	
Interest income . . . . .		88,035			46,849	
Repurchase agreements and Commercial paper <sup>(2)</sup> . . . . .	10,834,876	(42,087)	(1.52)%	7,753,049	(22,363)	(1.13)%
Derivative contracts <sup>(3)</sup> . . . . .		876			219	
	<u>\$10,834,876</u>	<u>(41,211)</u>	<u>(1.49)%</u>	<u>\$7,753,049</u>	<u>(22,144)</u>	<u>(1.12)%</u>
Other <sup>(1)</sup> . . . . .		(3,054)			(828)	
Interest expense . . . . .		(44,265)			(22,972)	
Net interest income /spread on MBS investing . . . . .		<u>\$ 43,770</u>	<u>1.51%</u>		<u>\$ 23,877</u>	<u>1.25%</u>

- (1) Other is comprised of non-mortgage-backed securities investment activities, such as reverse repurchase agreements and associated borrowings related to the Company's warehouse lending activities and long-term borrowings used for general corporate purposes.
- (2) Includes repurchase agreements and commercial paper borrowings used to finance mortgage-backed securities.
- (3) Includes the effect of interest rate swap agreements and Eurodollar futures contracts accounted for as cash flow hedges, including hedge ineffectiveness.

As shown in the table above, net interest income from principal investment activity increased by \$19.9 million from third quarter 2003 to third quarter 2004. This increase was due to a 45.5% increase in the average balance of the mortgage-backed securities portfolio, combined with an increase in the net interest spread on such investments. The increase in net interest spread was due to a decrease in premium amortization expense from \$38.8 million in the third quarter of 2003 to \$24.2 million in the third quarter of 2004, driven by a decrease in the average one month Constant Prepayment Rate ("CPR") from 41% to 30%, respectively. The positive effect of the decrease in premium amortization expense was partially offset by an increase in borrowing costs due to increases in the federal funds rate during the third quarter of 2004 and a reduction in the average coupon on the mortgage-backed securities from 4.42% in 2003 to 3.91% in 2004.

In addition to net interest income, the Company recorded \$5.8 million in dividend income from its merchant banking equity investment portfolio for third quarter 2004, compared to \$1.3 million during the third quarter 2003. The increase in dividend income was primarily due to an increase in such distributions, including a dividend payment from one issuer that totaled \$4.0 million. The Company also earned \$19.1 million in net investment income during the three months ended September 30, 2004, compared to \$18.2 million for the same period in 2003. The following table summarizes the components of net investment income (dollars in thousands)

	<b>Three Months Ended September 30,</b>	
	<b>2004</b>	<b>2003</b>
Gains on sale of equity investments .....	\$13,194	\$13,887
Gains on sale of mortgage-backed securities, net .....	1,842	471
Income from equity method investments .....	1,425	2,724
Gains on investment securities— marked-to-market, net .....	4,860	1,096
Other, net .....	(2,231)	—
	<u>\$19,090</u>	<u>\$18,178</u>

Income from equity method investments reflects the Company's equity in earnings from investments in proprietary investment partnerships and other managed investments. Gains and losses on investments securities—marked-to-market, relate to securities received in connection with capital raising activities. Other net investment income includes gains and losses from mortgage-backed securities classified as trading, paired-off commitments, derivatives not designated as hedges under SFAS 133 and impairments of long-term investments. See Notes 4 and 6 to the financial statements for further information on these other gains and losses, as well as gains on sale of equity investments and mortgage-backed securities.

Total non-interest expenses increased 45% from \$90.5 million in 2003 to \$131.2 million in 2004 due primarily to increases in variable compensation associated with increased revenue during 2004 as well as increased professional services and business development costs relating primarily to increased investment banking activities.

Compensation and benefits expense increased 42% from \$67.5 million in 2003 to \$95.8 million in 2004. This increase was primarily due to an increase in variable compensation associated with investment banking and institutional brokerage as a result of increased revenues. As a percentage of net revenues, compensation and benefits expense decreased from 42% in 2003 to 39% in 2004 due to the effects of the merger with FBR Asset and the increased revenues from principal investing activities.

Business development expenses increased 73% from \$4.8 million in 2003 to \$8.3 million in 2004. This increase is primarily due to costs associated the higher level of investment banking activity in 2004 as compared to 2003, as well as costs related to the Company's branding initiatives that commenced during the first quarter of 2004, including sponsorship of the PGA Tour's FBR Open and related advertising.

Professional services increased 106% from \$6.5 million in 2003 to \$13.4 million in 2004 primarily due to increases in legal costs associated with increased investment banking activity, including both completed and in-process transactions, as well increases in costs associated with corporate initiatives, including increased accounting, legal and recruiting expenses.

Clearing and brokerage fees decreased 24% from \$2.1 million in 2003 to \$1.6 million in 2004 reflecting increased institutional brokerage volume and related revenue, offset by a decrease in our negotiated transaction fees. As a percentage of institutional brokerage revenue, clearing and brokerage fees decreased from 10% in 2003 to 7% in 2004.

Occupancy and equipment expense increased 63% from \$2.4 million in 2003 to \$3.9 million in 2004 primarily due to the opening of a new office in the fourth quarter of 2003, as well as increases in the Company's headcount as of September 30, 2004 as compared to September 30, 2003.

Communications expense increased 10% from \$3.0 million in 2003 to \$3.3 million in 2004 primarily due to increased costs related to market data and customer trading services.

Other operating expenses increased 12% from \$4.3 million in 2003 to \$4.8 million in 2004. This change reflects increased 12b-1 fees of \$0.2 million combined with increases in various office operations and administrative expense items of \$0.3 million.

The total income tax provision increased from \$14.5 million in 2003 to \$20.3 million in 2004 due to increased taxable income in 2004 as compared to 2003. The Company's effective tax rate at its taxable REIT subsidiaries was 39% for the three months ended September 30, 2004 and 2003.

### ***Nine months ended September 30, 2004 compared to nine months ended September 30, 2003***

Our merger with FBR Asset was completed on March 31, 2003, accordingly only the last three quarters of 2003 results include the full effects of the merger. Therefore with respect to principal investing activities, results for the nine months September 30, 2004 are not comparable to the similar 2003 period. Net income increased from \$121.5 million during 2003 to \$263.0 million during 2004. This increase is primarily due to increased revenues and net investment income in 2004 as compared to 2003 in our principal investment and capital markets segments. Our 2004 net income also includes \$36.1 million of income tax expenses as compared to \$23.5 million of income tax expenses being recorded in 2003.

The Company's net revenues increased 90% from \$338.6 million in 2003 to \$642.8 million in 2004 due primarily to revenues associated with our principal investment activities and increases in revenues from investment banking and institutional brokerage activities. Within capital markets our investment banking revenue increased \$153.7 million and institutional brokerage revenue increased \$33.8 million in 2004 as compared to 2003.

Underwriting revenue increased 136% from \$70.3 million in 2003 to \$166.2 million in 2004. The increase is attributable to more managed transactions completed in 2004 as compared to 2003. During the first nine months of 2004, the Company managed sixty public equity/debt offerings raising \$9.0 billion. During the first nine months of 2003, the Company managed twenty-three public offerings raising \$3.1 billion. The average size of underwritten equity/debt transactions for which we were a lead or co-manager increased from \$133.7 million in 2003 to \$150.4 million in 2004. The company also managed nine asset-backed security offerings during the first nine months of 2004 totaling \$6.9 billion in transaction volume.

Corporate finance revenue increased 82% from \$70.7 million in 2003 to \$128.5 million in 2004 due to more transactions completed in 2004. The Company completed seven private placements in 2004 generating \$112.7 million in revenues compared to five in 2003 generating \$61.2 million. M&A and advisory fee revenue increased from \$9.5 million in 2003 to \$15.8 million in 2004 due to the increase in completed M&A transactions from five in 2003 to eight in 2004.

Institutional brokerage revenue from principal transactions decreased 7% from \$16.9 million in 2003 to \$15.7 million in 2004 as a result of decreases in both trading gains and trading volume. Institutional brokerage agency commissions increased 104% from \$33.7 million in 2003 to \$68.7 million in 2004 as a result of increases in trading volume primarily due to increased customer trading. The Company believes that this increase is due to achieving greater penetration of institutional accounts through broader research coverage and sales and trading services.

Asset management base management fees increased 7% from \$18.7 million in 2003 to \$20.0 million in 2004, reflecting the elimination of fees earned from FBR Asset in 2004 amounts (\$2.8 million earned in the first quarter of 2003), offset by increases in fees earned from our other managed vehicles. Asset management incentive allocations and fees decreased 65% from \$8.5 million in 2003 to \$3.0 million in 2004 primarily as a result of the elimination of fees earned from FBR Asset in 2004 amounts (\$5.6 million earned in first quarter of 2003), offset by a slight increase in incentive allocations from investment partnerships.

Revenues from our principal investment activities, net of interest expense, totaled \$236.0 million in 2004 compared to \$113.3 million in 2003. The primary source of principal investment revenues is interest income from investments in mortgage-backed securities, offset by interest expense from repurchase agreements and commercial paper. The following table summarizes the components of net interest income (dollars in thousands).

	Nine Months Ended September 30, 2004			Nine Months Ended September 30, 2003		
	Average Balance	Income / (Expense)	Yield / Cost	Average Balance	Income / (Expense)	Yield / Cost
Mortgage-backed securities . . . . .	\$10,986,397	\$ 259,417	3.15%	\$4,809,192	\$ 98,432	2.73%
Other <sup>(1)</sup> . . . . .		4,724			—	
Interest income . . . . .		264,141			98,432	
Repurchase agreements and Commercial paper <sup>(2)</sup> . . . . .	10,303,822	(99,515)	(1.27)%	4,695,414	(42,740)	(1.20)%
Derivative contracts <sup>(3)</sup> . . . . .		(6,187)			668	
	<u>\$10,303,822</u>	<u>(105,702)</u>	<u>(1.35)%</u>	<u>\$4,695,414</u>	<u>(42,072)</u>	<u>(1.18)%</u>
Other <sup>(1)</sup> . . . . .		(5,486)			(2,267)	
Interest expense . . . . .		(111,188)			(44,339)	
Net interest income /spread on MBS investing . . . . .		<u>\$ 152,953</u>	<u>1.80%</u>		<u>\$ 54,093</u>	<u>1.55%</u>

- (1) Other is comprised of non-mortgage-backed securities investment activities, such as reverse repurchase agreements and associated borrowings related to the Company's warehouse lending activities and long-term borrowings used for general corporate purposes.
- (2) Includes repurchase agreements and commercial paper borrowings used to finance mortgage-backed securities.
- (3) Includes the effect of interest rate swap agreements and Eurodollar futures contracts accounted for as cash flow hedges, including hedge ineffectiveness.

As shown in the table above, net interest income from principal investment activity increased by \$98.9 million from 2003 to 2004. This increase was due to a 128.4% increase in the average balance of the mortgage-backed security portfolio, combined with an increase in the net interest spread on such investments. The increase in net interest spread was due to a decrease in premium amortization expense. Premium amortization expense decreased from \$64.0 million in 2003 to \$60.9 million in 2004 as a result of generally lower CPRs in 2004 compared to 2003. The positive effect of the decrease in premium amortization expense was partially offset by increases in short-term interest rates during 2004 as a result of increases in the federal funds rate, and an increase in interest expense associated with interest rate swap agreements as a result of an increase in the notional amount of pay-fixed interest rate swaps at the end of 2003 and beginning of 2004 and the terms of these agreements.

In addition to net interest income, the Company recorded \$8.5 million in dividend income from its merchant banking equity investment portfolio in 2004, compared to \$3.7 million in 2003. The increase in dividend income

was primarily due to an increase in such distributions, including a dividend payment from one issuer that totaled \$4.0 million. The Company also earned \$74.5 million in net investment income in 2004, compared to \$55.5 million in 2003. The following table summarizes the components of net investment income (dollars in thousands).

	Nine Months Ended September 30,	
	2004	2003
Gains on sale of equity investments . . . . .	\$66,785	\$24,398
Gains on sale of mortgage-backed securities, net . . . . .	1,174	5,942
Income from equity method investments . . . . .	2,065	13,540
Gains on investments securities— marked-to-market, net . . . . .	7,173	9,761
Other, net . . . . .	<u>(2,666)</u>	<u>1,848</u>
	\$74,531	\$55,489

See Notes 4 and 6 to the financial statements for further information on gains on sale of equity investments and mortgage-backed securities, and other gains and losses, which includes gains and losses from mortgage-backed securities classified as trading, paired-off commitments, derivatives not designated as hedges under SFAS 133 and impairments of long-term investments.

Total non-interest expenses increased 78% from \$193.6 million in 2003 to \$343.7 million in 2004 due primarily to increases in variable compensation associated with increased revenue during 2004 as well as increased professional services and business development costs.

Compensation and benefits expense increased 69% from \$135.2 million in 2003 to \$228.4 million in 2004. This increase was primarily due to an increase in variable compensation associated with investment banking and institutional brokerage as a result of increased revenues. As a percentage of net revenues, compensation and benefits expense decreased from 40% in 2003 to 36% in 2004 due to the effects of the merger with FBR Asset and the increased revenues from principal investing activities.

Business development expenses increased 128% from \$14.8 million in 2003 to \$33.7 million in 2004. This increase is primarily due to costs associated the higher level of investment banking activity in 2004 as compared to 2003, as well as costs associated with the Company's branding initiatives that commenced during the first quarter of 2004, including sponsorship of the PGA Tour's FBR Open and related advertising.

Professional services increased 195% from \$13.1 million in 2003 to \$38.6 million in 2004 primarily due to increases in legal costs associated with increased investment banking activity, including both completed and in-process transactions, as well increases in costs associated with corporate initiatives, including increased accounting, legal and recruiting expenses.

Clearing and brokerage fees increased 38% from \$5.0 million in 2003 to \$6.9 million in 2004 due to increased institutional brokerage volume and related revenue. As a percentage of institutional brokerage revenue, clearing and brokerage fees decreased from 10% in 2003 to 8% in 2004.

Occupancy and equipment expense increased 49% from \$6.8 million in 2003 to \$10.1 million in 2004 primarily due to the opening of a new office in the fourth quarter of 2003, as well as increases in the Company's headcount as of September 30, 2004 as compared to September 30, 2003.

Communications expense increased 31% from \$7.4 million in 2003 to \$9.7 million in 2004 primarily due to increased costs related to market data and customer trading services.

Other operating expenses increased 43% from \$11.3 million in 2003 to \$16.2 million in 2004. This change reflects increased 12b-1 fees of \$1.0 million, increased D&O, E&O and other insurance premiums of \$0.7 million, increases in director fees of \$0.3 million, and increases in various office operations expense items of \$2.9 million.

The total income tax provision increased from \$23.5 million in 2003 to \$36.1 million in 2004 due to increased taxable income in 2004 as compared to 2003. The Company's effective tax rate at its taxable REIT subsidiaries was 39% for the nine months ended September 30, 2004. During the nine months ended September 30, 2003, the Company's tax provision related to income generated during the period prior to the effective date of the merger with FBR Asset as well as for income generated subsequently that was attributable to taxable REIT subsidiaries. The Company's effective tax rate applicable to this 2003 income also was 39%.

## **Liquidity and Capital Resources**

Liquidity is a measurement of our ability to meet potential cash requirements including ongoing commitments to repay borrowings, fund investments, loan acquisition and lending activities, and for other general business purposes. In addition, regulatory requirements applicable to our broker-dealer and banking subsidiaries require minimum capital levels for these entities. The primary sources of funds for liquidity consist of borrowings under repurchase agreements, principal and interest payments on mortgage-backed securities, dividends on equity securities, proceeds from sales of those securities, internally generated funds, equity capital contributions, and credit provided by banks, clearing brokers, and affiliates of our principal clearing broker. Potential future sources of liquidity for us include existing cash balances, internally generated funds, borrowing capacity through margin accounts and under lines of credit, and future issuances of common stock, preferred stock, or debt.

### *Sources of Funding*

We believe that our existing cash balances, cash flows from operations, and borrowing capacity under our unsecured credit facility (see discussion below) and the Georgetown Funding Company, LLC ("Georgetown Funding") commercial paper conduit (see discussion below) as well as borrowings under collateralized repurchase agreements are sufficient to meet our investment objectives and fund operating expenses. We have obtained, and believe we will be able to continue to obtain, short-term financing in amounts and at interest rates consistent with our financing objectives. We may, however, seek debt or equity financings, in public or private transactions, to provide capital for corporate purposes and/or strategic business opportunities, including possible acquisitions, joint ventures, alliances, or other business arrangements that could require substantial capital outlays. Our policy is to evaluate strategic business opportunities, including acquisitions and divestitures, as they arise. There can be no assurance that we will be able to generate sufficient funds from future operations, or raise sufficient debt or equity on acceptable terms, to take advantage of investment opportunities that become available. Should our needs ever exceed these sources of liquidity, we believe that our marketable equity securities could be sold, in most circumstances, to provide cash.

In July 2004, we entered into a \$255 million, 364-day senior unsecured credit agreement with various U.S. financial institutions. This facility includes a one-year term-out option. The facility is available for general corporate purposes, working capital and other potential short-term liquidity needs, including when deemed appropriate funding FBR Group's \$500 million subordinated line of credit with Friedman Billings Ramsey & Co., Inc. ("FBR & Co."). FBR & Co.'s borrowings under this intercompany agreement are allowable for net capital purposes and are used in connection with regulatory capital requirements to support underwriting activities.

As of September 30, 2004, the Company's indebtedness totaled \$10.7 billion, which resulted in a leverage ratio of 7.0 to 1. In addition to trading account securities sold short and other payables and accrued expenses, our indebtedness consisted of repurchase agreements with several financial institutions, commercial paper issued through Georgetown Funding and long term debentures issued through our taxable REIT subsidiary, FBR TRS Holdings, Inc. ("TRS Holdings"). Such long-term debt issuances have totaled \$102.5 million. These long term debt securities accrue and require payments of interest quarterly at annual rates of three-month LIBOR plus 2.50%-3.25%, mature in thirty years, and are redeemable, in whole or in part, without penalty after five years. As of September 30, 2004, we had \$108.2 million of long-term debt.

In August 2003, we formed Georgetown Funding, a special purpose Delaware limited liability company organized for the purpose of issuing extendable commercial paper notes in the asset-backed commercial paper market and entering into reverse repurchase agreements with us and our affiliates. We serve as administrator for Georgetown Funding's commercial paper program, and through our administration agreement maintain effective control over Georgetown Funding. Georgetown Funding is consolidated for financial reporting purposes. The extendable commercial paper notes issued by Georgetown Funding are rated A1+/P1 by Standard & Poor's and Moody's Investors Service, respectively. Our Master Repurchase Agreement with Georgetown Funding enables us to finance up to \$12 billion of mortgage-backed securities. Prior to August 31, 2004, financing capacity through Georgetown Funding was \$5 billion.

The following table provides additional information regarding the Company's indebtedness (dollars in millions).

	<u>As of</u> <u>September 30, 2004</u>
Long-term debt . . . . .	\$ 108.2
Repurchase agreements and commercial paper	
Outstanding balance . . . . .	\$10,131.3
Weighted-average rate . . . . .	1.78%
Weighted-average effective rate <sup>(1)</sup> . . . . .	1.56%
Weighted-average term to maturity . . . . .	34.8 days
Weighted-average effective reset date <sup>(1)</sup> . . . . .	71.2 days

<sup>(1)</sup> Effective rate and reset date considers the effect of interest rate swaps and Eurodollar futures contracts, which effectively convert these short-term borrowings into longer-term funding.

In October 2004, we formed Arlington Funding, LLC ("Arlington Funding"), a special purpose Delaware limited liability company organized for the purpose of issuing extendable commercial paper notes in the asset backed commercial paper market and entering into reverse repurchase agreements with mortgage originators. Arlington Funding allows the Company to fund warehouse lines of credit to asset-backed issuers. Our financing capacity through Arlington Funding is \$5 billion. We serve as administrator for Arlington Funding's commercial paper program, and through our administration agreement maintain effective control over Arlington Funding. We anticipate that we will consolidate Arlington Funding for financial reporting purposes.

#### *Assets*

Our principal assets consist of mortgage-backed securities, cash and cash equivalents, receivables, long-term investments, and securities held for trading purposes. As of September 30, 2004, liquid assets consisted primarily of cash and cash equivalents of \$173.5 million. Cash equivalents consist primarily of money market funds invested in debt obligations of the U.S. government. In addition, we held \$10.9 billion in MBS (not including commitments to purchase an additional \$405 million of Hybrid ARM securities), \$341.9 million in long-term investments, \$54.4 million in trading securities, and a receivable due from our clearing broker of \$227.3 million at September 30, 2004.

As of September 30, 2004, our mortgage-backed securities portfolio was comprised of agency-backed ARM and Hybrid ARM securities. Excluding principal receivable, which totaled \$120.7 million, the total par value of the portfolio was \$10.7 billion and the market value was \$10.8 billion. As of September 30, 2004, the weighted average coupon of the portfolio was 3.90%. The actual yield of the mortgage-backed securities portfolio is affected by the price paid to acquire the securities. Historically, we have purchased mortgage-backed securities at a price greater than the par value (i.e., a premium) resulting in the yield being less than the security's stated coupon. At September 30, 2004, the MBS portfolio had a net premium of \$192.5 million. Based on the amount of the premium and our estimates of future prepayments, the weighted average yield of the mortgage-backed securities portfolio was 3.01% as of September 30, 2004. Management's estimate of prepayments, which was equivalent to a lifetime CPR of approximately 26%, is based on historical performance and estimates of future

performance, including historical CPRs, interest rates and characteristics of the mortgage-backed securities portfolio, including Hybrid ARM type, age, and the weighted average coupon of the loans underlying the securities assessed in relation to current market data.

Long-term investments primarily consist of investments in marketable equity and non-public equity securities, managed partnerships (including hedge, private equity, and venture capital funds), and our investment in a long-term, mezzanine, debt instrument of a privately held company. Although our investments in hedge, private equity, and venture capital funds are mostly illiquid, the underlying investments of such entities are, in the aggregate, mostly publicly-traded, liquid equity and debt securities, some of which may be restricted due to contractual “lock-up” requirements.

The following table provides additional detail regarding the Company’s merchant banking investments as of September 30, 2004 (dollars in thousands).

	<u>Shares</u>	<u>Cost Basis</u>	<u>Fair Value</u>
<b>Merchant Banking Investments</b>			
Accredited Home Lenders Holding Company <sup>(1)</sup> .....	510,697	\$ 4,080	\$ 19,672
American Financial Realty Trust .....	525,000	7,639	7,408
Cmet <sup>(1),(2)</sup> .....	50,000	4,650	4,650
Fieldstone <sup>(1),(2)</sup> .....	3,588,329	49,734	49,734
Franklin Bank Corporation .....	350,000	3,500	5,968
Government Properties Trust <sup>(1)</sup> .....	210,000	2,100	1,995
JER Investors Trust <sup>(1),(2)</sup> .....	377,350	5,264	5,264
KKR <sup>(1),(2)</sup> .....	2,500,000	23,250	23,250
Medical Properties Trust <sup>(1),(2)</sup> .....	1,795,571	16,180	16,180
New Century Financial Corporation <sup>(1),(2)</sup> .....	636,885	35,050	38,353
New York Mortgage Trust .....	200,000	1,760	1,870
Provident Senior Living Trust <sup>(1),(2)</sup> .....	1,792,115	25,000	25,000
Quanta Capital Holdings .....	2,688,172	25,000	21,909
Saxon Capital, Inc. ....	1,840,000	33,342	39,560
Private debt investment .....	—	5,000	5,000
Other .....	—	3,744	2,921
<b>Total Merchant Banking Investments .....</b>		<u>\$245,293</u>	<u>\$268,734</u>

(1) As of September 30, 2004, the Company is restricted from selling its shares based on the terms of its purchase.

(2) As of September 30, 2004, these shares are not registered for public trading.

Net unrealized gains and losses related to our merchant banking investments that are included in “accumulated other comprehensive income” in our balance sheet totaled \$23.4 million as of September 30, 2004. If and when we liquidate these or determine that a decline in value of these investments below our cost basis is “other than temporary,” a portion or all of the gains or losses will be recognized as realized gain (loss) in the statement of operations during the period in which the liquidation or determination is made. Our investment portfolio is exposed to potential future downturns in the markets and private debt and equity securities are exposed to deterioration of credit quality, defaults, and downward valuations. On a quarterly basis, we review the valuations of our private debt and equity investments. If and when we determine that the net realizable value of these investments is less than our carrying value, we will reflect the reduction as an investment loss.

#### *Regulatory Capital*

FBR & Co., FBR Investment Services, Inc. (“FBRIS”), and Pegasus Capital Corporation (“Pegasus”), as U.S. broker-dealers, are registered with the Securities and Exchange Commission (“SEC”) and are members of

the National Association of Securities Dealers, Inc. (“NASD”). Additionally, Friedman, Billings, Ramsey International, Ltd. (“FBRIL”), our U.K. broker-dealer, is registered with the Financial Services Authority (“FSA”) of the United Kingdom. As such, they are subject to the minimum net capital requirements promulgated by the SEC and FSA, respectively. As of September 30, 2004, FBR & Co. had regulatory net capital as defined of \$76.3 million which exceeded its required net capital of \$10.4 million by \$65.9 million. In addition, each of FBRIS, Pegasus and FBRIL had regulatory net capital as defined in excess of amounts required.

FBR National Trust (“FBR Bank”) is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory-and possibly additional discretionary-actions by regulators that, if undertaken, could have a direct material effect on the financial statements of FBR Bank. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, FBR Bank’s assets, liabilities, and certain off-balance sheet items are calculated under regulatory accounting practices. FBR Bank’s capital levels and classification are also subject to qualitative judgments by the regulators with regard to components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require FBR Bank to maintain minimum capital levels and ratios of tangible and core capital (defined in the regulations) to total adjusted assets (as defined), and of total capital (as defined) to risk-weighted assets (as defined). Management believes, as of September 30, 2004, FBR Bank meets all capital adequacy requirements to which it is subject. As of September 30, 2004 the most recent notification from the Office of the Comptroller of Currency (“OCC”) categorized FBR Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, FBR Bank must maintain minimum tangible core and risk-based ratios. There are no conditions or events since that notification that management believes have changed FBR Bank’s well-capitalized status.

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

Market risk generally represents the risk of loss through a change in realizable value that can result from a change in the prices of equity securities, a change in the value of financial instruments as a result of changes in interest rates, a change in the volatility of interest rates or, a change in the credit rating of an issuer. The Company is exposed to the following market risks as a result of its investments in mortgage-backed securities and equity investments. Except for trading securities held by FBR & Co. and certain mortgage-backed securities designated as trading, none of these investments is held for trading purposes.

#### **Interest Rate Risk**

##### ***Leveraged MBS***

The Company is subject to interest-rate risk as a result of its investments in mortgage-backed securities and its financing with repurchase agreement and commercial paper borrowings. The Company is exposed to interest rate risk that fluctuates based on changes in the level or volatility of interest rates and mortgage prepayments and in the shape and slope of the yield curve. The Company attempts to hedge a portion of its exposure to changes in interest rates primarily through the use of paying fixed and receiving floating interest rate swaps and Eurodollar futures contracts. The counterparties to the Company’s interest rate swap agreements and Eurodollar futures contracts at September 30, 2004 are U.S. financial institutions.

The Company’s primary risk is related to changes in both short and long-term interest rates, which affect the Company in several ways. As interest rates increase, the market value of the mortgage-backed securities may be expected to decline, prepayment rates may be expected to go down, and duration may be expected to extend. An increase in interest rates is beneficial to the market value of the Company’s swap positions as the cash flows from receiving the floating rate portion increase and the fixed rate paid remains the same under this scenario, as well as the Company’s position in Eurodollar futures contracts. If interest rates decline, the reverse is true for mortgage-backed securities, paying fixed and receiving floating interest rate swaps, and Eurodollar futures contracts. See Note 6 to the financial statements for information regarding how the effects of interest rate swaps and Eurodollar futures contracts are reflected in the Company’s financial statements.

The table that follows shows the expected change in market value for the Company's current mortgage-backed securities, interest-rate swaps and Eurodollar futures under hypothetical interest-rate scenarios. Interest rates are defined by the U.S. Treasury yield curve. The changes in rates are assumed to occur instantaneously. It is further assumed that the changes in rates occur uniformly across the yield curve and that the level of LIBOR changes by the same amount as the yield curve. Actual changes in market conditions are likely to be different from these assumptions.

Changes in value are measured as percentage changes from their respective values presented in the column labeled "Value at September 30, 2004." Actual results could differ significantly from these estimates. The estimated change in value of the mortgage-backed securities reflects an effective duration of 1.25 years. The effective duration is based on observed market value changes, as well as management's own estimate of the effect of interest rate changes on the fair value of the mortgage-backed securities portfolio including assumptions regarding prepayments based, in part, on each security's age, prior exposure to refinancing opportunities, the interest rate distribution of the underlying loans, and an overall analysis of historical prepayment patterns under a variety of past interest rate conditions (dollars in thousands, except per share amounts).

	Value at September 30, 2004	Value of MBS and derivatives at September 30, 2004 with 100 basis point increase in interest rates	Percent Change	Value of MBS and derivatives at September 30, 2004 with 100 basis point decrease in interest rates	Percent Change
<b>Assets</b>					
Mortgage-backed securities- available-for-sale .....	\$10,839,255	\$10,671,247	(1.55)%	\$10,942,228	0.95%
Mortgage-backed securities- trading .....	79,409	77,384	(2.55)%	80,957	1.95%
Derivative assets .....	10,676	187	(98.25)%	16,574	55.25%
Reverse repurchase agreements .....	162,095	162,095		162,095	
Other .....	1,192,130	1,192,130		1,192,130	
<b>Total Assets</b> .....	<u>\$12,283,565</u>	<u>\$12,103,043</u>	(1.47)%	<u>\$12,393,984</u>	0.90%
<b>Liabilities</b>					
Repurchase agreements and commercial paper .....	\$10,131,285	\$10,131,285		\$10,131,285	
Derivative liabilities .....	2,112	(9,808)	(564.39)%	14,872	604.17%
Other .....	606,807	606,807		606,807	
<b>Total Liabilities</b> .....	<u>10,740,204</u>	<u>10,728,284</u>	(0.11)%	<u>10,752,964</u>	0.12%
<b>Shareholders' Equity</b>					
Common stock .....	1,687	1,687		1,687	
Paid-in-capital .....	1,477,413	1,477,413		1,477,413	
Employee stock loan receivable .....	(4,821)	(4,821)		(4,821)	
Deferred compensation .....	(17,492)	(17,492)		(17,492)	
Accumulated comprehensive income .....	(44,949)	(210,926)	(369.26)%	53,562	219.16%
Retained earnings .....	131,523	128,898	(2.00)%	130,671	(0.65)%
<b>Total Shareholders' Equity</b> .....	<u>1,543,361</u>	<u>1,374,759</u>	(10.92)%	<u>1,641,020</u>	6.33%
<b>Total Liabilities and Shareholders' Equity</b> ..	<u>\$12,283,565</u>	<u>\$12,103,043</u>	(1.47)%	<u>\$12,393,984</u>	0.90%
<b>Book Value per Share</b> .....	<u>\$ 9.26</u>	<u>\$ 8.24</u>	(10.92)%	<u>\$ 9.84</u>	6.33%

As shown above, the mortgage-backed securities portfolio generally will benefit less from a decline in interest rates than it will be adversely affected by a same scale increase in interest rates. This may effectively limit an investor's upside potential in a market rally.

### *Other*

The value of our direct investments in other companies is also likely to be affected by significant changes in interest rates. For example, many of the companies are exposed to risks similar to those identified above as being applicable to our own investments in mortgage-backed securities. Additionally, changes in interest rates often affect market prices of equity securities. Because each of the companies in which we invest has its own interest rate risk management process, it is not feasible for us to quantify the potential impact that interest rate changes would have on the stock price or the future dividend payments by any of the companies in which we have invested.

### **Equity Price Risk**

The Company is exposed to equity price risk as a result of its investments in marketable equity securities, investment partnerships, and trading securities. Equity price risk changes as the volatility of equity prices changes or the values of corresponding equity indices change.

While it is impossible to exactly project what factors may affect the prices of equity sectors and how much the effect might be, the table below illustrates the impact a ten percent increase and a ten percent decrease in the price of the equities held by the Company would have on the value of the total assets and the book value of the Company as of September 30, 2004 (dollars in thousands, except per share amounts).

	<u>Value at September 30, 2004</u>	<u>Value of Equity at September 30, 2004 with 10% Increase in Price</u>	<u>Percent Change</u>	<u>Value at September 30, 2004 with 10% Decrease in Price</u>	<u>Percent Change</u>
<b>Assets</b>					
Marketable equity securities . . . . .	\$ 139,656	\$ 153,622	10.00%	\$ 125,690	(10.00)%
Equity method investments . . . . .	58,937	64,831	10.00%	53,043	(10.00)%
Investment banking investments . . . . .	5,247	5,772	10.00%	4,722	(10.00)%
Other long-term investments . . . . .	138,102	138,102		138,102	
Trading securities . . . . .	133,782	147,160	10.00%	120,404	(10.00)%
Other . . . . .	11,807,841	11,807,841		11,807,841	
<b>Total Assets</b> . . . . .	<u>\$12,283,565</u>	<u>\$12,317,328</u>	0.27%	<u>\$12,249,802</u>	(0.27)%
<b>Liabilities</b> . . . . .	<u>\$10,740,204</u>	<u>\$10,740,204</u>		<u>\$10,740,204</u>	
<b>Shareholders' Equity</b>					
Common stock . . . . .	1,687	1,687		1,687	
Paid-in-capital . . . . .	1,477,413	1,477,413		1,477,413	
Employee stock loan receivable . . . . .	(4,821)	(4,821)		(4,821)	
Deferred compensation . . . . .	(17,492)	(17,492)		(17,492)	
Accumulated comprehensive income . .	(44,949)	(30,983)	(31.07)%	(58,915)	31.07%
Retained earnings . . . . .	131,523	151,320	15.05%	111,726	(15.05)%
<b>Total Shareholders' Equity</b> . . . . .	<u>1,543,361</u>	<u>1,577,124</u>	2.19%	<u>1,509,598</u>	(2.19)%
<b>Total Liabilities and Shareholders' Equity</b> . . . . .	<u>\$12,283,565</u>	<u>\$12,317,328</u>	0.27%	<u>\$12,249,802</u>	(0.27)%
<b>Book Value per Share</b> . . . . .	<u>\$ 9.26</u>	<u>\$ 9.46</u>	2.19%	<u>\$ 9.05</u>	(2.19)%

Except to the extent that the Company sells its marketable equity securities or other long term investments, or a decrease in their market value is deemed to be other than temporary, an increase or decrease in the market value of those assets will not directly affect the Company's earnings, however an increase or decrease in the value of equity method investments, investment securities-marked to market, as well as trading securities will directly effect the Company's earnings.

#### **Item 4. Controls and Procedures**

Pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's principal executive officers, Emanuel J. Friedman and Eric F. Billings, and principal financial officer, Kurt R. Harrington, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined under Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon that evaluation, Emanuel J. Friedman, Eric F. Billings and Kurt R. Harrington concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in the Company's periodic SEC filings.

There has been no change in the Company's internal control over financial reporting during the quarter ended September 30, 2004 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

#### **Forward-Looking Statements**

This Form 10-Q includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Some of the forward-looking statements can be identified by the use of forward-looking words such as "believes", "expects," "may," "will," "should," "seeks," "approximately," "intends," "plans," "estimates" or "anticipates" or the negative of those words or other comparable terminology. Such statements include, but are not limited to, those relating to the effects of growth, our principal investment activities, levels of assets under management and our current equity capital levels. Forward-looking statements involve risks and uncertainties. You should be aware that a number of important factors could cause our actual results to differ materially from those in the forward-looking statements. These factors include, but are not limited to, the effect of demand for public offerings, activity in the secondary securities markets, interest rates, interest spreads, and mortgage prepayment speeds, the risks associated with merchant banking investments, available technologies, competition for business and personnel, and general economic, political, and market conditions. We will not necessarily update the information presented or incorporated by reference in this Form 10-Q if any of these forward-looking statements turn out to be inaccurate. For a more detailed discussion of the risks affecting our business see our Form 10-K for 2003 and especially the section "Risk Factors."

## **PART II – OTHER INFORMATION**

### **Item 1. Legal Proceedings**

As of September 30, 2004, the Company was not a defendant or plaintiff in any lawsuits or arbitrations, nor involved in any governmental or self-regulatory organization (“SRO”) matters that are expected to have a material adverse effect on the Company’s financial condition or statements of operations. The Company is a defendant in a small number of civil lawsuits and arbitrations (together, litigation) relating to its various businesses. In addition, the Company is subject to various reviews, examinations, investigations and other inquiries by governmental agencies and SROs (together, regulatory matters).

Friedman, Billings, Ramsey & Co., Inc. (“FBR & Co.”) is involved in investigations by the SEC and the NASD concerning its role in 2001 as a placement agent for an issuer in a PIPE (private investment in public equity) transaction. The Company has cooperated fully with the investigations. To date, neither the SEC nor the NASD has initiated proceedings against the Company or its employees in connection with the investigations.

In addition, one of the Company’s investment adviser subsidiaries, Money Management Associates, Inc. (“MMA”) and one of its now closed mutual funds, are involved in an investigation by the SEC with regard to certain losses sustained by the fund in 2003. The Company has cooperated fully with the investigation. To date, the SEC has not initiated proceedings against the Company or its employees in connection with the investigation.

Since no proceedings have been initiated in these investigations, it is inherently difficult to predict the outcome of the investigations or their affect on FBR & Co., MMA or the Company. Either or both agencies may initiate proceedings as a result of the investigations and such proceedings could result in adverse judgments, injunctions, fines, penalties or other relief against the Company or one or more of its employees.

There can be no assurance that these matters individually or in aggregate will not have a material adverse effect on the Company’s financial condition or results of operations in a future period. However, based on management’s review with counsel, resolution of these matters is not expected to have a material adverse effect on the Company’s financial condition or results of operations.

Many aspects of the Company’s business involve substantial risks of liability and litigation. Underwriters, broker-dealers and investment advisers are exposed to liability under Federal and state securities laws, other Federal and state laws and court decisions, including decisions with respect to underwriters’ liability and limitations on indemnification, as well as with respect to the handling of customer accounts. For example, underwriters may be held liable for material misstatements or omissions of fact in a prospectus used in connection with the securities being offered and broker-dealers may be held liable for statements made by their securities analysts or other personnel. In certain circumstances, broker-dealers and asset managers may also be held liable by customers and clients for losses sustained on investments. In recent years, there has been an increasing incidence of litigation and actions by government agencies and SROs involving the securities industry, including class actions that seek substantial damages. The Company is also subject to the risk of litigation, including litigation that may be without merit. As the Company intends to actively defend such litigation, significant legal expenses could be incurred. An adverse resolution of any future litigation against the Company could materially affect the Company’s operating results and financial condition.

**Item 4. Submission of Matters to a Vote of Security Holders**

At the annual meeting of shareholders of Friedman, Billings, Ramsey Group, Inc., held on May 19, 2004, the shareholders re-elected each of the following directors:

<u>Nominee for Director</u>	<u>Votes in Favor</u>	<u>Votes Against</u>	<u>Votes Withheld</u>
Emanuel J. Friedman .....	168,785,420	1,662,449	0
Eric F. Billings .....	168,785,320	1,662,549	0
W. Russell Ramsey .....	168,754,520	1,663,349	0
Daniel J. Altobello .....	168,753,796	1,694,073	0
Peter A. Gallagher .....	168,753,796	1,694,073	0
Stephen D. Harlan .....	168,189,261	2,258,608	0
Russell C. Lindner .....	168,754,461	1,693,408	0
Wallace L. Timmeny .....	168,541,041	1,906,828	0
John T. Wall .....	168,753,796	1,694,073	0

The following two other matters were approved by shareholders:

<u>Proxy Item</u>	<u>Votes in Favor</u>	<u>Votes Against</u>	<u>Votes Abstaining</u>
Approval of the FBR Long Term Incentive Plan .....	118,838,562	4,073,106	1,071,600
Ratification of the Appointment of PricewaterhouseCoopers LLP as the Company's independent auditors for 2004 . . . .	168,702,979	847,731	897,159

**Item 6. Exhibits and Reports on Form 8-K**

(a) Exhibits

- 12 Computation of Ratio of Earnings to Fixed Charges
- 31(a) Certification of Emanuel J. Friedman, Co-Chief Executive Officer of Friedman, Billings, Ramsey Group, Inc. pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31(b) Certification of Eric F. Billings, Co-Chief Executive Officer of Friedman, Billings, Ramsey Group, Inc. pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31(c) Certification of Kurt R. Harrington, Chief Financial Officer of Friedman, Billings, Ramsey Group, Inc. pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32(a) Certification of Emanuel J. Friedman, Co-Chief Executive Officer of Friedman, Billings, Ramsey Group, Inc. pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32(b) Certification of Eric F. Billings, Co-Chief Executive Officer of Friedman, Billings, Ramsey Group, Inc. pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32(c) Certification of Kurt R. Harrington, Chief Financial Officer of Friedman, Billings, Ramsey Group, Inc. pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

- August 5, 2004: Press release announcing Second Quarter 2004 earnings, and script of the August 4, 2004 conference call regarding Second Quarter 2004 earnings.
- August 12, 2004: Announcement that Friedman, Billings, Ramsey & Co., Inc. had closed a \$780 million offering for KKR Financial Corp, a newly-formed real estate investment trust (REIT) to be managed by an affiliate of Kohlberg Kravis Roberts & Co.
- October 27, 2004: Press release announcing Third Quarter 2004 earnings.
- October 28, 2004: Script of the October 27, 2004 conference call regarding Third Quarter 2004 earnings.

**\* SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**Friedman, Billings, Ramsey Group, Inc.**

By: /s/ KURT R. HARRINGTON  
**Kurt R. Harrington**  
*Senior Vice President and Chief Financial Officer*  
*(Principal Financial Officer)*

Date: November 9, 2004

By: /s/ ROBERT J. KIERNAN  
**Robert J. Kiernan**  
*Vice President, Controller and Chief Accounting Officer*  
*(Principal Accounting Officer)*

Date: November 9, 2004