



F R I E D M A N B I L L I N G S R A M S E Y
L E A D E R S I N I N N O V A T I V E C A P I T A L M A R K E T S S O L U T I O N S

Investment Banking . Asset Management . Research . Institutional Brokerage . Private Client Services . Merchant Banking

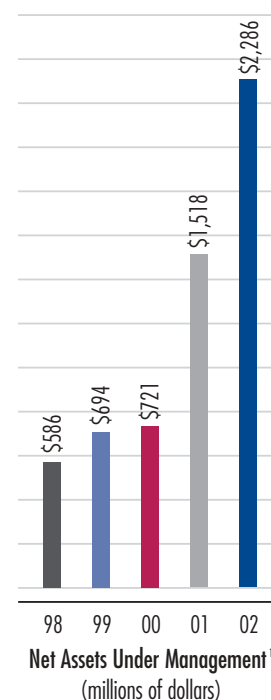
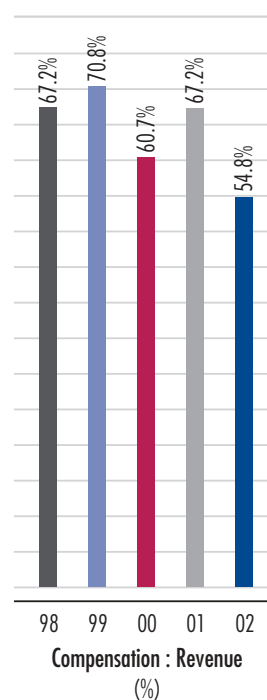
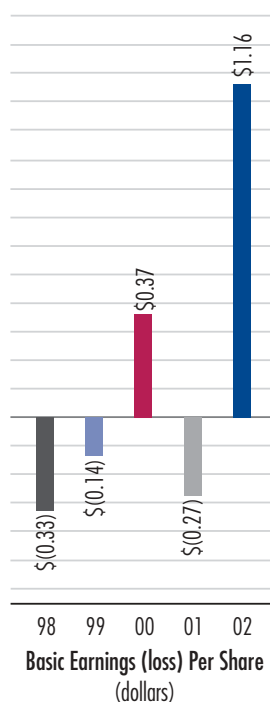
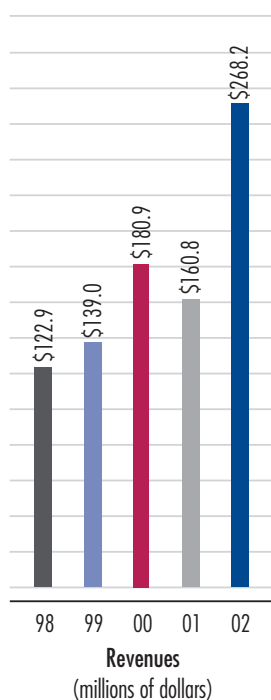


2002 ANNUAL REPORT

SELECTED CONSOLIDATED FINANCIAL INFORMATION

(Dollars in thousands, except per share amounts)

Years Ended December 31,	2002	2001	2000	1999	1998
Revenues:					
Investment banking:					
Underwriting	\$ 76,556	\$ 47,853	\$ 21,086	\$ 22,642	\$ 70,791
Corporate finance	58,595	28,534	31,404	22,541	41,356
Investment gains	8,725	6,762	1,453	3,853	—
Institutional brokerage:					
Principal transactions	27,512	26,330	32,319	22,058	(28,192)
Agency commissions	35,672	27,084	21,084	14,988	15,308
Asset management:					
Base management fees	28,956	19,744	9,719	9,409	7,556
Incentive allocations and fees	14,258	3,628	1,673	1,577	3,841
Net investment income (loss)	16,276	9,532	10,843	(5,268)	(3,972)
Technology sector net investment and incentive income (loss)	(5,622)	(18,100)	41,614	36,398	29
Interest, dividends and other	7,275	9,422	9,695	10,768	16,151
Total revenues	268,203	160,789	180,890	138,966	122,868
Net income (loss) before taxes and extraordinary gain	55,441	(15,622)	22,245	(6,971)	(16,209)
Income tax provision (benefit)	3,035	(1,760)	4,163	—	—
Net income (loss) before extraordinary gain	52,406	(13,862)	18,082	(6,971)	(16,209)
Extraordinary gain	1,413	1,148	—	—	—
Income tax provision on extraordinary gain	536	—	—	—	—
Net income (loss)	\$ 53,283	\$ (12,714)	\$ 18,082	\$ (6,971)	\$ (16,209)
Total assets	\$ 406,185	\$ 291,958	\$ 252,219	\$ 226,356	\$ 205,116
Shareholders' equity	245,165	185,311	214,556	188,969	186,902



Friedman, Billings, Ramsey Group, Inc. (“FBR”) is one of the leading independent capital markets firms in the United States, providing research, institutional brokerage, investment banking, private client services, asset management and merchant banking capital and expertise focused on six industry sectors: financial services, real estate, technology, healthcare, energy and diversified industries¹. We combine the institutional presence of a Wall Street firm, the investment acumen of a merchant bank and the industry focus of a research boutique to provide the potential for current income and future growth.



WASHINGTON, DC

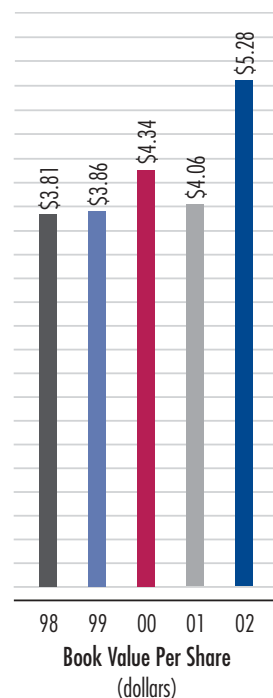
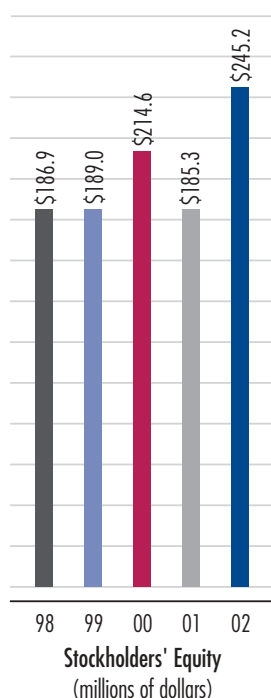
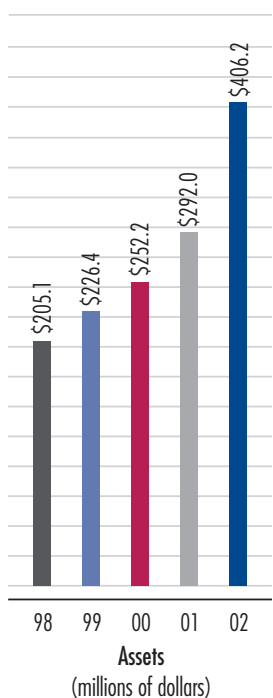


NEW YORK, NY



LONDON, UK

ARLINGTON . ATLANTA . BETHESDA . BOSTON . CHARLOTTE . CHICAGO . CLEVELAND . DALLAS
DENVER . IRVINE . NEW YORK . PORTLAND . SAN FRANCISCO . SEATTLE . LONDON . VIENNA



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¹ This report is for 2002. On March 31, 2003, FBR merged with FBR Asset, a separate public company which was FBR's largest managed vehicle in 2002. The new company resulting from the merger assumed the name Friedman, Billings, Ramsey Group, Inc.



*Emanuel J. Friedman and Eric F. Billings (seated)
Founders, Co-Chairmen and Co-Chief Executive Officers*

To Our Shareholders

April 20, 2003

Dear Fellow Shareholders:

We are pleased to report that 2002, which marked the completion of our fifth year as a public company, was the best year in FBR's history. For the one and five year periods ending December 31, 2002, we ranked #1 among all major equity underwriters in the United States for the aftermarket performance of our transactions, according to CommScan LLC¹. FBR achieved both record revenue and net income while maintaining growth and increased diversification in each of our profit centers — institutional brokerage, investment banking and asset management. Across these platforms, we continued to focus on and develop our six target industry sectors — financial services, real estate, technology, healthcare, energy and diversified industries.

For the year, FBR reported net income of \$53.3 million or \$1.16 (basic), \$1.10 (diluted) per share, on revenues of \$268.2 million. Our return on equity of 24.8% was among the highest in the securities industry.

Aggregate revenue growth in 2002 was 67% compared to 2001. Since 1998, our first year as a public company, our compounded annual growth in revenue has exceeded 20%.

In **research**, FBR added 114 new companies to coverage — 50 have market caps over \$3 billion in size bringing our total coverage in the large cap universe to 114 companies, and our total coverage universe to almost 400 companies. Of these, more than 80% have no investment banking relationship with the company² — enhancing the value of our independent research views. At the same time, we increased and upgraded our analyst team with new hires; continued to build out industries, initiating or expanding coverage in wireless telecommunications, large cap pharmaceuticals, energy, healthcare, large cap oil companies, media infrastructure and large cap semiconductors; and expanded our high yield research effort.

Institutional brokerage, supported by FBR's research capabilities, continued a multi-year growth trend. Total trading volume increased 39% over the previous year with sales and trading revenues generated across all of our industry sectors — more than half outside financial services and real estate, our historically strong sectors. We are particularly pleased by the significant level of activity in technology and healthcare, which accounted for more than 32% of our 2002 volume. Sales and trading in listed business was up 58% over 2001 and that for NASDAQ/OTC companies grew 27%. Secondary business in the industry-recognized McLagen top 100 accounts — among the largest institutions in the country — grew 25% from the previous year.

In **investment banking**, during 2002, FBR raised more than \$5 billion in capital for our clients — up 96% over 2001. We completed 98 transactions — including 43 lead or co-managed capital raises, as well as 33 M&A transactions and other advisory assignments. M&A and advisory business grew 100% from 2001, accounting for approximately 15%



Selected 2002 transactions in public and private equity, M&A and advisory transactions.

¹ Non-weighted average aftermarket performance calculated on 1 year (2002) and 5 year (1998-2002) basis for lead-managed IPOs and Secondaries only (closed end funds excluded). 1 year calculation included only lead managers of more than 10 transactions; 5 year calculation included only lead managers of more than 25 transactions. Aftermarket performance varies considerably between offerings. Past performance is no guarantee of future results.

² 12-month rolling average through December 31, 2002 and March 31, 2003.



of overall investment banking revenues in 2002. Repeat business accounted for 30% of our investment banking transactions.



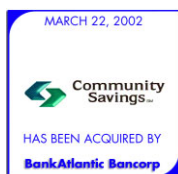
For 2002, FBR ranked 3rd by the number of deals and 8th by dollars raised for issuers with market caps below \$1 billion. We ranked 8th for the number of deals and 12th by dollars raised for all issuers, regardless of market cap¹.



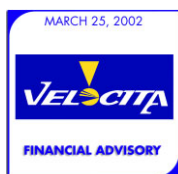
Emanuel J. Friedman
Co-Chairman & Co-Chief Executive Officer



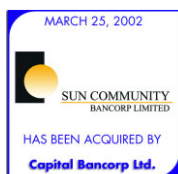
As in the previous year, the interest rate environment remained beneficial to **financial services** businesses such as mortgage companies, banks and thrifts, commercial finance companies and mortgage REITs. Again in 2002, FBR ranked #1 among all lead managers of transactions in financial services public equity underwritings based on the number of deals, raising \$1.5 billion in 13 transactions².



In 2002, FBR also ranked #1 based on the total number of lead managed **real estate**³ transactions. We lead managed 8 follow-on offerings with a \$1.4 billion value. Examples include Entertainment Properties Trust, American Mortgage Acceptance Company, One Liberty Properties, Inc. and Crown American Realty Trust.



Of particular note, we also raised \$405 million in a 144A institutional placement for American Financial Realty Trust, a new company chaired by Lew Ranieri.



We are naturally gratified that we maintained our top-ranked position in financial services and real estate. Of equal importance, to our declared goal of diversification, is the fact that approximately 35% of our investment banking transactions during 2002 were in other sectors. In **energy**, we participated in nearly \$1.5 billion of capital markets and advisory activities. FBR lead-managed or co-managed five energy transactions for more than \$800 million of equity and debt underwritings and acted as financial advisor on nearly \$700 million of M&A and other advisory transactions. Revenue



“We’ve very prudently tried to grow the business while maintaining cost discipline. And, we have grown our capital very dramatically. That capital has created strong earnings. Today, we are in a very advantageous position while the industry is in turmoil.”

Emanuel J. Friedman

growth in energy investment banking in 2002 was 300% over 2001 and our energy group now covers oil and gas production, pipelines, transportation, refining and service sectors, as well as the coal mining industry — as the presence in Texas that we established in 2001 gains traction.

The public capital markets for **technology** companies continued to be challenging, just as they were in 2001 and the majority of 2000. Given this environment, our achievements centered on 18 private placements, mergers and acquisitions, and restructurings. Notable M&A activities included advising ACTV, an interactive television company, on their merger with OpenTV and the sale of security company Vance International to SPX Corporation. We also served as financial advisor to Ardent Communications during their Chapter 11 proceedings and provided financial advisory services to broadband service



¹ Lead managed only, excluding closed-ends.

² IPO and secondary common stock offerings from 01/01/02–12/31/02; For underwriters raising more than \$50MM; Excluding insurance transactions; \$ in millions.

³ IPO and secondary common stock offerings from 01/01/02–12/31/02; For underwriters raising more than \$30MM; #1 ranking by number of transactions. Investment banking services provided by Friedman, Billings, Ramsey & Co., Inc.



provider Velocita Corp. In 2002, we also marked the launch of our **healthcare** investment banking practice and initially focused on life sciences and biotech — with one of the largest private placements for a biotech company, Iomai Corporation.



In **asset management**, by year-end 2002, FBR had \$2.7 billion in gross assets under management; \$8.1 billion including FBR Asset, FBR's largest managed vehicle with which we merged March 31, 2003.

FBR's mutual funds grew 17.4% during 2002, a terrific result in the face of a brutal market for equities generally, and mutual funds in particular. Of our four equity mutual funds with track records of at least three years, three continue to hold five-star ratings and one a four-star rating from Morningstar™.*

Our alternative assets (hedge, private equity and venture capital) and asset allocation managed accounts grew as we launched a new fund of funds and offshore arbitrage fund during the year.

In **private client services**, our newest group — which combines our institutional asset management and brokerage expertise for the benefit of high net worth individuals — managed assets increased by 25% in 2002. With respect to brokerage activity emanating from our private client group, commissions more than doubled in 2002.

Overall, we are particularly well positioned for growth at this time and we have been actively hiring across the platform. In 2002 we added nearly 50 professionals (net) to our ranks hailing from other leading securities firms. The net additions include 7 in Research, 25 in Sales & Trading, and 8 in Investment Banking, bringing total headcount at year end to 481 — up over 10% during the year.

Last year we opened our San Francisco office to take advantage of opportunities in technology banking and upgraded other operations in New York, Boston, Chicago and Denver based on business demands.

“For middle-market issuers in the United States seeking to raise equity capital in size, we are now one of the few remaining investment banks outside of Wall Street that can execute underwritings.”
Eric F. Billings

Going forward, we remain prudently optimistic. The growth, diversification, and excellence that our platform has demonstrated throughout our history, and in particular over the last five year period since we went public, have positioned us well for the future. We have greater resources — in terms of human as well as financial capital — than ever before. At this time, more than ever, our services fit a need for issuers and investors as market conditions fuel the necessity for the innovative capital markets solutions that are FBR's hallmark. Concurrently, several other mid-tier investment banks have all but ceased to



exist, and many of the great firms of Wall Street are under unprecedented pressure from the regulatory, market and economic environment.

Given the successful completion of FBR's merger with FBR Asset last month, we believe our potential now to be even greater.

For FBR, the merger is expected to be accretive to earnings and book value. More efficient internal access to capital will enhance investment banking growth while greater visibility and market presence are expected to expand overall opportunities. The move will also diversify, and provide greater stability, to the revenue base while allowing us to deploy excess capital in a more tax efficient manner. The initiation of a dividend coupled with growth increases total return potential to our shareholders while garnering wider coverage and a broader investor base.

FBR Asset has also benefited by internalizing management and by adding a new growth dynamic. The new FBR combines dividends with an enhanced growth opportunity, expected to result in accretion to earnings and reduced leverage levels for FBR Asset shareholders. Further, we believe greater flexibility and diversification is achieved that will be of benefit in different environments.

In closing, we are pleased with our results for 2002 in both quantitative and qualitative terms. FBR continued a trend of growth, diversification and excellence. We achieved the strongest year-over-year revenue growth since 1998, while continuing to diversify our revenue stream across three profit centers and six industry sectors. In the post merger environment, our foundation is clearly more substantial and diverse — with two additional profit centers in the MBS spread-based business and the merchant banking portfolio coming from FBR Asset — and our plans are firmly in place to reap strong rewards.

We thank each of our fellow shareholders for their confidence as we continue to grow the company through foresight, focus, innovation and exceptional client service.

Emanuel J. Friedman
Co-Chairman and Co-Chief Executive Officer

Eric F. Billings
Co-Chairman and Co-Chief Executive Officer

* Past performance is no guarantee of future results. For each fund with at least a 3-year history, Morningstar calculates a Morningstar Rating™ metric each month by subtracting the return of a 90-day U.S. Treasury Bill from the fund's load-adjusted return for the same period, and then adjusting the excess return for risk. The top 10% of funds in each broad asset class receive five stars, the next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars and the bottom 10% receive one star. The Overall Morningstar Rating™ for a fund is derived from a weighted average of the performance figures associated with its 3-, 5- and 10-year (if applicable) Morningstar metrics. The FBR Small Cap Financial Services Fund and the FBR Small Cap Value Fund received 5 stars for 3-year and 5-year periods and were rated among 78 and 44 U.S. domiciled specialty financial funds and 433 and 293 U.S. domiciled small growth funds respectively. The FBR American Gas Index Fund received 5 stars for the 3-year, 4 stars for the 5-year and 5 stars for the 10-year period and was rated among 79, 74 and 22 U.S. domiciled specialty utility funds respectively. The FBR Financial Services Fund received 4 and 3 stars for the 3- and 5-year periods and was rated among 78 and 44 U.S. domiciled specialty financial funds. ©2002 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results.

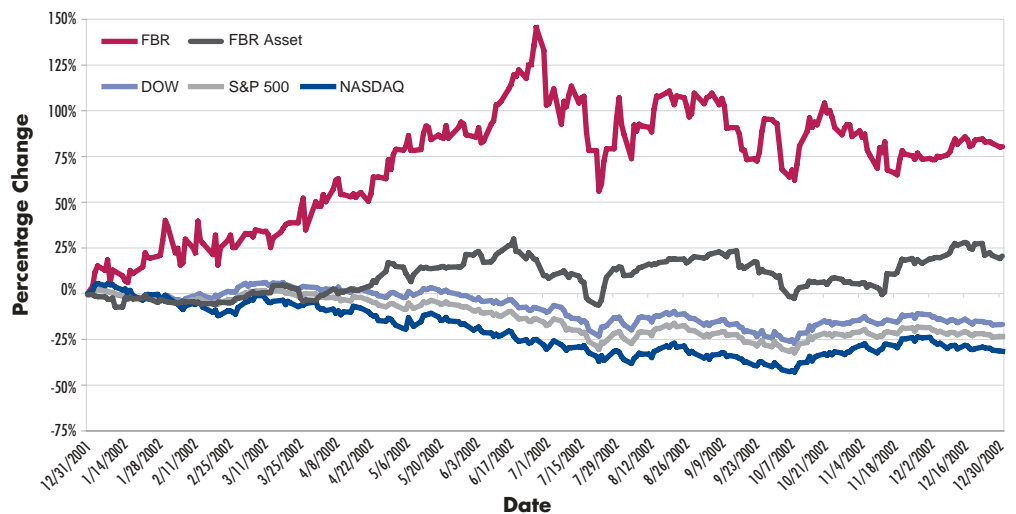
Achieving the Goal

Since late 1999, we have worked to achieve a three-fold goal — to maintain growth while diversifying revenues and introducing greater predictability in earnings. Our 2002 results are the culmination of these.



“Since the beginning of 2002, FBR Group and FBR Asset have outperformed the Dow, S&P 500 and NASDAQ. This outcome is the product of a decade-long journey of growth and evolution to become a leading capital markets firm.”
Robert S. Smith, Chief Operating Officer

FBR Group and FBR Asset stock price performance in comparison with the DOW, S&P 500 and NASDAQ from 12/31/01 until 12/31/02.



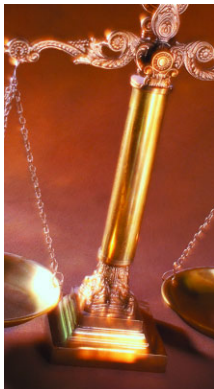
With the completion of the merger of FBR and FBR Asset, the combined company will have a highly liquid balance sheet with an equity capital base of approximately \$1 billion, and total shares outstanding of approximately 136 million. We have added two new profit centers — mortgage backed securities and merchant banking — to institutional sales & trading, investment banking and asset management.

	REIT Principal Activities ¹ — 2 Profit Centers	Taxable Subsidiaries (TRSs) ² — 3 Profit Centers Supported by Research				
The New FBR	Mortgage Backed Securities Assets Approximately \$5 Billion • AAA rated securities — guaranteed by Freddie Mac, Fannie Mae or Ginnie Mae • Low effective duration of 1 to 2 years; limits price risk • Leverage target of 8–8.5x within mortgage portfolio	Merchant Banking \$178 Million of Invested Capital • Preferred and Common Equity • Senior Secured and Mezzanine Loans • Interest in Proprietary Funds • Direct Assets • Non-Levered Portfolio	Research 64 Senior Analysts Approximately 400 Companies under Coverage • Independence • In-Depth Company Analysis • Theme-Driven Industry Coverage • Daily Morning Note • Daily Meetings with Sales Force • Up-to-Date Economic and Policy News • Frequent Management Roadshows • Annual Investor Conferences	Institutional Sales & Trading 54 Institutional Brokers 30 Traders and Sales Traders Market-Maker in Over 480 Equity and Debt Securities • Covering Over 1,000 Institutional Accounts • Mutual Funds • Hedge Funds • Money Managers • Pension Funds	Investment Banking 73 Investment Bankers 6 Focused Industry Sectors • Financial Services • Real Estate • Technology • Energy • Diversified Industries • Healthcare Top 10 Lead-Managing Equity Underwriter • 76 Transactions with \$5.2B in Total Transaction Value • 28 Lead and Sole Managed Public/Private Transactions • 33 M&A and Advisory Assignments	Asset Management Private Equity Hedge Funds Venture Capital Equity Mutual Funds Fixed Income Mutual Funds Tax-Exempt Funds Money Market Funds Private Client Group • Investment Management • Restricted 144A Stock Sales • Financial Planning / Trust & Estate Services • Credit Lines • Hedging & Mitigation • Employee Stock Option Management • Cash Management

¹ Based on pro forma financial data as of December 31, 2002.
² For 12 months ended December 31, 2002.

Financial Integrity

FBR's financial systems and internal controls function to assure the accuracy of our financial reports.



Management is responsible for preparing FBR's consolidated financial statements and related notes contained in this Annual Report. Management also devotes its attention to understanding the risks of its businesses, promoting the highest standards of ethical conduct, exercising prudent stewardship over FBR's assets and presenting fair financial statements.



*"Financial integrity is the foundation of the capital markets."
Kurt R. Harrington
Chief Financial Officer*

FBR regularly reviews its internal controls which, in the opinion of management, provide reasonable assurance that assets are safeguarded and that transactions are properly recorded and executed in accordance with management's authorizations. Management also exercises judgments to assess and balance the relative costs and expected benefits of these controls and implements improvements when considered cost effective. The framework of internal controls includes policies, procedures and organizational structures that are overseen by an independent Audit Committee of the Board of Directors.

The Audit Committee, which consists of three independent directors, reviews the consolidated financial statements with management and the independent auditors. The Audit Committee appoints the independent auditors and reviews the professional services they provide, including their performance, independence and fees. The Audit Committee also oversees the internal audit function and compliance with risk management and policies and procedures.

The 20 members of the Financial/Operations team establish accounting policies and procedures, measure and monitor financial capital and liquidity risk, and prepare financial statements that fairly present FBR's underlying transactions and events in accordance with Generally Accepted Accounting Principles. Results are reported quarterly to the independent Audit Committee and the Board of Directors.

The independent auditors, PricewaterhouseCoopers, LLP, perform annual audits of FBR's consolidated financial statements in accordance with generally accepting auditing standards, and also perform quarterly reviews on unaudited interim financial statements. The independent auditors meet quarterly with the Audit Committee and openly discuss their views on the quality of the financial statements and related disclosures and the adequacy of FBR's internal accounting controls.

The consolidated financial statements and related notes are prepared by management in accordance with Generally Accepted Accounting Principles and are necessarily based on judgments and estimates.

Analytic Objectivity

FBR's research team comprises over 60 equity analysts covering approximately 400 U.S. and global companies in six defined industry sectors—which integrate the most current economic and policy research, as well as high yield debt research.



Through the unique integration of our six key industry sectors with our economic and policy research group, as well as our high yield debt research group, we focus to see deeper than our competitors. We initiate creative ideas and provide superior service to enhance our clients' investment returns in equity and high yield investing.



“Our historical focus on small- to mid-capitalization companies has broadened to include many large-caps.”
Martin S. Friedman
Managing Director,
Research

The heart of FBR's broker/dealer subsidiary, Friedman, Billings, Ramsey & Co., Inc. (FBR & Co.), is the research department, which excels at identifying and articulating hidden, undervalued investment opportunities. In fact, more than 85% of FBR's senior analysts garnered rankings of honorable mention or above in the 2002 *Institutional Investor* "All American Research Team Report."

Through our metropolitan Washington, D.C. location, FBR's economic and policy research group is uniquely positioned to work closely with the rest of the research team to provide analysis of the latest legislative initiatives on Capitol Hill. This translates to constant new insight into the marketplace for our clients. This solid commitment across our industry sectors enables FBR to provide its clients with the most complete picture of the financial landscape.

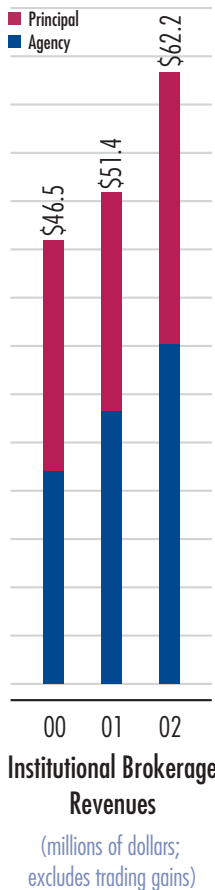
FBR's more than 60 equity analysts have detailed knowledge of the S&P 500 issuers in their respective industries, as well as small- and mid-cap names, providing research on approximately 400 publicly traded companies. This research includes individual company reports, industry overviews, and broad economic and political analysis.

Distinguished internationally for its focus, timeliness, and creativity, FBR research demonstrates industry expertise throughout its key sectors with the highest quality and objectivity.

Economic and Policy Research	Financial Services	Real Estate	Technology	Energy	Healthcare	Diversified Industries	High Yield
	19 Analysts	5 Analysts	17 Analysts	9 Analysts	5 Analysts	5 Analysts	
	<ul style="list-style-type: none"> Asset Management Broker/Dealers* Community Banks Government-Sponsored Enterprises (GSEs) Insurance Brokerage Money-Center Banks Mortgage Companies Property/Casualty Insurance Regional Banks Specialty Finance: Consumer /Commercial Thriffs Mortgage Insurance Life Insurance 	<ul style="list-style-type: none"> Diversified REITs Hotel REITs Industrial REITs Mortgage REITs Multifamily REITs Office REITs Triple-Net REITs Home Builders* Retail REITs* Real Estate Operating Companies* 	<ul style="list-style-type: none"> Display and Semiconductor Technologies Enterprise Platform and Application Software Enterprise Services Media Infrastructure Network Software Semiconductors Specialty Contracting Telecom Equipment and Services Wireless Services 	<ul style="list-style-type: none"> Coal Mining Companies Gas Gathering and Processing Pipeline Integrated Oil Companies & Independent Refineries Oil & Gas Exploration & Production (E&P): Canadian & U.S. Oilfield Services 	<ul style="list-style-type: none"> Biotechnology* Genomics and Proteomics* Large-Cap Pharmaceuticals Specialty Pharmaceuticals 	<ul style="list-style-type: none"> Pollution Control / Solid Waste Industrials Special Situations Security Services* Defense Electronics* 	

* In process. Research is provided by Friedman, Billings, Ramsey & Co., Inc.'s (FBR & Co.) Research Department, which is independent from the Investment Banking Department of FBR & Co. and has the sole authority to determine what companies receive research coverage and the recommendations contained in the coverage. In the normal course of its business, FBR & Co. seeks to perform investment banking and other fee generating services for companies that are the subject of FBR & Co. research reports. Research analysts are eligible to receive bonus compensation that is, in part, based on overall investment banking revenues. Specific information is contained in each research report concerning FBR & Co.'s relationship with the company that is the subject of the report.

Specialized Expertise



The Honorable William S. Cohen, former U.S. Secretary of Defense, was keynote speaker at the 1,000+ attendee Friedman Billings Ramsey 9th Annual Investor Conference — in New York, December 2002.

FBR focuses on institutional sales and trading services to equity and high-yield investors in the United States, Europe, Middle East and Asia. We execute securities transactions for institutional investors such as mutual funds, hedge funds, money managers, banks, insurance companies and pension/profit-sharing plans.

In 2002 we hired 22 sales professionals, bringing the total complement to 95. During the year, we opened sales operations in San Francisco and expanded the sales and trading floors in New York, Boston and Denver. Additionally, we expanded our London operation, which now services large regions of the non-U.S. world.

At present, from sales offices in Arlington, Atlanta, Boston, Charlotte, Denver, Irvine, London, New York, San Francisco and Vienna, FBR's sales professionals work closely with our research analysts and our trading desk to provide the most up-to-date information to our institutional clients.

They rely on discussions with the research analysts at daily sales meetings, as well as on the distribution of, and frequent updates



*"Providing timely, relevant and objective research and analysis with close client interaction has been a distinguishing trait in FBR's offerings."
Jon Billings
Managing Director, Sales*

*"We begin with a thorough understanding of our clients' needs."
Claire F. Newman
Managing Director,
Sales*

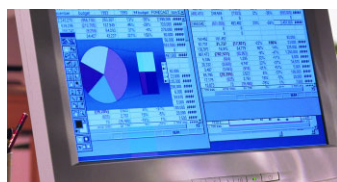


2002 Contributions

- Nearly 100 different management teams on the road (excluding syndicate roadshows).
- Investor offerings of over 30 specialized conference calls and investor days as well as a major investor conference in December.
- Current information from research analysts at daily sales meetings and throughout each business day.

Institutional brokerage services provided in the United States by Friedman, Billings, Ramsey & Co., Inc. and in Europe by Friedman, Billings, Ramsey International, Ltd. (FBRIL).


to, research reports and trading updates. As a consequence, our sales professionals possess a deep understanding of the research product and the market, and are able to clearly articulate what drives the valuation of companies.



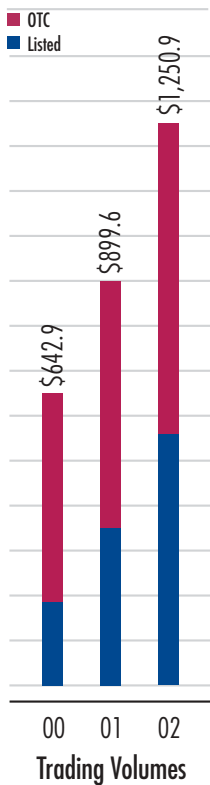
Efficient Execution

Our traders work closely with their buy-side counterparts to effect purchases and sales of large blocks without market disruption. Execution is handled with efficiency and effectiveness to bring the best possible service to our customers with appropriate capital commitment levels by the firm.

“We provide liquidity and efficient execution through ready, albeit cautious, use of the firm’s capital and timely match-up in order flow.”
Scott E. Dreyer
 Managing Director, Trading



FBR makes markets in 470 NASDAQ and other OTC securities, as well as engaging in principal transactions in securities listed on the NYSE and other exchanges. We provide sales trading services directly to the trading desks of major institutions in the United States and Europe.



(millions of dollars; source: Autex, not all trades are reported to Autex)

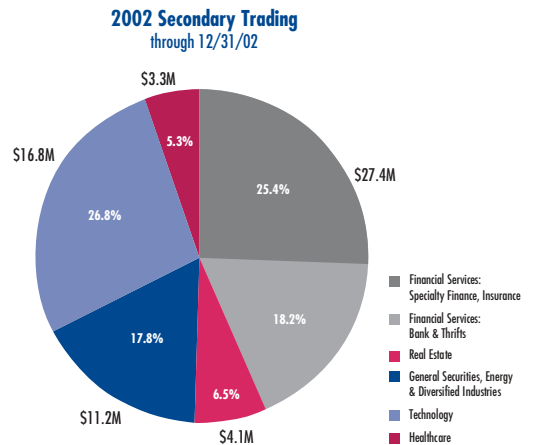
Trading volumes have doubled in the last two years based on calculated and successful penetration of the McLagen top 100 accounts and strong customer service to over 1,000 accounts worldwide.

“Thoughtful service custom tailored to client needs produces the excellence by which FBR is known.”
Timothy H. Burns
 Managing Director, Sales Trading

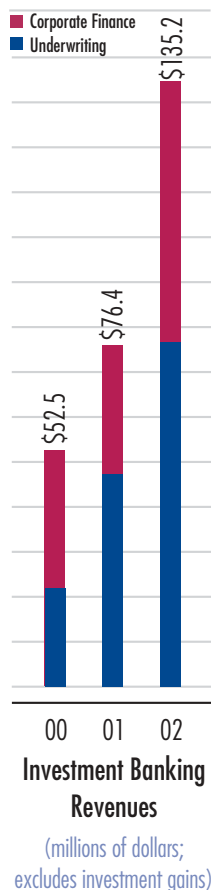


In 2002, FBR hired five additional traders in three locations from firms such as Credit Suisse First Boston, J.P. Morgan and ABN-AMRO, bringing the total trader count to 29. We now have traders in Arlington, VA, Atlanta, Boston, London, New York and San Francisco offering close proximity to a number of our major institutional accounts.

Order flow and sector diversification continue to increase with trades now distributed across all six sectors of specialization as well as involving nearly every sector of the S&P 500.



Innovative, Effective Delivery



In 2002, the number of FBR's investment banking transactions rose 49% over 2001 and transaction value rose 96%. M&A/advisory business more than doubled.

Consistent with other parts of our business, in investment banking we focus on specific industries in which we have developed in-depth expertise. Our capital-raising ability is evident in the initial and follow-on transactions successfully executed for our clients. For those seeking to access capital through the equity and high-yield markets, FBR provides the necessary confidence, guidance and results throughout every phase of the process regardless of market conditions.

"Our specialized industry focus and refined expertise is evident in every step of the process."
J. Rock Tonkel, Jr.
Executive Vice President, Head of Investment Banking



We have had increasing success in the public equity markets since our founding. We reaffirmed our record as a top ten equity underwriter in the U.S. again in 2002. With the opening of our San Francisco office last October, we continued the build-out of our national platform, deepened our technology presence, and capitalized on the opportunity in the West Coast competitive landscape.

In 2002, we completed 76 capital markets transactions with a value in excess of \$5 billion, including 28 lead (or sole-) managed public and private offerings. FBR was ranked #1 performing lead-managing equity underwriter in the United States by after-market performance for lead managers of more than ten and twenty-five transactions for both the one and five-year period ended December 31, 2002. We also maintained our position as a major underwriter by number of deals and transaction volume, and we confirmed our prominence as a top underwriter for middle-market issuers, ranking 3rd by the number of deals and 8th by the dollar amount raised for issuers with a market cap under \$1 billion.

Lead Manager Aftermarket Performance Across All Industries

January 1, 2002 through December 31, 2002

Lead Manager	# of Deals	Aftermarket Performance ¹
1 Friedman Billings Ramsey	20	8.06% ²
2 Goldman, Sachs & Co	32	-0.36%
3 J.P. Morgan Securities Inc.	16	-1.29%
4 Merrill Lynch & Co	39	-3.91%
5 Deutsche Bank Securities	16	-6.16%
6 Bear, Stearns & Co.	21	-7.11%
7 Salomon Smith Barney	30	-10.24%
8 Morgan Stanley	36	-10.51%
9 Banc of America Securities	18	-15.81%
10 Credit Suisse First Boston	56	-16.72%
11 UBS Warburg LLC	24	-17.75%
12 Lehman Brothers	23	-19.44%
	331	-8.44%

MARCH 25, 2002
\$49,650,000

OXFORD
 Oxford Finance Company
PRIVATE PLACEMENT
 SOLE MANAGER

JUNE 3, 2002
\$50,312,500

CROWN AMERICAN
 REALTY TRUST
SECONDARY OFFERING
 LEAD MANAGER

JULY 11, 2002
\$95,795,000
First Community Bancorp
SECONDARY OFFERING
 LEAD MANAGER

SEPTEMBER 4, 2002
\$405,018,000

AMERICAN FINANCIAL
 REALTY TRUST
PRIVATE PLACEMENT
 SOLE MANAGER

SEPTEMBER 26, 2002

ACTV
 HAS BEEN ACQUIRED BY
OpenTV

OCTOBER 10, 2002
\$90,000,000

NRP
 NATURAL RESOURCE PARTNERS
INITIAL PUBLIC OFFERING
 CO-MANAGER

NOVEMBER 19, 2002
\$18,560,000

SenSyTech Inc.
SECONDARY OFFERING
 LEAD MANAGER

DECEMBER 4, 2002
\$54,350,000

IOMAI
 CORPORATION
PRIVATE PLACEMENT
 SOLE MANAGER

DECEMBER 19, 2002
\$139,380,000

RLI
SECONDARY OFFERING
 LEAD MANAGER

Selected 2002 transactions in public and private equity and M&A transactions.

Market Caps under \$1B — All Industries
 January 1, 2002 through December 31, 2002 — IPOs and Secondaries

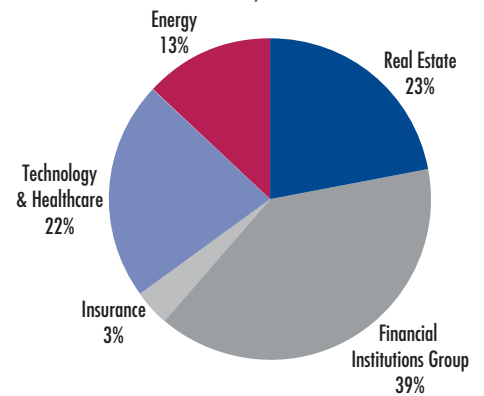
Lead Manager	# of Deals	Total Amount Raised ¹
1 Credit Suisse First Boston	29	\$ 3,274.40
2 Merrill Lynch & Co	20	2,251.20
3 Friedman Billings Ramsey	19	1,361.20 ²
4 Bear, Stearns & Co	18	2,035.70
5 Morgan Stanley	18	1,944.30
6 UBS Warburg LLC	18	1,334.80
7 Lehman Brothers	14	1,674.60
8 Goldman, Sachs & Co	12	2,332.60
9 Salomon Smith Barney Inc	9	1,015.90
10 Banc of America Securities	9	734.90
11 CIBC World Markets	9	476.80
12 Raymond James	9	280.10
13 Deutsche Bank Securities	9	1,367.60
14 J.P. Morgan Securities Inc	7	506.10
15 Robertson Stephens	7	386.00
16 Wachovia Securities Inc	7	351.20
17 Keefe, Bruyette & Woods Inc	7	291.10
18 Sandler O'Neil & Partners LP	5	338.70
19 U.S Bancorp Piper Jaffray Inc	5	314.60
20 William Blair & Co	5	230.60
235		\$ 1,125.10

We also continued our great record in execution of 144A institutional equity placements, raising over \$500 million in 2002. The record for the year demonstrates sustained progress in the diversification of our products, services and industry coverage.

Products and Services		
Seed Capital	Private Equity & P.I.P.E.s	144A Institutional & Private Placements
High Yield Debt and Preferred Equity	Initial Public Offerings	Secondary & Follow-On Offerings
Restructuring and Recapitalizations	Mergers & Acquisitions	Fairness Opinions and other Advisory Services

Plus Mezzanine Debt and Equity through
 FBR Asset/FBR Group Merchant Banking

Investment Banking Transactions
 (By Sector)



In 2002, our deal flow was nicely distributed. While the financial services and real estate sectors accounted for approximately 65% of our transactions, energy, technology, healthcare and diversified industries accounted for the balance — about 35%.

¹ Lead managed IPO's and secondaries only (closed-end funds excluded). All deals included, no minimum, \$ in millions. Source: CommScan LLC
² In addition, FBR raised more than \$500 million in 144A Institutional Equity Placements.

Informed Solutions



The FBR Private Client Group provides informed, customized wealth management solutions to individuals, families and foundations controlling significant assets.

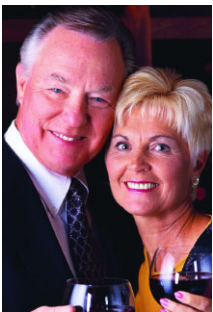
Our financial advisers have extensive experience in asset allocation and management, equity research and securities trading, wealth



“We respond with specialized skills and experience to the specific wealth management needs of each individual client.”

*Robert Feinstein
Managing Director,
Private Client Group*

advisory services, tax, real estate and banking. They work together in flexible teams, responding with specialized skills to the relevant spectrum of wealth management needs specific to each client. These frequently include: sales of restricted stock, stock option exercise, financial structuring, asset allocation, risk management, securities trading and investment structures to further tax and estate planning goals.



Our Private Client Group clients have access to our institutional research and trading capabilities, proprietary asset management products, and new securities issues that are underwritten by FBR.

Brokerage

- FBR Proprietary Research
- Portfolio Management
- Access to FBR IPOs and Other New Issues
- Block Trades
- Private Placements
- Trading Directly with FBR's Institutional Trading Desk

Investment Management

- Financial Planning
- Asset Allocation
- Manager Selection and Monitoring
- Tax-Efficient Investment Policy Design
- Portfolio Risk Management
- Trust and Estate Services
- FBR Proprietary Products

Corporate Executive Services

- Restricted Stock Sales / 144 Sales
- Hedging and Monetization
- Stock Option Execution and Management
- Secured Lending
- Fixed Income Strategies

With respect to constructing asset allocation portfolios, the Private Client Group takes a “best of class” multi-manager approach. This enables us to respond to each client’s unique financial requirements and need for tax efficiency. Portfolio construction is shaped by the client’s financial horizons, financial objective, risk tolerance and suitability profile.

After portfolio construction, members of the Private Client Group dynamically monitor portfolio performance, closely assessing the overall portfolio’s volatility characteristics and performance against relevant peers and benchmarks. This monitoring process in turn informs portfolio rebalancing decisions. State of the art consolidated reporting delivers the information clients need to maintain a unified investment strategy within a multi-manager set.



Alternative Investments



FBR's Alternative Asset Management group is supported by a professional infrastructure that comprises a dedicated compliance, risk management and accounting function.

Through its registered investment adviser subsidiaries, FBR manages a broad spectrum of alternative asset investment vehicles, including hedge, private equity and venture capital funds. FBR has been active in the alternative asset class since 1989, and today manages more than a dozen different domestic and offshore investment vehicles and assets.

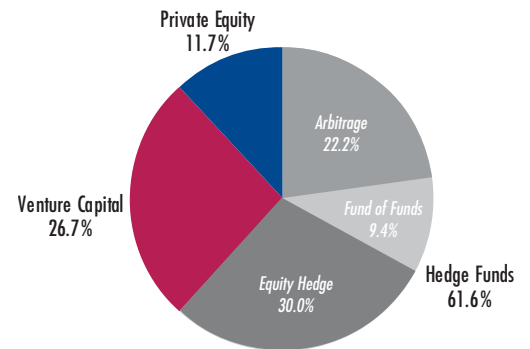


*"FBR has managed alternative asset vehicles since it was formed in 1989; longevity is the hallmark of excellent service and superior performance."
Neal J. Wilson
Managing Director,
Asset Management*

Our investors comprise both high net worth individuals and institutions, including pension funds, foundations, university endowments, corporations and funds of funds. FBR has a comprehensive approach to alternative asset risk management and employs more than 30 professionals in its alternative investment business, including portfolio managers, research professionals, traders, accountants, compliance/risk management professionals and marketing/administrative personnel.

FBR manages seven hedge funds and five private equity and venture capital funds. These vehicles are primarily focused on the industry sectors we know best — financial services, real estate, technology and health-care/biotech, as well as merger arbitrage. During 2002, we expanded our alternative asset offerings with a U.S.-equity bias fund of hedge funds.

FBR Alternative Asset Vehicles



Based on Net Assets Under Management, as of 12/31/02.

Alternative investments have not only become a permanent asset class, but one of the best performing vehicles during times of volatility. FBR has been active in this asset class since our formation, and continues to present these well-managed, goal-oriented investment opportunities to our clients.

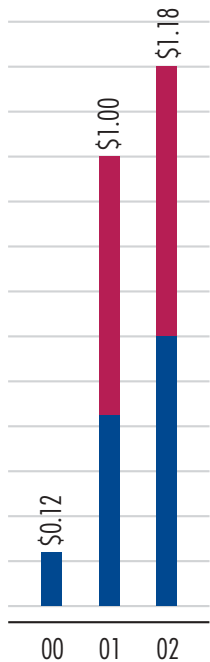
INVESTMENT RETURNS

	1998	1999	2000	2001	2002	5-Year Average
FBR Managed Vehicles¹	6.59%	111.54%	39.70%	-8.20% ¹	-5.35% ¹	28.86%
S&P 500²	28.57%	21.03%	-9.10%	-11.88%	-22.1%	1.3%

Simple average returns on investment of all FBR managed vehicles (other than mutual funds) for each of the last five years, and the 5-year average. Presented for purposes of FBR Group annual report only; returns to Limited Partner and other investors, net of fees and expenses, would be less; excludes carried interest and other incentive gains or losses. ¹Includes technology venture capital vehicles; excluding these, FBR managed vehicles returned an average of 13.16% in 2001 and 6.26% in 2002. ²The S&P 500 index is unmanaged and, unlike the FBR managed vehicles, has no management fees or operating costs that reduce reported returns. The volatility and other risk characteristics for the FBR vehicles will differ from the volatility of the index.

Capital Preservation

■ Fixed Income & Money Market
■ Equity



Mutual Fund Net Assets Under Management (billions of dollars)

For more than five years, Friedman Billings Ramsey has been active in the mutual fund business, currently managing over \$1.2 billion of mutual fund assets.

In 2001, we augmented our existing fund group with the acquisition of Money Management Associates — the manager of more than \$800 million of fixed income, money market and index mutual funds with a 27 year history — and Rushmore Bank (Now FBR National Bank & Trust), which provides us the platform to offer trust and custody services to our funds and third party clients.



“Our broad range of investment vehicles provides the diversity required to build and maintain a strong portfolio.”
Webb C. Hayes, IV
Managing Director, Private Client Group; Chairman, FBR National Bank & Trust

Investment management clients did well during 2002, in spite of severe market volatility, due to dynamic management which implemented new strategies and modified asset allocations. Capital preservation became the primary objective with most clients.

FBR National Bank & Trust’s assets held in custody at year end were \$1.4 billion, an increase of \$100 million during the year.

FBR Money Market Funds	7-Day Yield	Average Total Returns through 12/31/2002					Since Inception
		Q4 2002	1Y	3Y	5Y	10Y	
FBR Fund for Government Investors (FUSXX) ¹	0.56%	0.20%	1.03%	3.17%	3.57%	3.76%	n/a
FBR Tax-Free Money Market Portfolio (FFTX) ¹	0.62%	0.18%	0.94%	2.06%	2.28%	2.38%	3.38%

FBR Bond Funds	Overall Morningstar Rating	Average Total Returns through 12/31/2002					Since Inception
		Q4 2002	1Y	3Y	5Y	10Y	
FBR Total Return Bond Fund (RSGVX)	★★★	3.43%	7.50%	9.72%	6.19%	7.36%	8.00%
FBR Maryland Tax-Free Portfolio (RSXLX) ²	★★★	0.04%	8.01%	7.04%	5.02%	5.59%	6.72%
FBR Virginia Tax-Free Portfolio (RSXIX) ²	★★★★	(0.04)%	9.25%	7.98%	5.06%	5.72%	6.60%

TOTAL RETURN REPRESENTS PAST PERFORMANCE, WHICH IS NO GUARANTEE OF FUTURE RESULTS. Investment returns and principal will fluctuate so that investors’ shares when redeemed may be worth more or less than their original cost. Returns assume reinvestment of all distributions. The yield quotation for the FBR Fund for Government Investors and FBR Tax-Free Money Market Portfolio more closely reflects the current earnings of the money market fund than the total return quotation. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the Fund. An Investment in Funds is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other Government Agency. Some income may be subject to the federal alternative minimum tax. Income earned by non-Maryland or non-Virginia residents will be subject to the applicable state and local taxes. For each fund with at least a 3-year history, Morningstar calculates a Morningstar Rating™ metric each month by subtracting the return of a 90-day U.S. Treasury Bill from the fund’s load-adjusted return for the same period, and then adjusting the excess return for risk. The top 10% of funds in each broad asset class receive five stars, the next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars and the bottom 10% receive one star. The Overall Morningstar Rating™ for a fund is derived from a weighted average of the performance figures associated with its 3-, 5- and 10-year (if applicable) Morningstar metrics. The FBR Total Return Fund received 3 stars for the 3-year, 2 stars for the 5-year and 3 stars for the 10-year periods and was rated among 54, 45, and 24 U.S. domiciled long government bond funds respectively. The FBR Maryland Tax-Free Portfolio received 3 stars for the 3-year, 4 stars for the 5-year and 3 stars for the 10-year period and was rated among 314, 293 and 111 U.S. domiciled single state intermediate municipal bond funds respectively. The FBR Virginia Tax-Free Portfolio received 4 stars for the 3 and 5-year periods and 3 stars for the 10-year period and was rated among 314, 293 and 1111 U.S. domiciled single state intermediate municipal bond funds respectively. ©2002 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information.

For additional information including fees and expenses please call 1.888.888.0025 for a copy of a free prospectus. Please read the prospectus carefully before you invest or send money. FBR Mutual Funds are NOT FDIC insured, NOT bank guaranteed and may lose value. Money Management Advisers, Inc. a subsidiary of FBR National Bank & Trust, serves as advisor to the FBR Fixed-Income Funds. FBR Mutual Funds are distributed by FBR Investments Services, Inc., member NASD/SIPC. FBR National Bank & Trust, Member FDIC and an equal housing lender.



Sector Focus

FBR's Equity Funds target opportunities in the areas we know and understand best.



The FBR Equity Mutual Funds are a family of no-load, open-end mutual funds. The Funds are designed for the sophisticated long-term investor and provide a means to fine-tune an existing diversified portfolio by targeting and unlocking opportunities specific to certain industries.



"It is imperative to treat investors' money with respect. We do this by providing a family of no-load equity funds designed to capture the value in various industry segments, while diligently monitoring risk."

*David H. Ellison
President, FBR Family of Funds*

The severity of the multi-year bear market has taken its toll on equity fund investors. According to the Investment Company Institute (ICI), the nation's equity fund industry experienced a net outflow of \$27.1 billion, a decline of 21.97% from December 2001 through December 2002. This marks the first time since 1988 the nation's equity mutual fund industry experienced negative asset flows. The FBR Equity Funds ended 2002 with approximately \$600 million in assets under management and bucked the over-riding industry trend of negative asset flows by gaining 41.23% in new net assets.

For the five-year period ended December 2002, 100% of our equity fund assets out-performed their respective benchmarks, demonstrating the true value our equity fund managers bring to long-term investors. For the 1-year ended December 2002, the FBR Small Cap Value Fund and the FBR Small Cap Financial Services Fund were both the top-performing funds among their respective peer groups*. The FBR Technology Fund, our newest offering, is off to a solid start and has out-performed its benchmark, the NASDAQ Composite Index, since inception last February.

FBR Equity Funds	Overall MORNINGSTAR® Rating	Average Total Returns through 12/31/2002					Since Inception**
		Q4 2002	1Y	3Y	5Y	10Y	
FBR Small Cap Value Fund (FBVX) ^{1,2}	★★★★★	12.02%	2.63%	7.48%	7.46%	n/a	12.88%
FBR Small Cap Financial Fund (FBRSX) ²	★★★★★	6.33%	18.68%	24.86%	9.74%	n/a	16.64%
FBR American Gas Index Fund (GASFX) ³	★★★★★	6.50%	(23.93)%	0.35%	0.48%	7.75%	7.57%
FBR Financial Services Fund (FBRFX) ¹	★★★★	1.83%	(4.06)%	11.55%	3.70%	n/a	10.01%
FBR Technology Fund (FBRTX) ⁴	n/a	24.09%	n/a	n/a	n/a	n/a	n/a

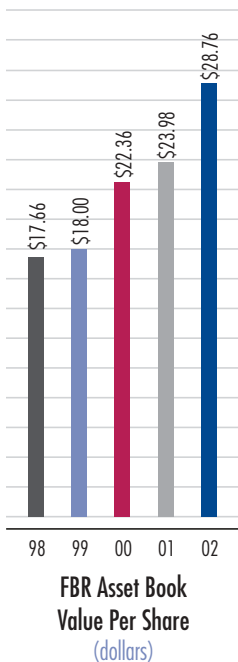
TOTAL RETURNS REPRESENT PAST PERFORMANCE, WHICH IS NO GUARANTEE OF FUTURE RESULTS. Investment return and principal will fluctuate so that investors' shares when redeemed, may be worth more or less than their original cost. Returns assume reinvestment of all distributions. For additional information including fees and expenses please call 1.888.888.0025 for a copy of a free prospectus.

* According to Morningstar, for the 1-year ended 12/31/02, the FBR Small Cap Financial Services Fund was ranked 1 among 28 no-load specialty financial funds and the FBR Small Cap Value Fund was ranked 1 among 260 no-load small growth funds.

** The FBR Mutual Funds commenced operations on 01/03/97. The FBR American Gas Index Fund commenced operations on 05/15/89. The FBR Technology Fund commenced operations on 02/01/02.

Please read the prospectus carefully before you invest or send money. FBR Mutual Funds are NOT FDIC insured, NOT bank guaranteed and may lose value. FBR Fund Advisors, Inc. and FBR Investment Services, Inc., member NASD/SIPC, each a subsidiary of Friedman, Billings, Ramsey Group Inc., serve as advisor to, and distributor of the FBR Mutual Funds respectively. For each fund with at least a 3-year history, Morningstar calculates a Morningstar Rating™ metric each month by subtracting the return of a 90-day U.S. Treasury Bill from the fund's load-adjusted return for the same period, and then adjusting the excess return for risk. The top 10% of funds in each broad asset class receive five stars, the next 22.5% receive four stars, the next 35% receive three stars, the next 22.5% receive two stars and the bottom 10% receive one star. The Overall Morningstar Rating™ for a fund is derived from a weighted average of the performance figures associated with its 3-, 5- and 10-year (if applicable) Morningstar metrics. The FBR Small Cap Financial Services Fund and the FBR Small Cap Value Fund received 5 stars for 3-year and 5-year periods and were rated among 78 and 44 U.S. domiciled specialty financial funds and 433 and 293 U.S. domiciled small growth funds respectively. The FBR American Gas Index Fund received 5 stars for the 3-year, 4 stars for the 5-year and 5 stars for the 10-year period and was rated among 79, 74 and 22 U.S. domiciled specialty utility funds respectively. The FBR Financial Services Fund received 4 and 3 stars for the 3- and 5-year periods and was rated among 78 and 44 U.S. domiciled specialty financial funds. ©2002 Morningstar, Inc. All Rights Reserved. The information contained herein: (1) is proprietary to Morningstar and/or its content providers; (2) may not be copied or distributed; and (3) is not warranted to be accurate, complete or timely. Neither Morningstar nor its content providers are responsible for any damages or losses arising from any use of this information. †Fund investments are focused in the financial services industry, which may be adversely affected by regulatory or other market conditions, such as rising interest rates. ‡Small capitalization stocks as a group may not respond to market rallies or downturns as much as other types of equity investments. †The natural gas industry is sensitive to increasing interest rates because of the capital-intensive nature of the industry. Typically, a significant portion of the financing of the gas industry's assets is financed through debt. As interest rates increase, such refinanced debt would be acquired at higher rates, thereby adversely affecting earnings. †Fund investments are focused in the technology sector, which may be adversely affected by rapidly changing technology, availability of capital, research and development and relatively high risk of obsolescence caused by scientific and technological advances.

Growing Our Capital Base



We earn a spread between the cost of borrowing and the yield on the mortgage-backed securities — a business model similar to many financial institutions.



As previously noted, on March 31 FBR and FBR Asset merged into a new company, structured as a REIT for U.S. Federal income tax purposes. FBR has been the external manager of FBR Asset since it was formed in 1997. FBR Asset had several business lines which now complement and become part of the FBR mix of businesses, including investments in agency-backed (guaranteed by Fannie Mae (FNMA), Freddie Mac (FHLMC) or Ginnie Mae (GNMA)), residential mortgage-backed securities (MBS), as well as merchant banking investments in companies that typically have a relationship with the FBR investment banking group.



“We believe that our merchant banking activities will generate very attractive risk-adjusted returns without the use of leverage.”

*Richard J. Hendrix
Chief Investment Officer*

In 2002, FBR Asset recorded record earnings. Net income was \$117.1 million or \$5.72 per fully diluted share on revenues of \$186 million. The company declared a total of \$5.30 in dividends per share in 2002. Return on equity for the full year was 22%. At that date, FBR owned approximately 11% of FBR Asset.

At December 31, 2002, FBR Asset had total assets of \$5.4 billion and equity capital of approximately \$752.2 million. Investments were divided between the MBS portfolio and merchant banking as follows:

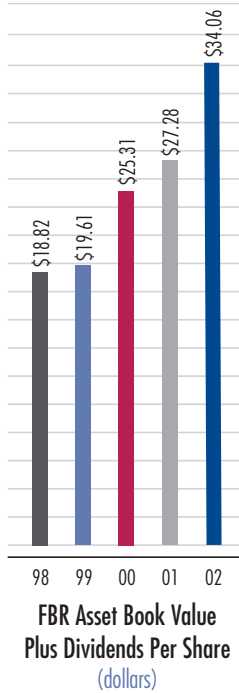
FBR Asset	Assets	Equity Capital
Mortgage Backed Securities	97%	86%
Merchant Banking Investments	3%	14%

MORTGAGE BACKED SECURITIES

At December 31, 2002, FBR Asset’s portfolio of MBS was valued at \$5.2 billion. From January 1, 2002, total MBS under management grew four-fold from approximately \$1.2 billion, due in large part to FBR Asset’s success in raising approximately \$600 million of fresh capital during the last eighteen months.

We achieve returns in the MBS portfolio by earning a spread between the yield on our assets and our cost of borrowing to finance the portfolio. The weighted average annual yield of the MBS portfolio was 4.63% for 2002 and the company’s weighted average interest rate of financing for the MBS was 1.88%, resulting in a net interest spread of 2.75% for 2002. Net interest income and gains from the MBS portfolio totaled \$118.8 million for 2002, or 80.9% of FBR Asset’s total net revenue.

Our approach to investing in the MBS market is to purchase whole-pool mortgage-backed securities with no credit risk, low effective duration and to maintain a debt-to-



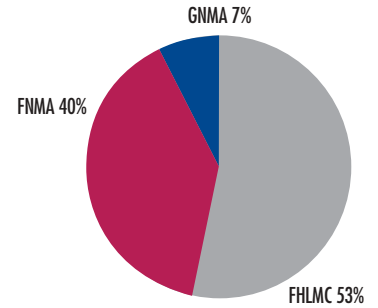
Through our merchant banking activities, we are able to effectively leverage FBR's investment professionals to increase both investment banking income and overall portfolio performance.

FBR Asset MBS Sector Report
as of December 31, 2002

Sector	Current Face	Market Value	% of Portfolio	Average Coupon	Average Yrs to Mat	Book Yield	Effective Duration	Relevant Prepayment Assumptions
ARM	\$5,048,575,748	\$5,208,616,030	100.00%	5.21%	2.35	4.23%	1.18	37 CPR

capital target of 8 to 8.5. At year-end, our leverage was 7.0 to 1 in the MBS portfolio. FBR buys only agency-backed MBS, which are not exposed to the credit risk of borrower defaults. The low effective duration of the portfolio (1.18 at year end) is designed to manage price risk, resulting from changes in interest rates. To further manage this risk, FBR Asset owned, at year-end, only adjustable rate mortgages (ARMs) — mortgages that reprice after a fixed and relatively short period of time.

FBR Asset MBS Portfolio
(As of December 31, 2002)



MERCHANT BANKING INVESTMENTS

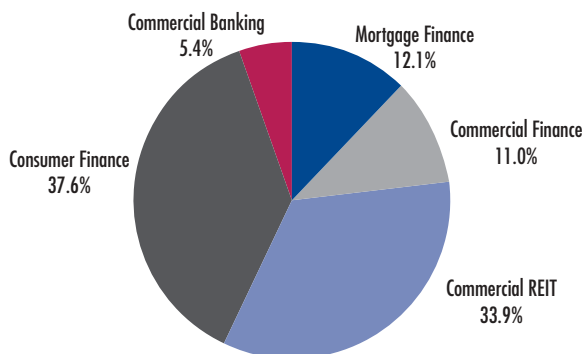
Our merchant banking activities consist of investments in equity securities as well as short and medium term mezzanine or senior loans. At December 31, 2002, FBR Asset's merchant banking investments totaled \$103.2 million, 3% of FBR Asset's entire portfolio. We do not borrow against our assets on this portion of the portfolio and have a typical holding period of 12 to 18 months. For the year, dividends and net gains from these investments totaled \$20 million or 13.6% of net revenue. In addition, FBR Asset earned advisory fees related to FBR investment banking transactions of \$6.4 million or approximately 4.4% of net revenue.

Our lending and investment strategy is to focus on companies that have well defined, predictable business models. The investments are typically priced at or near book or liquidation value and, in most cases, provide a current return in the form of interest or dividends.

The relationship with FBR, which was internalized and made seamless following the merger, provides this area of our business with advantages in identifying, analyzing and responding quickly to opportunities to fund equity investments and mezzanine or senior loans. Many companies in which we invest will have an investment banking relationship

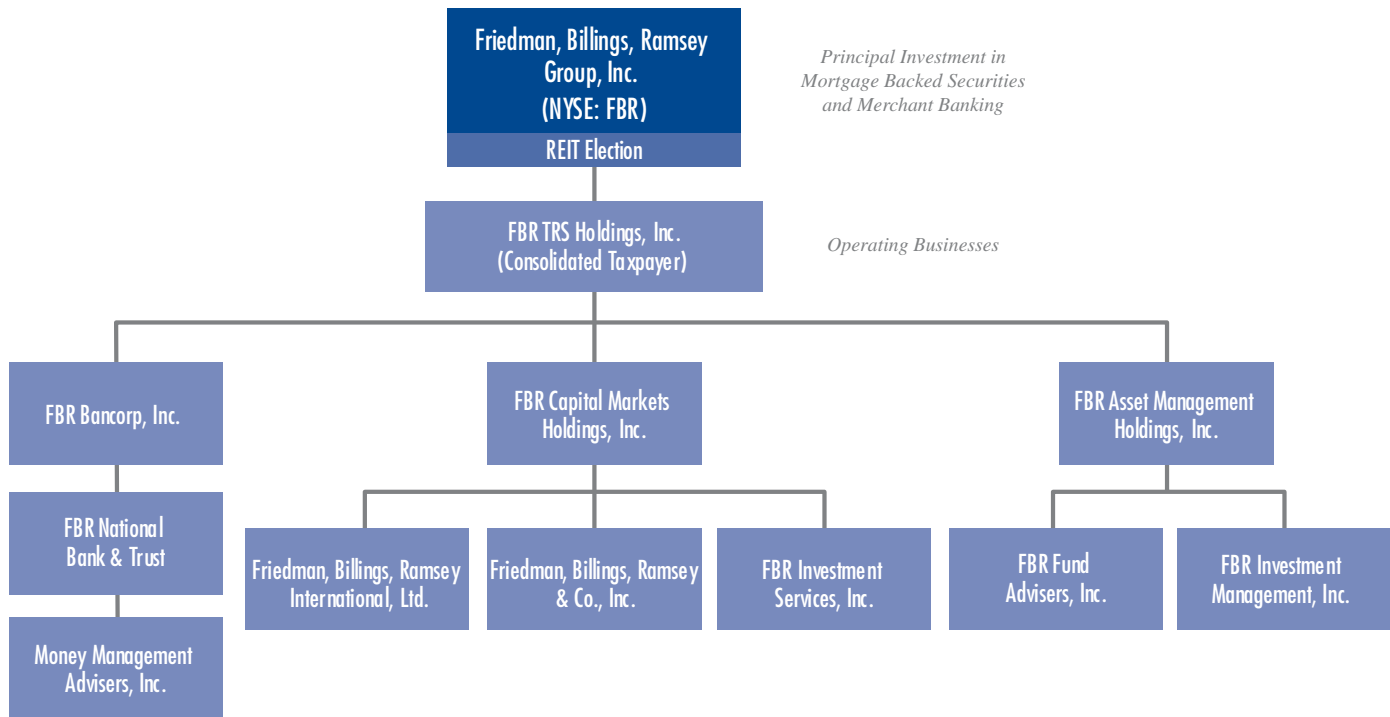
with FBR. By providing this capital, FBR often leverages these investments into longer-term, more profitable relationships.

FBR Asset Merchant Banking Investments
(As of December 31, 2002)



We believe the ability to more effectively deploy capital in our merchant banking business, as a result of the merger, will enhance both our fee-driven investment banking business and our overall investment returns.

Organizational Chart



The chart above illustrates the structure of the new FBR following the merger of FBR with FBR Asset on March 31, 2003.

Financial Information

CAUTIONS ABOUT FORWARD-LOOKING INFORMATION

This Annual Report 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,” “plans,” “estimates” or “anticipates” or the negative of those words or other comparable terminology. Statements concerning projections, future performance developments, events, revenues, expenses, earnings, run rates, and any other guidance on present or future periods constitute forward-looking statements. Such statements include, but are not limited to, those relating to the effects of growth, our principal investing 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 overall environment for interest rates, repayment speeds within the mortgage backed securities market, risk associated with equity investments, the demand for public offerings, activity in the secondary securities markets, competition among Financial services firms for business and personnel, the high degree of risk associated with venture capital investments, the effect of demand for public offerings, mutual fund and 401(k) pension plan inflows or outflows in the securities markets, volatility of the securities markets, available technologies, the effect of government regulation and of general economic conditions on our own business and on the business in the industry areas on which we focus, fluctuating quarterly operating results, the availability of capital to us and risks related to online commerce. We will not necessarily update the information presented in this Annual Report if any of these forward looking statements turn out to be inaccurate. Risks affecting our business are described throughout our 2002 Form 10-K, especially in the section entitled “Risk Factors” beginning on page 28 of the Form 10-K. The entire Form 10-K, including the Consolidated Financial Statements and the notes and any other documents incorporated by reference into the Form 10-K should be read for a complete understanding of our business and the risks associated with that business. Our Form 10-K is available on our web site www.fbr.com or, at no charge by sending a written request to Investor Relations, Friedman, Billings, Ramsey Group, Inc., 1001 Nineteenth Street North Arlington, Virginia 22209, fax 703.469.1081.

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SELECTED CONSOLIDATED FINANCIAL DATA

(Dollars in thousands, except per share amounts)

	Year Ended December 31,				
	2002	2001	2000	1999	1998
Consolidated Statements of Operations					
Revenues:					
Investment banking:					
Underwriting	\$ 76,556	\$ 47,853	\$ 21,086	\$ 22,642	\$ 70,791
Corporate finance	58,595	28,534	31,404	22,541	41,356
Investment gains	8,725	6,762	1,453	3,853	—
	<u>143,876</u>	<u>83,149</u>	<u>53,943</u>	<u>49,036</u>	<u>112,147</u>
Institutional brokerage:					
Principal transactions	27,512	26,330	32,319	22,058	(28,192)
Agency commissions	35,672	27,084	21,084	14,988	15,308
	<u>63,184</u>	<u>53,414</u>	<u>53,403</u>	<u>37,046</u>	<u>(12,884)</u>
Asset management:					
Base management fees	28,956	19,744	9,719	9,409	7,556
Incentive allocations and fees	14,258	3,628	1,673	1,577	3,841
Net investment income (loss)	16,276	9,532	10,843	(5,268)	(3,972)
	<u>59,490</u>	<u>32,904</u>	<u>22,235</u>	<u>5,718</u>	<u>7,425</u>
Technology sector net investment and incentive income (loss)	(5,622)	(18,100)	41,614	36,398	29
Interest, dividends and other	7,275	9,422	9,695	10,768	16,151
Total revenues	<u>268,203</u>	<u>160,789</u>	<u>180,890</u>	<u>138,966</u>	<u>122,868</u>
Expenses:					
Compensation and benefits	147,072	108,112	109,768	98,424	82,599
Business development and professional services	30,589	28,879	19,229	23,582	29,313
Clearing and brokerage fees	5,353	7,087	6,207	4,693	5,078
Occupancy and equipment	8,838	10,852	9,544	6,674	4,225
Communications	8,185	5,832	5,085	4,323	3,592
Interest expense	2,073	1,083	1,665	1,323	4,927
Other operating expenses	10,652	9,415	7,147	6,918	9,343
Restructuring and software impairment charges	—	5,151	—	—	—
Total expenses	<u>212,762</u>	<u>176,411</u>	<u>158,645</u>	<u>145,937</u>	<u>139,077</u>
Net income (loss) before taxes and extraordinary gain	55,441	(15,622)	22,245	(6,971)	(16,209)
Income tax provision (benefit)	3,035	(1,760)	4,163	—	—
Net income (loss) before extraordinary gain ...	52,406	(13,862)	18,082	(6,971)	(16,209)
Extraordinary gain	1,413	1,148	—	—	—
Income tax provision on extraordinary gain ...	536	—	—	—	—
Net income (loss)	<u>\$ 53,283</u>	<u>\$(12,714)</u>	<u>\$ 18,082</u>	<u>\$ (6,971)</u>	<u>\$(16,209)</u>

SELECTED CONSOLIDATED FINANCIAL DATA

(Dollars in thousands, except per share amounts)

	Year Ended December 31,				
	2002	2001	2000	1999	1998
Consolidated Balance Sheet Data					
Assets:					
Cash and cash equivalents	\$ 90,007	\$ 46,246	\$ 52,337	\$ 43,743	\$ 46,827
Marketable trading securities	8,298	15,706	18,447	6,137	13,150
Long-term investments	150,447	119,982	142,950	135,723	97,157
Other	157,433	110,024	38,485	40,753	47,982
Total assets	<u>\$406,185</u>	<u>\$291,958</u>	<u>\$252,219</u>	<u>\$226,356</u>	<u>\$205,116</u>
Liabilities:					
Accounts payable and other liabilities	\$108,882	\$ 66,411	\$ 36,733	\$ 34,358	\$ 15,322
Short-term debt	26,940	21,165	—	—	—
Long-term collateralized loan	5,266	5,694	—	—	—
Trading account securities sold short	19,932	13,377	930	3,029	2,892
Total liabilities	<u>161,020</u>	<u>106,647</u>	<u>37,663</u>	<u>37,387</u>	<u>18,214</u>
Shareholders' equity	<u>245,165</u>	<u>185,311</u>	<u>214,556</u>	<u>188,969</u>	<u>186,902</u>
Total liabilities and shareholders' equity	<u>\$406,185</u>	<u>\$291,958</u>	<u>\$252,219</u>	<u>\$226,356</u>	<u>\$205,116</u>
Statistical Data					
Basic earnings (loss) per share	\$ 1.16	\$ (0.27)	\$ 0.37	\$ (0.14)	\$ (0.33)
Diluted earnings (loss) per share	\$ 1.10	\$ (0.27)	\$ 0.36	\$ (0.14)	\$ (0.33)
Book value per share (1)	\$ 5.28(2)	\$ 4.06(2)	\$ 4.34	\$ 3.86	\$ 3.81
Total employees (1), (3)	481	433	386	390	358
Revenue per employee	\$ 587	\$ 393	\$ 466	\$ 372	\$ 394
Pre-tax return on average equity	26%	(8)%	11%	(4)%	(8)%
Compensation and benefits expense as a percentage of revenues	55%	67%	61%	71%	67%
Basic weighted average shares outstanding (in thousands)	46,098(2)	47,466(2)	49,162	48,872	49,724
Diluted weighted average shares outstanding (in thousands)	48,442	47,466	50,683	48,872	49,724

(1) As of end of the period reported.

(2) Excludes employee stock and purchase loan receivable of \$24.2 million and \$22.7 million as of December 31, 2002 and 2001, respectively, and four million shares pledged as collateral.

(3) Includes 59 and 54 employees of FBR Bank as of December 31, 2002 and 2001, respectively.

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

Overview

FBR is a holding company for subsidiaries that conduct institutional investment banking and institutional brokerage activities ("the Capital Markets Group"), investment management and advisory services ("the Asset Management Group"). The Capital Markets Group includes an online broker-dealer and securities distributor. The Asset Management Group also provides administrative, shareholder and accounting services for mutual funds, holds investments, as principal, in several of the funds that it manages and other investments acquired in connection with its business. Our company operates primarily in the United States and Europe.

Merger Agreement with FBR Asset

On November 15, 2002, FBR and FBR Asset announced that they had signed a definitive agreement to merge the two firms in a tax-free stock for stock exchange. Under terms of the transaction, each share of FBR Asset common stock outstanding at closing will be converted into 3.65 shares of Class A Common Stock, and each share of FBR will be converted into one corresponding Class A or Class B share of New FBR, which will elect REIT status for tax purposes. The principal investments of FBR will be included in New FBR while our operating businesses will be included as they currently are in a taxable REIT subsidiary of New FBR. The merger will be accounted for as a purchase of FBR Asset by us using the purchase method of accounting. If our merger with FBR Asset is completed, we have entered into an undertaking with the Federal Reserve Board ("the Board") to convert to an entity that would allow us to continue to provide trust and custody services, but that would remove New FBR from regulation by the Board as a financial holding company. See discussion below for further information regarding our current investment in FBR Asset.

FBR Asset Investment Corporation

FBR Asset is a corporation that has been managed by us since its creation in 1997 through a management agreement with one of our investment adviser subsidiaries. At December 31, 2002, our long-term investment was 9.9% of the company. At December 31, 2002, FBR Asset had gross assets of \$5.4 billion and shareholder's equity of \$752.2 million. Our Vice Chairman and Co-Chief Executive Officer, Mr. Billings, serves as the Chairman and Chief Executive Officer of FBR Asset and our Chairman and Co-Chief Executive Officer, Mr. Friedman, is also a director of FBR Asset. FBR Asset also has three outside, independent members of its Board of Directors who approved the management agreement with us, which agreement includes the base and incentive fees that are paid to us.

Our principal broker-dealer subsidiary, FBR & Co. has entered into an agreement with FBR Asset, regarding FBR Asset's extension of credit to or investment in entities that are or may be FBR & Co. investment banking clients. In 2002, pursuant to this agreement, FBR Asset received \$6.4 million in fees from FBR & Co. from five investment banking transactions. Our investment banking revenues for these transactions are recorded net of these fees.

During 2002, we earned \$10.1 million (net of expenses) in fees in our Capital Markets Group in connection with FBR & Co. underwriting three follow-on offerings for FBR Asset. In 2001, we earned \$4.4 million in connection with one follow-on offering for FBR Asset.

FBR Asset invests directly in fixed- and adjustable-rate residential mortgage-backed securities guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae, and merchant banking investments: equity securities, mezzanine or senior loans, and opportunistic investments. As of December 31, 2002, 97% and 2% of FBR Asset's total assets were invested in mortgage-backed securities and equity securities, respectively, compared with 93% and 5% respectively as of December 31, 2001. FBR Asset uses leverage to enhance the return on its mortgaged-backed securities and as of December 31, 2002, the debt-to-equity ratio of its mortgage-backed securities portfolio was 7.00 to 1.

Our management agreement with FBR Asset provides that we receive base management fees of 0.20% based on the value of mortgage related assets and 0.75% based on the value of all other invested assets. For the years ended December 31, 2002 and 2001, we received base management fees of \$8.6 million and \$1.8 million respectively. In addition, we are entitled to receive incentive fees based on performance above a benchmark. For the years ended December 31, 2002 and 2001, we received incentive fees of \$13.8 million and \$1.7 million. We did not receive incentive fees in any other year. The management agreement with FBR Asset will cease upon completion of our merger.

We account for our equity interest in FBR Asset under the equity method and for the years ended December 31, 2002 and 2001 recorded \$20.9 million and \$4.3 million of net investment income for our proportionate share (including the effect of new share issuances in 2002 and 2001) of FBR Asset's net income for those years.

Business Environment

Our principal business activities, investment banking (capital raising and merger and acquisition, restructuring, and advisory services), institutional brokerage and asset management (including investments), are linked to the capital markets. 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.

During 2002, we continued to experience an increase in underwriting, private placement, M&A and advisory activity, especially in two of our focused industry sectors: the financial institutions and real estate sectors and, to a lesser extent, the energy, healthcare and technology sectors. The economic slowdown that began in the second half of 2000, however, continued to adversely affect equity valuations and has now adversely affected the broad equity markets. In addition, the advent of decimal pricing in 2001 has continued to adversely affect secondary equity market trading margins.

Our 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. The downturn in the technology sector has adversely affected this portion of our business and caused reductions in certain unrealized gains in technology sector securities held by us either directly or through funds we manage. 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.

Fluctuations in revenues and net income also occur due to the overall level of market activity which, among other things, affects the flow of investment dollars and the size, number and timing of investment banking transactions. For example, new issue activity was down significantly in the fourth quarter of 2002 and this softness has carried over into 2003. In addition, a downturn in the level of market activity can lead to a decrease in brokerage revenues. Similar to investment banking, beginning in the second half of 2002, institutional brokerage has experienced volume declines that have continued into 2003. Therefore, net income and revenues in any particular period may not be representative of full-year results and may vary significantly from year to year and from quarter to quarter.

The financial services industry continues to be affected by the intensifying competitive environment, as demonstrated by consolidation through mergers and acquisitions, as well as significant growth in competition

in the market for brokerage and investment banking services. The relaxation of banks' barriers to entry into the securities industry and expansion by insurance companies into traditional brokerage products, coupled with the repeal of laws separating commercial and investment banking activities, has changed the number and size of companies competing for a similar customer base, many of which have greater capital resources and additional associated services with which to pursue these activities.

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. Our merger with FBR Asset reflects this strategy to diversify and strengthen our revenue base. 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.

Operating Groups

Capital Markets Group

Our capital markets activities consist of investment banking and institutional brokerage (including research).

Investment Banking

Our investment banking (underwriting and corporate finance) activities consist of a broad range of services, including public and private capital raising transactions that include a wide variety of securities and financial advisory services in merger, acquisition, restructuring and strategic partnering transactions. During 2002, we completed or advised on 98 investment banking transactions including 28 lead or sole-managed public underwritings or private placements, 15 co-managed public underwritings or private placements, 33 merger and acquisition (M&A) and advisory transactions and 22 underwriting transactions as a syndicate or selling group member representing \$5.2 billion of aggregate transaction value, with \$4.4 billion in public underwritings and private placements and \$853.4 million in merger and acquisition and advisory transactions.

During the year ended December 31, 2002, we managed or co-managed five initial public offerings (IPO) and 30 secondary (or follow-on equity, trust preferred and debt) offerings raising approximately \$3.7 billion and generating \$76.6 million in revenues. The average size of transactions managed was \$105.7 million.

Corporate finance revenues include private placement fees and M&A, restructuring and other advisory service fees. During the year ended December 31, 2002, we acted as private placement agent or 144A initial purchaser in eight non-public transactions, raising \$684.7 million and generating \$38.9 million in revenues. We also advised on 33 M&A and other advisory assignments generating \$19.7 million in revenues.

The following table shows details of our investment banking revenues for the years indicated:

Investment Banking Revenues					
	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
Revenues:					
Public Underwritings					
Initial public offerings	\$ 2,414	\$ 9,926	\$ 8,343	\$ 8,910	\$ 50,502
Secondary public offerings	73,719	37,927	10,234	12,407	15,623
High yield debt & preferred	423	—	2,509	1,325	4,666
Underwriting	<u>76,556</u>	<u>47,853</u>	<u>21,086</u>	<u>22,642</u>	<u>70,791</u>
Non Public Capital Raising and M&A					
High yield debt & preferred	—	—	—	4,428	6,427
M&A and advisory services	19,744	9,753	22,511	14,554	15,608
Private equity placements	<u>38,851</u>	<u>18,781</u>	<u>8,893</u>	<u>3,559</u>	<u>19,321</u>
Corporate finance	58,595	28,534	31,404	22,541	41,356
Investment gains	<u>8,725</u>	<u>6,762</u>	<u>1,453</u>	<u>3,853</u>	<u>—</u>
Total investment banking	<u>\$143,876</u>	<u>\$83,149</u>	<u>\$53,943</u>	<u>\$49,036</u>	<u>\$112,147</u>
Capital raising	\$115,407	\$66,634	\$29,979	\$30,629	\$ 96,539
Total M&A, restructuring, other advisory and investment gains	28,469	16,515	23,964	18,407	15,608
Total investment banking	<u>\$143,876</u>	<u>\$83,149</u>	<u>\$53,943</u>	<u>\$49,036</u>	<u>\$112,147</u>

Institutional Brokerage

In addition to our investment banking activities, we also offer institutional brokerage services to customers. Revenues related to these services are:

Institutional Brokerage Revenues					
	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
Principal sales credits	\$26,575	\$24,310	\$25,453	\$24,305	\$ 30,976
Trading gains and losses, net	<u>937</u>	<u>2,020</u>	<u>6,866</u>	<u>(2,247)</u>	<u>(59,168)</u>
Principal transactions	27,512	26,330	32,319	22,058	(28,192)
Agency commissions	<u>35,672</u>	<u>27,084</u>	<u>21,084</u>	<u>14,988</u>	<u>15,308</u>
Total	<u>\$63,184</u>	<u>\$53,414</u>	<u>\$53,403</u>	<u>\$37,046</u>	<u>\$(12,884)</u>
Principal and agency, excluding trading gains and losses	\$62,247	\$51,394	\$46,537	\$39,293	\$ 46,284
Trading gains and losses, net	<u>937</u>	<u>2,020</u>	<u>6,866</u>	<u>(2,247)</u>	<u>(59,168)</u>
Total	<u>\$63,184</u>	<u>\$53,414</u>	<u>\$53,403</u>	<u>\$37,046</u>	<u>\$(12,884)</u>

Asset Management Group

Asset management revenue increased 264% over the last year from \$14.8 million in 2001 to \$53.9 million in 2002 primarily as a result of an increase in revenues from FBR Asset, and, to a lesser extent, a reduced impact from the downturn in the technology sector. During 2002, we recorded net investment and incentive

income from FBR Asset of \$34.7 million and technology sector net investment and incentive loss of \$(5.6) million. During 2001, we recorded net investment and incentive income from FBR Asset of \$5.9 million and technology sector net investment and incentive loss of \$(18.1) million.

Fee Revenues

Our asset management activities consist of managing and investing in a broad range of pooled investment vehicles, including investment partnerships, FBR Asset, mutual funds, and separate accounts, as well as some direct principal investments. Our total net assets under management (AUM) increased 53% from \$1.5 billion at December 31, 2001 to \$2.3 billion at December 31, 2002 due primarily to the growth in FBR Asset and to a lesser extent growth in mutual fund assets:

	2002		
	Productive Capital(1)	Gross(2)	Net(3)
Managed accounts (including FBR Asset)	\$6,538.0	\$6,538.0	\$ 871.5
Hedge and offshore funds	162.4	247.0	162.4
Mutual funds	1,173.3	1,188.5	1,173.3
Private equity funds	91.2	34.7	30.9
Technology sector funds	249.0	63.8	48.2
Total	<u>\$8,213.9</u>	<u>\$8,072.0</u>	<u>\$2,286.3</u>
	2001		
	Productive Capital(1)	Gross(2)	Net(3)
Managed accounts (including FBR Asset)	\$1,371.4	\$1,371.4	\$ 250.2
Hedge and offshore funds	153.4	260.6	153.4
Mutual funds	1,001.7	1,005.8	1,001.7
Private equity funds	93.3	48.3	47.6
Technology sector funds	248.3	71.0	64.9
Total	<u>\$2,868.1</u>	<u>\$2,757.1</u>	<u>\$1,517.8</u>

- (1) Productive capital assets under management represents the amount of actual or committed capital that determines the respective investment vehicles' base management fees payable to FBR. The productive capital base for each vehicle is determined by the terms of its specific agreement (which is generally a partnership, operating or management agreement). For FBR Asset the productive capital includes both equity and debt, and for technology sector funds and certain private equity funds the productive capital represents primarily committed capital.
- (2) Gross assets under management represent the amount of actual gross assets of FBR Asset and our proprietary investment partnerships and mutual funds including leverage.
- (3) Net assets under management represent gross assets under management, net of any repo debt, margin loans, securities sold but not yet purchased, lines of credit, and any other liabilities.

We generate fees from our asset management activities in two ways:

- As investment adviser we receive management fees for the management of investment vehicles' or accounts, including hedge, private equity and venture capital funds, mutual funds, separate accounts and FBR Asset, based upon the amount of capital committed or under management. Additionally, during 2001 we began earning mutual fund administrative servicing fees from mutual funds for which

we provide custody, transfer agent, shareholder and mutual fund accounting services. These fees are earned on both mutual funds we manage and mutual funds managed by others. This revenue is recorded in base management fees in our statements of operations.

- Based on the performance of certain investment vehicles we receive incentive income based upon their operating results. Incentive income from investment partnerships represents special allocations, generally 20%, of realized and unrealized gains to our capital accounts as managing partner of the partnerships. This special allocation is sometimes referred to as carried interest and is recorded in incentive allocations and fees in our statements of operations. In addition, we receive quarterly cash incentive fees from FBR Asset, based on 25% of net income over a performance hurdle. Technology sector funds incentive allocations are reported in technology sector net investment and incentive income (loss) in our statements of operations.

Base management fees are earned on our productive capital AUM and are determined based on a percentage of actual or committed capital, excluding, in some cases, our own investment and certain other affiliated capital. The percentages used to determine our base fee vary from vehicle to vehicle (from 0.25% for FBR Asset's mortgage-backed securities to 2.5% for two of our venture capital funds). We earn base management fees from our managed vehicles monthly or quarterly, and generally receive base management fees quarterly or semi-annually. We recorded \$29.0 million in base management fees (including mutual fund administrative servicing fees) for the year ended December 31, 2002. During 2002, the base management fees on our managed assets as a percentage of ending productive capital AUM decreased from 0.7% to 0.4%, as the major increases in the productive capital AUM came from mutual funds and FBR Asset, which earn relatively lower percentage fees. The base management fees on our managed assets as a percentage of net AUM increased slightly from 1.2% to 1.3%. Our annualized effective fee during the fourth quarter of 2002 on the December 31, 2002 productive capital AUM was 0.4%, and on net AUM was 1.4%.

In addition to base management fees, we may earn incentive income on FBR Asset and our managed hedge, private equity and venture capital partnerships. FBR Asset pays us a quarterly incentive fee based on an annual rate of 25% of its excess net income for the trailing twelve months over a performance hurdle. We generally are allocated 20% of the net realized and unrealized investment gains (if any) over a hurdle on the assets contributed by third parties to the investment partnerships. For the year ended December 31, 2002, we recorded \$14.3 million of non-technology sector incentive allocations and fees, and in the technology sector \$(0.4) million related to TVP. Under the terms of TVP's partnership agreement, after allocations have been made to the limited partners in amounts totaling their commitments, we are entitled to receive special allocations in an amount equal to 20% of the realized and unrealized gains allocated to the limited partners. In succeeding periods, we are entitled to an allocation of 20% of the partnership's realized and unrealized gains and losses and the remaining 80% is allocated to the limited partners on a pro-rata basis. Changes in our TVP capital account, as of December 31, 2002, include the effect of the allocation of this 20% carried interest.

Principal Investments

As of December 31, 2002, our long-term investments totaled \$150.4 million, an increase of 25% from \$120.0 million at December 31, 2001. We target a blended rate of return on our long-term investments, including our own investments in the vehicles we manage as well as direct investments, of 10-12%. During 2002, we recorded net investment income (excluding technology sector investment losses of \$5.6 million) of \$16.3 million and \$1.0 million of interest on our long-term debt investments, representing approximately 16% return on our average non-technology sector long-term investments of \$109.8 million. Including technology sector investment losses and related investments, during 2002 total net investment income and interest on our long-term debt investments totaled \$11.7 million, representing approximately 9% return on average long-term investments of \$135.2 million.

As investor, we record realized and unrealized gains and losses on our investments. Under the equity method of accounting, we record allocations for our proportionate share of the earnings or losses of the hedge, private equity and venture funds and other partnerships that we manage and FBR Asset. Income or loss allocations are recorded in net investment income (loss) in our statements of operations. The portion of

technology sector funds income and losses is reported in technology sector net investment and incentive income (loss) in our statements of operations.

The incentive allocations and gains/(losses) in our managed investment partnerships are determined, in part, by the value of securities held by those partnerships. To the extent that our managed partnerships hold securities of public companies that are restricted as to resale due to contractual lock-ups, regulatory requirements including Rule 144 holding periods, or for other reasons, these securities are generally valued by reference to the public market price, subject to discounts to reflect the restrictions on liquidity. These discounts are sometimes referred to as haircuts. As the restriction period runs, the amount of the discount is generally reduced. We review these valuations and discounts quarterly.

In May 1998, as part of our strategy to create new asset management products and to diversify our asset management business, we organized a business trust designed to extend financing to middle-market businesses in need of subordinated debt or mezzanine financing. In connection therewith, in July 1998, we made two loans and an equity investment totaling \$24.5 million to three unrelated businesses. The equity investment was in a company in the technology sector. During 1999 and 2000, we wrote-down the technology sector equity investment to zero. During 2001, one of the loans was repaid with interest and an equity kicker resulting in a total annual return of approximately 20%. The remaining loan, valued at \$7.5 million, bears interest at an annual rate of 15.0%. We subsequently decided not to seek outside investment for this vehicle but continue to hold its investment as principal.

Results of Operations

Revenues

Our revenues consist primarily of (1) underwriting revenue, corporate finance fees and investment gains in investment banking; (2) agency commissions and principal transactions in institutional brokerage; and (3) base management fees, incentive allocations and fees, net investment income and technology sector net investment income and incentive income in asset management. We also generate interest and dividends. Revenue from underwriting and corporate finance transactions is substantially dependent on the market for public and private offerings of equity and debt securities in the sectors within which we focus our efforts. Agency commissions are dependent on the level of trading volume and penetration of our institutional client base by research, sales and trading. Principal transactions are dependent on these same factors and on Nasdaq trading volume and spreads in the securities of such companies; net trading gains and losses are dependent on the market performance of securities held, as well as our decisions as to the level of market exposure we accept in these securities. Asset management revenues are dependent on the level of the productive capital on which our base management fees are calculated, the amount and performance of capital on which we have the potential to generate incentive income, and the amount of our own long-term investments and the performance of those investments. Our asset management vehicles are subject to market risk caused by illiquidity and volatility in the markets in which they would seek to sell financial instruments. Revenue earned from these activities, including unrealized gains that are included in the incentive income portion of our asset management revenues and in net gains and losses, may fluctuate as a result. Accordingly, our revenues have fluctuated, and are likely to continue to fluctuate, based on these factors.

Underwriting revenue consists of underwriting discounts, selling concessions, management fees and reimbursed expenses associated with underwriting activities. We act in varying capacities in our underwriting activities, which, based on the underlying economics of each transaction, determine our ultimate revenues from these activities. When we are engaged as lead-manager of an underwriting, we generally bear more risk and earn higher revenues than if engaged as a co-manager, an underwriter (syndicate member) or a broker-dealer included in the selling group. As lead manager, we generally receive 50% to 60% of the total underwriting spread and as a co-manager, we generally receive 5% to 40% of the total underwriting spread.

Corporate finance revenues consist of M&A, restructuring, private placement, mutual-to-stock conversion and other corporate finance advisory fees and reimbursed expenses associated with such activities. Corporate finance fees have fluctuated, and are likely to continue to fluctuate, based on the number and size of our completed transactions.

In connection with certain capital raising transactions, the Company has received and holds warrants for the stock of the issuing companies, which are generally exercisable at the respective offering price of the transaction. Similarly, the Company may receive and hold shares of the issuing companies. For restricted warrants and shares, including private company warrants and shares, the Company carries the securities at fair value based on internal valuation models and estimates made by management. Due to the restrictions on the warrants and the underlying securities, and the subjectivity of these valuations, these warrants may have nominal values. The Company values warrants to purchase publicly traded stocks, where the restriction periods have lapsed, using an undiscounted Black-Scholes valuation model.

Principal transactions consist of a portion of dealer spreads attributed to the securities trading activities of FBR & Co. as principal in Nasdaq-listed and other securities, and are primarily derived from FBR & Co.'s activities as a market-maker. Trading gains and losses are combined and reported on a net basis as part of principal transactions. Gains and losses result primarily from market price fluctuations that occur while holding positions in FBR & Co.'s trading security inventory.

Agency commissions revenue includes revenue resulting from executing stock exchange-listed securities and other transactions as agent.

We receive asset management revenue in our capacity as the investment manager to advisory clients, including FBR Asset and our mutual funds, as general partner of several hedge, private equity and venture capital investment partnerships and as administrator to mutual funds. Management fees and incentive income on FBR Asset and investment partnerships have been earned from entities that have invested primarily in the securities of companies engaged in the financial services, real estate and technology sectors. Incentive income is likely to fluctuate with the performance of securities in these sectors.

Asset management investment income and losses are combined and reported on a net basis. Income and losses primarily represent our proportionate share of income or loss related to investments in proprietary investment partnerships and FBR Asset, in addition to recognized losses for other than temporary impairment on securities held as available-for-sale and realized gains and losses from the sale of investment securities. As of December 31, 2002, we had \$4.3 million of unrealized gains related to available-for-sale securities including our interest in FBR Asset's unrealized gains, recorded in accumulated other comprehensive income. Upon the sale of these securities or in the event a decline in value is deemed other than temporary, the resulting difference between the cost and market value will be recorded as an investment gain or loss.

Interest, dividends and other primarily includes interest earned on mortgage-backed securities and bank loans and 12b-1 fees earned by our online broker dealer.

Expenses

Compensation and benefits expense includes base salaries as well as incentive compensation paid to sales, trading, research, asset management, investment banking professionals and to executive management. Incentive compensation varies primarily based on revenue production and net income. Salaries, payroll taxes and employee benefits are relatively fixed in nature. During 2002, certain of our executive officers were eligible for bonuses under the Key Employee Incentive Plan (the Key Employee Plan). During 2002, we recorded \$14.2 million with respect to executive officer compensation. As of December 31, 2002, \$9.7 million of this compensation had been paid and \$4.5 million was accrued.

Business development and professional services expenses include travel and entertainment, expenses related to investment banking transactions, costs of conferences, advertising, legal and consulting fees, recruiting fees and asset management sub-advisory fees. Many of these expenses, such as investment banking expenses and sub-advisory fees, are to a large extent variable with revenue.

Clearing and brokerage fees include trade processing expense that we pay to our clearing brokers, execution fees that we pay to floor brokers and electronic communication networks. These expenses are almost entirely variable with revenue.

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

Communications expenses include voice, data and Internet service fees, and data processing costs. While variable in nature, these do not tend to vary with revenue.

Interest expense includes the cost of capital for equipment and acquisition notes, subordinated credit lines, and bank deposits and other financing.

Other operating expenses include amortization of acquired management contracts, professional liability and property insurance, printing and copying, business licenses and taxes, offices supplies, charitable contributions and other miscellaneous office expenses.

The following table sets forth financial data as a percentage of revenues for the years presented:

	Year Ended December 31,				
	2002	2001	2000	1999	1998
Revenues:					
Investment banking:					
Underwriting	28.5%	29.8%	11.7%	16.3%	57.6%
Corporate finance	21.8%	17.7%	17.4%	16.2%	33.7%
Investment gains	3.3%	4.2%	0.8%	2.8%	—
	<u>53.6%</u>	<u>51.7%</u>	<u>29.9%</u>	<u>35.3%</u>	<u>91.3%</u>
Institutional brokerage:					
Principal transactions	10.3%	16.4%	17.5%	15.9%	(22.9)%
Agency commissions	13.3%	16.8%	12.0%	10.8%	12.5%
	<u>23.6%</u>	<u>33.2%</u>	<u>29.5%</u>	<u>26.7%</u>	<u>(10.4)%</u>
Asset management:					
Base management fees	10.8%	12.3%	5.4%	6.8%	6.1%
Incentive allocations and fees	5.3%	2.3%	0.9%	1.1%	3.1%
Net investment income (loss)	6.1%	5.9%	6.0%	(3.8)%	(3.2)%
	<u>22.2%</u>	<u>20.5%</u>	<u>12.3%</u>	<u>4.1%</u>	<u>6.0%</u>
Technology sector net investment and incentive income (loss)	(2.1)%	(11.3)%	23.0%	26.2%	—
Interest, dividends and other	2.7%	5.9%	5.3%	7.7%	13.1%
Total revenues	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>	<u>100.0%</u>
Expenses:					
Compensation and benefits	54.8%	67.2%	60.7%	70.8%	67.2%
Business development and professional services	11.4%	18.0%	10.6%	17.0%	23.9%
Clearing and brokerage fees	2.0%	4.4%	3.4%	3.4%	4.2%
Occupancy and equipment	3.3%	6.7%	5.3%	4.8%	3.4%
Communications	3.0%	3.6%	2.8%	3.1%	2.9%
Interest expense	0.8%	0.7%	0.9%	0.9%	4.0%
Other operating expenses	4.0%	5.9%	4.0%	5.0%	7.6%
Restructuring and software impairment charges	—	3.2%	—	—	—
Total expenses	<u>79.3%</u>	<u>109.7%</u>	<u>87.7%</u>	<u>105.0%</u>	<u>113.2%</u>
Income (loss) before income taxes	<u>20.7%</u>	<u>(9.7)%</u>	<u>12.3%</u>	<u>(5.0)%</u>	<u>(13.2)%</u>

We estimate that our fixed costs, which for these purposes we consider to include all expenses except for restructuring and software impairment charges, variable compensation, investment banking deal expenses, sales and trading travel and entertainment, asset management sub-advisory fees, clearing and brokerage fees, and interest expense, as a percentage of revenues, decreased from 58% of revenue to 32% of revenue from 2001 to 2002 in part due to increased revenue and cost containment in 2002, partially offset by the full-year effect in 2002 of the acquisition of MMA/Rushmore in 2001.

Comparison of the Years Ended December 31, 2002 and 2001

Net income (loss) increased from \$(12.7) million in 2001 to \$53.3 million in 2002. This increase is primarily due to increased revenues in 2002 as compared to 2001 and cost containment. Specifically, within capital markets our investment banking revenue increased \$60.7 million and institutional brokerage revenue increased \$9.8 million in 2002. Asset management revenue (including technology sector net investment and incentive loss) increased \$39.1 million. Total expenses increased 21% from \$176.4 million in 2001 to \$212.8 in 2002. This increase is due primarily to an increase in variable compensation expense associated with increased revenue.

Our revenues increased 67% from \$160.8 million in 2001 to \$268.2 million in 2002 primarily due to an increase in investment banking revenue of \$60.7 million and an increase in asset management revenue (including technology sector net investment and incentive loss) of \$39.1 and, to a lesser extent, an increase in revenue from institutional brokerage of \$9.8 million.

Underwriting revenue increased 60% from \$47.9 million in 2001 to \$76.6 million in 2002. The increase is attributable to more lead-managed transactions resulting in higher fees per transaction. During 2002, we managed 35 public offerings, of which we lead-managed 20, raising \$3.7 billion and generating \$76.6 million in revenues, net of \$2.8 million in revenues paid to FBR Asset pursuant to the strategic agreement with FBR & Co. These revenues included \$10.9 million in underwriting fees in connection with three follow on offerings for FBR Asset that we lead managed. During 2001, we managed 25 public offerings, of which we lead-managed 16, raising \$1.9 billion and generating \$47.9 million in revenues. These revenues included \$4.4 million in underwriting fees in connection with a follow on offering for FBR Asset that we lead managed. The average size of underwritten transactions for which we were a lead or co-manager increased from \$76.0 million in 2001 to \$105.7 million in 2002.

Corporate finance revenue increased 105% from \$28.5 million in 2001 to \$58.6 million in 2002 due primarily to an increase in the number of private placement and M&A transactions completed. M&A and advisory fee revenue increased from \$9.8 million in 2001 to \$19.7 million in 2002. We completed eight M&A transactions in 2001 compared to fourteen in 2002. In 2001, we completed four private placements generating \$18.7 million in revenues, net of \$2.9 million in revenues paid to FBR Asset pursuant to the strategic agreement with FBR & Co., compared to eight completed transactions in 2002 generating \$38.9 million in revenues, net of \$3.6 million in revenues paid to FBR Asset pursuant to the strategic agreement with FBR & Co.

During 2002, we recorded an investment banking gain of \$8.7 million; of this amount, \$5.6 million related to gains on restricted shares and \$2.5 million related to warrants received in connection with capital raising activities. By December 31, 2002, \$0.5 million of the warrant gain had been realized.

Institutional brokerage revenue from principal transactions increased 4% from \$26.3 million in 2001 to \$27.5 million. We recorded trading gains of \$0.9 million in 2002 compared to \$2.2 million in 2001.

Institutional brokerage agency commissions increased 32% from \$27.1 million in 2001 to \$35.7 million in 2002 primarily due to increased customer trading attributed to, among other things, greater penetration of institutional accounts through broader research coverage and sales and trading services.

Asset management base management fees increased 47% from \$19.7 million in 2001 to \$29.0 million in 2002 primarily due to an increase of \$6.8 million in fees from FBR Asset and an increase of \$2.3 million in fees from our mutual funds.

Asset management incentive allocations and fees increased 293% from \$3.6 million in 2001 to \$14.3 million in 2002, primarily due to FBR Asset. During 2002, we earned incentive fees from FBR Asset of \$13.8 million compared to \$1.7 million in 2001.

Asset management net investment income increased 71% from \$9.5 million in 2001 to \$16.3 million in 2002. Net investment income in 2002 includes: \$20.9 million of net investment income from our investment in FBR Asset offset by \$(3.4) million of net investment loss from investments in proprietary investment partnerships, \$(0.9) million of other than temporary unrealized depreciation related to our available-for-sale securities and \$(0.3) million of other miscellaneous net investment loss. Net investment income in 2001 includes: \$4.3 million of net investment income from our investment in FBR Asset (net of \$1.1 million of investment loss, representing dilution associated with FBR Asset's secondary offering in August 2001), \$4.9 million of net investment income from investments in proprietary investment partnerships, and \$1.7 million of net investment income from our private debt investments offset by \$(1.0) million of other than temporary unrealized depreciation related to an available for sale security and \$(0.4) million of other miscellaneous net investment loss.

Asset management technology sector net investment and incentive loss decreased 69% from \$(18.1) million in 2001 to \$(5.6) million in 2002. Technology sector net investment and incentive loss in 2002 was comprised entirely of net investment and incentive loss from investments in venture capital proprietary investment partnerships. Technology sector net investment and incentive income in 2001 included \$(14.8) million of net investment and incentive income from investments in venture capital proprietary investment partnerships, of which \$(13.6) million was associated with TVP I and TVP II, \$(2.3) million of net investment loss from direct technology sector investments and \$(0.9) million of other than temporary unrealized depreciation related to technology sector available-for-sale securities.

Unrealized gains related to asset management investments that are included in accumulated other comprehensive income in our balance sheet totaled \$4.3 million as of December 31, 2002. If and when we liquidate these or determine that a decline in value of these investments is other than temporary, a portion or all of the gains or losses will be recognized as investment income (loss) in the statement of operations during the period in which the liquidation or determination is made. Our investment portfolio is exposed to 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.

Net interest, dividends, and other revenue (net of interest expense) decreased 38% from \$8.3 million in 2001 to \$5.2 million in 2002. Interest, dividend and other revenues decreased \$2.1 million primarily due to a decrease in earnings on invested cash primarily as a result of a decline in interest rates. Interest expense increased \$1.0 million as a result of our increased short-term loans as well as a full year's interest accretion associated with our long-term collateralized loan of \$5.3 million associated with our acquisition of MMA/Rushmore.

Total expenses increased 21% from \$176.4 million in 2001 to \$212.8 million in 2002 due primarily to an increase in variable compensation expense associated with increased revenue.

Compensation and benefits expense increased 36% from \$108.1 million in 2001 to \$147.1 million in 2002 due to an increase of \$28.5 million in variable compensation primarily associated with investment banking and institutional brokerage and, to a lesser extent, an increase of \$13.6 million in executive officer compensation as a result of profitability and the provisions of the 2002 executive officer plan which is calculated as up to twenty percent of pre-tax profits, offset by a decrease in fixed compensation of \$2.9 million. As a percentage of revenues, compensation and benefits expense decreased from 67% in 2001 to 55% in 2002.

Business development and professional services increased 6% from \$28.9 million in 2001 to \$30.6 million in 2002 primarily due to an increase in travel, legal and other expenses associated with the increase in investment banking activity. Business development and professional services expenses associated with

investment banking fees increased \$3.4 million from \$8.6 million in 2001 to \$12.0 million in 2002 or 11.3% of corresponding revenue in 2001 and 8.9% of corresponding revenue in 2002.

Clearing and brokerage fees decreased 24% from \$7.1 million in 2001 to \$5.4 million in 2002. As a percentage of institutional brokerage revenue, clearing and brokerage fees decreased from 13% in 2001 to 8% in 2002. This percentage decrease is attributable to new clearing and execution arrangements finalized in 2002.

Occupancy and equipment expense decreased 19% from \$10.9 million in 2001 to \$8.8 million in 2002 due to a decrease in depreciation and amortization expense of \$1.8 million in 2002 compared to 2001. The decline in depreciation and amortization expense is primarily a result of the \$2.7 million accelerated write-off of capitalized software costs of our online broker dealer operation (fbr.com) due to us determining such capitalized costs were impaired and written-off during the third quarter of 2001.

Communications expense increased 40% from \$5.8 million in 2001 to \$8.2 million in 2002 primarily due to the opening of new offices, higher levels of business and system upgrades relating to trust and custody services.

Other operating expenses increased 13% from \$9.4 million in 2001 to \$10.7 million in 2002 primarily due to the opening of new offices as well as our acquisition of MMA/Rushmore in April 2001. During 2002, the Company recorded \$1.3 million in amortization expense associated with the MMA acquired management contracts compared to \$1.0 million in 2001.

Restructuring and software impairment charges of \$5.2 million recorded in 2001 relate to the \$2.7 million accelerated write-off of capitalized fbr.com software costs due to our determining such capitalized costs were impaired during the third quarter of 2001, and the \$2.4 million of restructuring costs recorded in the fourth quarter of 2001 related to cost containment measures announced in October, 2001 associated with personnel reductions and facility consolidation. Substantially all of the \$2.4 million restructuring costs had been paid by December 31, 2002. There were no additional restructuring costs incurred in 2002.

Comparison of the Years Ended December 31, 2001 and 2000

Net income (loss) decreased from \$18.1 million in 2000 to \$(12.7) million in 2001. This decrease is primarily due to an adverse change in technology sector net investment and incentive income (loss) of \$59.7 million in 2001, offset by increases in investment banking revenue of \$29.2 million and non-technology sector asset management revenue of \$10.7 million. In addition, total expenses increased 11% from \$158.6 million in 2000 to \$176.4 in 2001 primarily due to an increase in business development and professional services due to increased business levels and recruiting and, to a lesser extent restructuring costs associated with personnel reductions and facility consolidation and software impairment charges relating to capitalized software of fbr.com and other operating expenses offset by a decrease in variable compensation expense.

Our revenues decreased 11% from \$180.9 million in 2000 to \$160.8 million in 2001 primarily due to an adverse change in technology sector net investment and incentive income (loss) of \$59.7 million offset by an increase in investment banking revenue of \$29.2 million and an increase in base management fees of \$10.0 million.

Underwriting revenue increased 127% from \$21.1 million in 2000 to \$47.9 million in 2001. The increase is attributable to more lead-managed transactions resulting in higher fees per transaction. During 2001, we managed 25 public offerings, of which we lead-managed sixteen, raising \$1.9 billion and generating \$47.9 million in revenues. These revenues included \$4.4 million in underwriting fees in connection with a follow on offering for FBR Asset that we lead managed. During 2000, we managed 22 public offerings, of which we lead-managed four, raising \$4.0 billion and generating \$21.1 million in revenues. The average size of underwritten transactions for which we were a lead or co-manager decreased from \$181.9 million in 2000 to \$76.0 million in 2001, but the average fee per transaction increased.

Corporate finance revenue decreased 9% from \$31.4 million in 2000 to \$28.5 million in 2001 due primarily to a decrease in the number of technology private placement and M&A transactions completed offset by higher fees per private placement transaction. M&A and advisory fee revenue decreased from \$22.5

million in 2000 to \$9.8 million in 2001. We completed 15 M&A transactions in 2001 compared to eight in 2000. In 2000, we completed five private placements generating \$8.9 million in revenues compared to four completed transactions in 2001 generating \$18.7 million in revenues, net of \$2.9 million in revenues paid to FBR Asset pursuant to the strategic agreement with FBR & Co.

During 2001, we recorded an investment banking gain of \$6.8 million; of this amount, \$5.7 million related to warrants received in connection with capital raising activities. By December 31, 2001, \$5.5 million of the warrant gain had been realized.

Institutional brokerage revenue from principal transactions decreased 19% from \$32.3 million in 2000 to \$26.3 million. We recorded trading gains of \$2.2 million in 2001 compared to \$6.9 million in 2000.

Institutional brokerage agency commissions increased 28% from \$21.1 million in 2000 to \$27.1 million in 2001 primarily due to increased customer trading attributed to, among other things, greater penetration of institutional accounts through broader research coverage and sales and trading services.

Asset management base management fees increased 103% from \$9.7 million in 2000 to \$19.7 million in 2001 primarily due to additional fees earned as a result of our acquisition of MMA/Rushmore and, to a lesser extent, FBR Asset and other managed vehicles.

Asset management incentive allocations and fees increased 117% from \$1.7 million in 2000 to \$3.6 million in 2001, primarily due to FBR Asset.

Asset management net investment income decreased 12% from \$10.8 million in 2000 to \$9.5 million in 2001. Net investment income in 2001 includes: \$4.3 million of net investment income from our investment in FBR Asset (net of \$1.1 million of investment loss, representing dilution associated with FBR Asset's secondary offering in August 2001), \$4.9 million of net investment income from investments in proprietary investment partnerships; \$1.7 million of net investment income from our private debt investments, offset by \$(1.0) million of other than temporary unrealized depreciation related to an available-for-sale security and \$(0.4) million of other miscellaneous net investment loss. Net investment income in 2000 includes: \$7.1 million of net investment income from our investment in FBR Asset, \$8.7 million of net investment income from investments in proprietary investment partnerships, offset by \$(2.0) million in write-downs of our private equity and private debt investments and \$(2.8) million of other than temporary unrealized depreciation related to our available-for-sale securities.

Asset management technology sector net investment and incentive income decreased from \$41.6 million in 2000 to \$(18.1) million in 2001. Technology sector net investment and incentive loss in 2001 included \$(14.8) million of net investment and incentive from investments in venture capital proprietary investment partnerships, of which \$(13.6) million was associated with TVP I and TVP II, \$(2.3) million of net investment loss from direct technology sector investments and \$(0.9) million of other than temporary unrealized depreciation related to technology sector available-for-sale securities. Technology sector net investment and incentive income in 2000 included \$46.7 million of net investment and incentive income from investments in venture capital proprietary investment partnerships, which was almost entirely attributable to TVP I and \$1.5 million of net investment income from direct technology sector investments offset by \$(5.9) million in write-downs of our technology sector private equity.

Unrealized gains related to our investments that are included in accumulated other comprehensive income in our balance sheet totaled \$3.2 million as of December 31, 2001. If and when we liquidate these or determine that a decline in value of these investments is other than temporary, a portion or all of the gains or losses will be recognized as investment income (loss) in the statement of operations during the period in which the liquidation or determination is made. Our investment portfolio is exposed to 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.

Net interest, dividends, and other revenue (net of interest expense) increased 4% from \$8.0 million in 2000 to \$8.3 million in 2001. Interest dividend and other revenues decreased \$0.3 million and interest expense decreased \$0.6 million resulting in the net increase. The change is primarily due to lower cash balances and lower interest rates, offset by increased other income.

Total expenses increased 11% from \$158.6 million in 2000 to \$176.4 million in 2001 due primarily to an increase in business development and professional services due to increased business levels and recruiting and, to a lesser extent, restructuring costs associated with personnel reductions and facility consolidation and software impairment charges relating to capitalized software of fbr.com and other operating expenses offset by a decrease in variable compensation expense.

Compensation and benefits expense decreased 2% from \$109.8 million in 2000 to \$108.1 million in 2001 due to a decrease of \$10.6 million in variable compensation primarily related to TVP and, to a lesser extent, a decrease of \$5.5 million of executive officer bonus compensation. These decreases were offset by an increase in fixed compensation from \$27.7 million in 2000 to \$41.2 million in 2001 associated with the hiring of investment banking, sales and trading, and research professionals and as a result of adding more than 50 employees with the acquisition of MMA/Rushmore.

Business development and professional services increased 51% from \$19.2 million in 2000 to \$28.9 million in 2001 primarily due to an increase in consulting expenses associated with recruiting investment banking, sales and trading, and research professionals and travel associated with the increase in underwriting activity and, to a lesser extent, sub-advisory expenses for some asset management vehicles.

Clearing and brokerage fees increased 15% from \$6.2 million in 2000 to \$7.1 million in 2001 primarily due to an increase in market-making activity and agency transactions. As a percentage of institutional brokerage revenue, clearing and brokerage fees increased from 12% in 2000 to 13% in 2001, due primarily to \$6.6 million of trading gains in 2000 and pressure on spread margins from the over-the-counter business.

Occupancy and equipment expense increased 15% from \$9.5 million in 2000 to \$10.9 million in 2001 due to new offices and more equipment offset by the closing of non-profitable offices at the end of the year 2001. Depreciation and amortization expense remained stable, decreasing \$0.1 million in 2001 compared to 2000.

Communications expense increased 14% from \$5.1 million in 2000 to \$5.8 million in 2001 primarily due to expenses in connection with the MMA/Rushmore business, acquired in April 2001.

Other operating expenses increased 31% from \$7.2 million in 2000 to \$9.4 million in 2001 primarily due to expenses in connection with the MMA/Rushmore business, acquired in April 2001, including \$1.0 million of amortization related to the capitalized costs of the acquired asset management contracts. These contracts, at the date of closing, related to the management of \$933.4 million of net assets under management.

Restructuring and software impairment charges of \$5.2 million recorded in 2001 relate to the \$2.7 million accelerated write-off of capitalized fbr.com software costs due to our determining such capitalized costs were impaired during the third quarter, and the \$2.4 million of restructuring costs recorded in the fourth quarter related to cost containment measures announced in October, 2001 associated with personnel reductions and facility consolidation.

Liquidity and Capital Resources

Historically, we have satisfied our liquidity and regulatory capital needs through three primary sources: (1) internally generated funds; (2) equity capital contributions; and (3) credit provided by banks, clearing brokers, and affiliates of our principal clearing broker. We have used, and may continue to use, temporary subordinated loans in connection with regulatory capital requirements to support our underwriting activities. At December 31, 2002, we had \$26.9 million of short-term loans payable, of which \$16.4 million represented repurchase agreements financing a portion of our mortgage-backed securities portfolio, \$4.6 million was on margin in connection with our exercise of warrants to purchase FBR Asset common stock, \$5.0 million was a drawdown on a \$20 million line-of-credit and \$1.0 million representing the current portion of our long-term acquisition debt. We have no long-term debt other than acquisition debt of \$5.3 million.

Our principal assets consist of cash and cash equivalents, receivables, securities held for trading purposes and long-term investments. As of December 31, 2002, liquid assets consisted primarily of cash and cash equivalents of \$90.0 million and a receivable for cash on deposit with FBR & Co.'s clearing broker of \$23.2 million (net of \$19.9 million of short position), for a total of \$113.2 million. Cash equivalents consist primarily of money market funds invested in debt obligations of the U.S. government. We also held \$8.3 million in trading securities. As of December 31, 2002, the Company had allocated \$35 million of its cash and cash equivalents for the planned re-deployment of excess capital into a leveraged mortgage backed security (MBS) investment strategy. The company closed on the first tranche of MBS purchases during January, 2003 with the purchase of \$360 million of MBS.

Long-term investments consist primarily of our investment in FBR Asset, investments in managed partnerships, including hedge, private equity and venture capital funds in which we serve as managing partner, our investment in Capital Crossover Partners (a partnership we do not manage), available-for-sale securities and our investment in a long-term debt instrument of a privately held company. Although our investments in hedge, private equity and venture capital funds are for the most part 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.

As of December 31, 2002, we were a FHC under the Gramm-Leach-Bliley Act of 1999, or GLB Act, and are therefore subject to supervision, regulation and examination by federal banking regulatory agencies. If our merger with FBR Asset is completed, we have entered into an undertaking with the Federal Reserve Board ("the Board") to convert to an entity that would allow us to continue to provide trust and custody services, but that would remove New FBR from regulation by the Board as a financial holding company. In order for a bank holding company to qualify as an FHC, all of its subsidiary depository institutions must be well-capitalized and well-managed and must also maintain at least a satisfactory rating under the Community Reinvestment Act. Under the GLB Act, the Board serves as the umbrella supervisor for FHCs and has the power to supervise, regulate and examine FHCs and their non-banking affiliates, subject to statutory functional regulation provisions.

FBR & Co. and FBRIS, 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. Additionally, FBRIL our U.K. broker dealer is registered with the Securities and Futures Authority (SFA) of the United Kingdom. As such, they are subject to the minimum net capital requirements promulgated by the SEC and SFA. As of December 31, 2002, FBR & Co. was required to maintain minimum regulatory net capital of \$2.7 million and had total regulatory net capital of \$44.6 million, which was \$41.9 million in excess of its requirement. As of December 31, 2002, all of our broker/dealers were required to maintain minimum regulatory net capital of \$3.5 million and had total regulatory net capital of \$46.9 million, which was \$43.4 million in excess of their requirement. Regulatory net capital requirements increase when the broker/dealers are involved in underwriting activities based upon a percentage of the amount being underwritten.

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 December 31, 2001, FBR Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2001 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.

During 2001, we repurchased five million shares of Class B common stock from our former president and Co-CEO for \$5.50 per share. The shares were converted to Class A common stock and sold to other Company employees at the same price. Upon settlement of the repurchase and sales transactions we received 20% (\$1.10 per share) of the purchase price in cash from the employees, and received five-year, limited recourse promissory notes from the employees with interest accruing at 6.5% accreting to principal for the remaining purchase price. Each employee's note is collateralized by all of the stock purchased by that employee under the plan.

For accounting purposes, the portion of the employee share purchase financed by us (80%) is considered a stock option, and deducted from shareholders' equity. These shares are deducted from shares outstanding, similar to treasury stock, in computing book value and earnings per share. As a result, both the \$24.2 million financed (including accrued interest) by us and the 4,000,000 common shares related to the financing are reflected as a receivable in shareholders' equity. As the employees repay the loans, shareholders' equity and shares outstanding will increase. In addition, the interest earned on the employee loans is added to paid-in-capital and excluded from net income.

As of December 31, 2002, we had \$6.4 million of unfunded commitments to various investment partnerships that may be called over the next ten years. This commitment was \$18.0 million at December 31, 2001. As of December 31, 2002, FBR Group had made commitments to purchase approximately \$360.0 million of mortgage-backed securities.

We believe that our current level of equity capital, including funds generated from operations, are adequate to meet our liquidity and regulatory capital requirements and other activities. We may, however, seek debt or equity financing, in public or private transactions, or otherwise re-deploy assets, to provide capital for corporate purposes and/or to fund strategic business opportunities, including possible acquisitions, joint ventures, alliances or other business arrangements which could require substantial capital outlays. Our policy is to evaluate strategic business opportunities, including acquisitions and divestitures, as they arise.

The proposed merger with FBR Asset will increase the combined company's assets and equity to approximately \$6.5 billion and \$1.0 billion, respectively. These additional capital resources are expected to increase the financial flexibility and enhance the competitive position of the combined company within the financial services industry.

We constantly review our capital needs and sources, the cost of capital and return on equity, and we seek strategies to provide favorable returns on capital. In evaluating our anticipated capital needs and current cash resources during 1998, our Board of Directors authorized a share repurchase program of up to 2,500,000 shares of our company's Class A Common Stock. Since announcing the share repurchase program, we repurchased 1,468,027 shares as of December 31, 2002, leaving 1,031,973 additional shares authorized for repurchase. During the first quarter of 2003, pursuant to our Stock Repurchase Plan, the Company purchased 976,600 shares of its Class A Common Stock at a cost of \$8.2 million. Of the total shares repurchased to-date, 900,139 have been reissued to employees pursuant to our Employee Stock Purchase Plan.

The Company has contractual obligations to make future payments in connection with short and long-term debt and non-cancelable lease agreements 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>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>Thereafter</u>	<u>Total</u>
Short-term debt(1)	\$26,940	\$ —	\$ —	\$ —	\$ —	\$ —	\$26,940
Long-term debt.....	—	970	970	970	970	3,880	7,760
Minimum rental commitments(2)	3,319	3,177	2,929	2,854	2,739	2,377	17,395
Capital commitments(3)	—	—	—	—	—	—	—
Total Contractual Obligations.....	<u>\$30,259</u>	<u>\$4,147</u>	<u>\$3,899</u>	<u>\$3,824</u>	<u>\$3,709</u>	<u>\$6,257</u>	<u>\$52,095</u>

- (1) The short-term debt obligation in 2002 includes: \$16.4 million of repurchase agreements, \$4.6 million in the form of a demand note that may be called at anytime, \$5.0 million in the form of a drawdown on a line-of-credit and the short-term portion of long-term debt of \$1.0 million.
- (2) Equipment and office rent expense for 2002, 2001 and 2000 were \$5.1 million, \$5.0 million and \$3.9 million, respectively.
- (3) The table above excludes \$6.4 million 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.

High Yield and Non-Investment Grade Debt and Preferred Securities

We underwrite, trade, invest in, and make markets in high-yield corporate debt securities and preferred stock of below investment grade-rated companies. For purposes of this discussion, non-investment grade securities are defined as preferred securities or debt rated BB+ or lower, or equivalent ratings, by recognized credit rating agencies, as well as non-rated securities or debt. Investments in non-investment grade securities generally involve greater risks than investment grade securities due to the issuer's creditworthiness and the comparative illiquidity of the market for such securities. Our holdings of such securities is included in trading securities and long-term investments and (excluding those in which we may have an indirect interest through FBR Asset, proprietary investment partnerships or otherwise) at December 31, 2002 and 2001 had an aggregate fair value of approximately \$8.1 million and \$9.2 million, respectively. Our trading and investment portfolios may, from time to time, contain concentrated holdings of selected issues. Our largest, un-hedged, non-investment grade securities position was \$7.5 million at December 31, 2002 and 2001.

Critical Accounting Policies

Our significant accounting policies are described in Note 2 to the Consolidated Financial Statements. We believe our most critical accounting policies that are both very important to the portrayal of financial condition and results of operations and require management's most difficult, subjective or complex judgments or estimates include: 1) valuation of private and restricted public company investments, 2) recognition of incentive allocation revenue, 3) valuation allowance determination related to deferred taxes and 4) the impairment assessments we apply to our long-term investments in marketable equity securities.

As of December 31, 2002 our pro rata share of non-public securities of partnerships that we manage (including unrealized gains and incentive allocations) and non-public direct investments was \$30.4 million. During 2002 we recognized \$(0.3) million of incentive allocations from these partnerships. At December 31, 2002, there is no investment valuation allowance recorded on our balance sheet relative to these investments and with respect to our available-for-sale investment securities of \$42.0 million, as of December 31, 2002, other than temporary impairment charges recorded for the year ended December 31, 2002 were \$(0.9) million.

The investment partnerships that we manage record their investments in securities at fair value. Certain investments consist of equity investments in securities of development-stage and early-stage privately and publicly held companies. The disposition of these investments may be restricted due to the lack of a ready market (in the case of privately held companies) or due to contractual or regulatory restrictions on disposition

(in the case of publicly held companies). In addition, these securities may represent significant proportions of the issuer's equity and carry special contractual privileges not available to other security holders. As a result of these factors, precise valuation for the restricted public securities and private company securities is a matter of judgment, and the determination of fair value must be considered only an approximation and may vary significantly from the amounts that could be realized if the investment were sold.

We receive incentive allocations based on the operating results of our managed partnerships. Incentive allocations represent a share of the gains in the partnerships, and are based on our partnership capital account, assuming the partnership were terminated on the balance sheet date. Incentive allocations may be based on unrealized and realized gains and losses, and could vary significantly in the future based upon the ultimate realization of the gains or losses. We may, therefore, reverse previously recognized incentive allocations in future periods.

Deferred tax assets and liabilities represent the differences between the financial statement and income tax bases of assets and liabilities, using enacted tax rates. The measurement of net deferred tax assets is adjusted by a valuation allowance if, based on our evaluation, it is more likely than not that they will not be realized. We previously have provided a valuation allowance against our deferred tax assets based on our ongoing assessment of their future realization. This allowance was reversed during 2002 in connection with the Company's utilization of its tax net operating loss carryforward

We evaluate our long-term investments in marketable equity securities for other than temporary impairment. If it is determined that an investment is impaired then the amount that the fair value is below its current basis is recorded as an impairment charge and recorded through earnings as opposed to through other comprehensive income, as other temporary changes in fair value would be. The value of our long-term investments in marketable equity securities can fluctuate significantly. Generally, when a long-term marketable equity security's value has been below its current basis for an extended period of time we will record an impairment charge.

Recently Issued Accounting Pronouncements

In April 2002, the Financial Accounting Standards Board ("FASB") issued SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections" ("SFAS 145"), effective for the Company on January 1, 2003. SFAS 145 requires classification of gains and losses recognized from the extinguishment of debt to be included in continuing operations unless it meets the criteria of an extraordinary item. SFAS 145 also requires that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as a sale-leaseback transaction. Adoption of SFAS 145 had no effect on the Company's results of operations, financial position, or liquidity but may affect the accounting for future transactions.

The FASB has issued SFAS No. 146, "Accounting for Exit or Disposal Activities." SFAS 146 addresses significant issues regarding the recognition, measurement, and reporting of costs that are associated with exit and disposal activities, including restructuring activities that are currently accounted for pursuant to the guidance that the Emerging Issues Task Force ("EITF") of the FASB has set forth in EITF Issue No 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The scope of SFAS 146 also included (1) costs related to terminating a contract that is not a capital lease and (2) termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred compensation contract. SFAS 146 will be effective for exit or disposal activities initiated after December 31, 2002. The Company does not expect that the adoption of SFAS 146 will have a material effect on the Company's results of operations and financial position.

The FASB has issued SFAS No. 147, "Acquisitions of Certain Financial Institutions," which is effective for certain transactions arising on or after October 1, 2002. SFAS 147 will have no impact on the Company.

The FASB has issued SFAS No. 148 "Accounting for Stock-Based Compensation - Transition and Disclosure." SFAS 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide

alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has adopted the disclosure requirements of SFAS 148. The Company currently accounts for stock-based employee compensation in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. Accordingly, the alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation mandated by SFAS 148 are not applicable to the Company at this time.

FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others — an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34," ("FIN 45") was issued in November 2002. FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements in FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company does not believe that the adoption of FIN 45 will have a significant effect on the Company's results of operations and financial position.

FASB Interpretation No. 46, "Consolidation of Variable Interest Entities — an interpretation of ARB 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. This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. FIN No. 46 is effective immediately for variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. The Interpretation applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The Company does not anticipate that the adoption of FIN 46 will have a material effect on its financial position or results of operations.

Market and Business Risk

We monitor market and business risk, including credit risk, operations, liquidity, compliance, legal, reputational and equity ownership risk through a number of control procedures designed to identify and evaluate the various risks to which our businesses and investments are exposed. We have established various committees to assess and to manage risk associated with our investment banking, merchant banking and other activities. We review, among other things, business and transactional risks associated with investment banking potential clients and engagements. We seek to manage the risks associated with our investment banking and merchant banking activities by review and approval of transactions by the relevant committee, prior to accepting an engagement or pursuing a material investment transaction.

Through our investment in FBR Asset we are exposed to interest rate risk in connection with FBR Asset's ownership of mortgage-backed securities and other debt instruments. That risk is magnified due to FBR Asset's strategy of borrowing funds to increase the size of its investment in mortgage-backed securities. In addition, the use of such borrowings exposes FBR Asset to the risk of margin calls.

We believe that our primary risk exposure is to equity and debt price changes and the resulting impact on our marketable trading and long-term investments and unrealized incentive income as well as the risk to FBR Asset's spread income posed by interest changes. Direct market risk exposure to changes in foreign exchange rates is not material. Equity and debt price risk is managed primarily through the monitoring and reporting of

capital exposure to various issuers. FBR Asset seeks to mitigate interest risk by managing the duration of their assets and liabilities.

Marketable and Trading Securities

We generally attempt to limit exposure to market risk on securities held as a result of our daily trading activities by limiting our intra-day and overnight inventory of trading securities to that needed to provide the appropriate level of liquidity in the securities for which we are a market maker. At December 31, 2002, the fair value of our trading securities was \$8.3 million in long positions and \$19.9 million in short positions, for a net short position of \$11.6 million. The net potential loss in fair value at December 31, 2002, using a 10% hypothetical increase in reported value of short positions (offset by a 10% hypothetical decline in reported value of long positions) was \$1.2 million.

Long-Term Investments

Our long-term investments consist of investments in FBR Asset, hedge, venture capital and private equity investment partnerships that we manage, direct investments in partnerships managed by others, direct debt and equity investments in privately held companies and direct investments in equity securities of public companies.

As of December 31, 2002, a majority, by value, of the underlying assets of the investment partnerships and FBR Asset were equity securities of domestic, publicly traded companies or, in the case of FBR Asset, agency-backed mortgage-backed securities. These underlying investments are marked to market, subject to liquidity discounts in the case of securities that are subject to contractual lock-up requirements or regulatory restrictions (including Rule 144) or otherwise not readily marketable, and we record our proportionate share of unrealized gains and losses. To the extent the underlying investments in the investment partnerships, FBR Asset and direct investments are not marketable securities, they are valued at estimated fair values. In 2002, we recorded net realized and unrealized gains from our investments (other than technology sector funds) of \$16.3 million, incentive income (other than from technology sector funds) of \$14.3 million and a net investment and incentive loss in our technology sector funds of \$(5.6) million. We also maintained at December 31, 2002, as a separate component of shareholders' equity, \$4.3 million of accumulated other comprehensive income, representing \$0.4 million of unrealized gains on our direct investments and \$3.9 million of unrealized gains related to our proportionate share of FBR Asset's unrealized gains.

We are an investor in Capital Crossover Partners (CCP), an investment fund launched in 2001 by our former President and Co-Chief Executive Officer, W. Russell Ramsey. On December 31, 2001, Mr. Ramsey resigned as our President and Co-Chief Executive Officer; he remains a director of our company. As of December 31, 2002, we have a fully-funded capital commitment to the fund of \$15 million. We made our investment in CCP based on our assessment of the potential return on the investment and because we believed it presented us with the potential for certain strategic relationships that could be beneficial to our business. We are entitled to receive three points of carried interest in CCP, which was determined based on negotiations with Mr. Ramsey. We do not control CCP or have influence over the management or investment strategy of CCP. We did not record any income in connection with our carried interest in CCP during 2002. We classify our investment in CCP in our technology sector investments based on CCP's representations to us in its offering memorandum and based on the value of the majority of the investments disclosed in its report to us of its investments as of December 31, 2002. We account for the investment under the equity method based on the size of our investment in CCP relative to the total size of the fund, approximately 13% at December 31, 2002.

The following chart shows the allocation of our long-term investments as stated on the December 31, 2002 and 2001 balance sheets, by sector and by managed fund and also shows, as of December 31, 2002, the allocation of long-term investments in publicly traded and private securities. Managed funds are categorized to an industry sector by the value of the majority of their investments. In addition, from time to time, we

implement risk management strategies, the value of which may not be included in the balance sheet line for long-term investments.

	December 31, 2002				December 31, 2001	
	Public	Private	Total	%	Total	%
Financial						
FBR Ashton, Limited Partnership	\$ 6,692	\$ —	\$ 6,692	4.4%	\$ 19,000	15.8%
FBR Private Equity Fund, L.P.	450	995	1,445	1.0%	1,878	1.6%
FBR Future Financial Fund, L.P.	—	1,040	1,040	0.7%	867	0.7%
FBR Financial Services Partners, L.P.	55	579	634	0.4%	1,519	1.3%
Direct investment	2,141	750	2,891	1.9%	1,637	1.3%
	9,338	3,364	12,702	8.4%	24,901	20.7%
Real Estate & Mortgages						
FBR Asset Investment Corporation	70,194	4,582	74,776	49.7%	42,459	35.4%
Direct investment	3,179	4,880	8,059	5.4%	3,440	2.9%
	73,373	9,462	82,835	55.1%	45,899	38.3%
Subtotal	82,711	12,826	95,537	63.5%	70,800	59.0%
Technology						
FBR Technology Venture Partners, L.P.						
(1)	—	654	654	0.4%	1,068	0.9%
FBR Technology Venture Partners II	—	2,128	2,128	1.4%	2,771	2.3%
FBR CoMotion Venture Capital I, L.P. (2)	—	1,886	1,886	1.3%	3,148	2.6%
FBR Family of Funds	752	—	752	0.5%	—	—
DDL and related direct investments	1,176	5,497	6,673	4.4%	5,645	4.7%
Direct investment	372	—	372	0.2%	73	0.1%
Third-party partnerships other than CCP	—	2,901	2,901	1.9%	2,953	2.4%
Other	91	797	888	0.6%	86	0.1%
	2,391	13,863	16,254	10.7%	15,744	13.1%
Capital Crossover Partners	12,736	—	12,736	8.5%	6,000	5.0%
Subtotal	15,127	13,863	28,990	19.2%	21,744	18.1%
Debt						
Direct investment (3)	—	7,500	7,500	5.0%	7,500	6.3%
Other						
FBR Pegasus Fund, LLC	2,685	—	2,685	1.8%	—	—
FBR Arbitrage, L.L.C.	11,259	—	11,259	7.5%	11,415	9.5%
FBR Weston, Limited Partnership	2,890	—	2,890	1.9%	2,327	1.9%
Third-party partnerships	750	—	750	0.5%	5,613	4.7%
Other	64	772	836	0.6%	583	0.5%
	17,648	772	18,420	12.3%	19,938	16.6%
TOTALS	\$115,486	\$34,961	\$150,447	100.0%	\$119,982	100.0%

(1) Amount includes accrued Fund Manager Compensation expense (FMC) of \$88 and \$157 as of December 31, 2002 and 2001, respectively. Asset value net of FMC as of December 31, 2002 and 2001 was \$566 and \$911, respectively.

(2) Amount includes loans of \$456 and \$1,369 as of December 31, 2002 and 2001, respectively, made by us to FBR CoMotion Venture Capital I, LP.

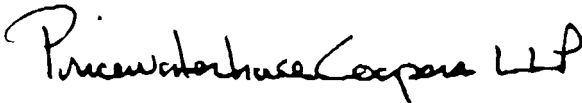
(3) Represents private debt of one issuer with a face amount of \$7,500.

As of December 31, 2002, the recorded value of our long-term investment securities was \$150.4 million. The net potential loss in fair value, using a 10% hypothetical decline in reported value, was \$15.0 million. In addition, the hedge funds and other partnerships that we manage through subsidiaries as general partner or managing member had \$103.8 million of liabilities as of December 31, 2002, primarily margin debt, not reflected on our balance sheet. We believe that our maximum potential exposure to a catastrophic loss (defined for these purposes as a 40% decline in the asset value of each partnership) would not exceed the value of our investment in these entities. In addition, FBR Asset had repo debt of \$4.6 billion as of December 31, 2002. FBR Asset is a separate corporation that we manage under an agreement between FBR Asset and our subsidiary FBRIM. We are not a general partner or managing member of FBR Asset. We neither directly, nor indirectly, guarantee any of these liabilities or other obligations of FBR Asset. After the merger, FBR Assets liabilities and obligations will be assumed by New FBR.

REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Shareholders of Friedman, Billings, Ramsey Group, Inc.:

In our opinion, the accompanying consolidated balance sheet as of December 31, 2002 and the related consolidated statements of operations, of changes in shareholders' equity and of cash flows present fairly, in all material respects, the financial position of Friedman, Billings, Ramsey Group, Inc. and its subsidiaries (the "Company") at December 31, 2002 and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The financial statements of the Company as of December 31, 2001 and for each of the two years in the period ended December 31, 2001 were audited by other independent accountants who have ceased operations. Those independent accountants expressed an unqualified opinion on those financial statements in their report dated January 31, 2002.



PricewaterhouseCoopers LLP
Baltimore, Maryland
January 28, 2003

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.
CONSOLIDATED BALANCE SHEETS

	December 31,	
	2002	2001
	(Dollars in thousands, except per share amounts)	
ASSETS		
Cash and cash equivalents	\$ 90,007	\$ 46,246
Receivables:		
Asset management fees	13,494	3,604
Investment banking	1,725	3,464
Affiliates	7,117	2,209
Other	5,786	4,352
Investments:		
Long-term investments	150,447	119,982
Mortgage-backed securities, at fair value	38,505	7,908
Trading securities, at fair value	8,298	15,706
Due from clearing broker	43,146	44,621
MMA acquired management contracts	17,629	18,729
Bank loans, net	15,052	12,459
Building, furniture, equipment, software and leasehold improvements, net of accumulated depreciation and amortization of \$20,013 and \$17,138, respectively ..	9,156	9,203
Prepaid expenses and other assets	5,823	3,475
Total assets	\$406,185	\$291,958
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Trading account securities sold but not yet purchased, at fair value	\$ 19,932	\$ 13,377
Accounts payable and accrued expenses	16,412	19,179
Accrued compensation and benefits	41,255	27,775
Bank deposits	51,215	19,457
Short-term loans payable	26,940	21,165
Long-term collateralized loan	5,266	5,694
Total liabilities	161,020	106,647
Commitments and contingencies (Note 11)	—	—
Shareholders' Equity:		
Preferred Stock, \$0.01 par value, 15,000,000 shares authorized, none issued and outstanding	—	—
Class A Common Stock, \$0.01 par value, 150,000,000 shares authorized, 25,047,980 and 23,468,403 shares issued, respectively	250	235
Class B Common Stock \$0.01 par value, 100,000,000 shares authorized, 25,975,449 and 26,946,029 shares issued and outstanding, respectively	260	269
Additional paid-in capital	215,862	210,703
Employee stock loan receivable including accrued interest (4,000,000 shares) ..	(24,182)	(22,706)
Treasury stock, at cost, 567,888 and 809,462 shares, respectively	(4,143)	(5,906)
Accumulated other comprehensive income, net of taxes	4,345	3,226
Retained (deficit) earnings	52,773	(510)
Total shareholders' equity	245,165	185,311
Total liabilities and shareholders' equity	\$406,185	\$291,958

The accompanying notes are an integral part of these consolidated financial statements.

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS

	Years Ended December 31,		
	2002	2001	2000
	(Dollars in thousands except per share amounts)		
Revenues:			
Investment banking:			
Underwriting	\$ 76,556	\$ 47,853	\$ 21,086
Corporate finance	58,595	28,534	31,404
Investment gains	8,725	6,762	1,453
Institutional brokerage:			
Principal transactions	27,512	26,330	32,319
Agency commissions	35,672	27,084	21,084
Asset management:			
Base management fees	28,956	19,744	9,719
Incentive allocations and fees	14,258	3,628	1,673
Net investment income	16,276	9,532	10,843
Technology sector net investment and incentive income (loss)	(5,622)	(18,100)	41,614
Interest, dividends and other	7,275	9,422	9,695
Total revenues	268,203	160,789	180,890
Expenses:			
Compensation and benefits	147,072	108,112	109,768
Business development and professional services	30,589	28,879	19,229
Clearing and brokerage fees	5,353	7,087	6,207
Occupancy and equipment	8,838	10,852	9,544
Communications	8,185	5,832	5,085
Interest expense	2,073	1,083	1,665
Other operating expenses	10,652	9,415	7,147
Restructuring and software impairment charges	—	5,151	—
Total expenses	212,762	176,411	158,645
Net income (loss) before taxes and extraordinary gain	55,441	(15,622)	22,245
Income tax provision (benefit)	3,035	(1,760)	4,163
Net income (loss) before extraordinary gain	52,406	(13,862)	18,082
Extraordinary gain	1,413	1,148	—
Income tax provision on extraordinary gain	536	—	—
Net income (loss)	<u>\$ 53,283</u>	<u>\$ (12,714)</u>	<u>\$ 18,082</u>
Basic earnings (loss) per share before extraordinary gain	<u>\$ 1.14</u>	<u>\$ (0.29)</u>	<u>\$ 0.37</u>
Diluted earnings (loss) per share before extraordinary gain	<u>\$ 1.08</u>	<u>\$ (0.29)</u>	<u>\$ 0.36</u>
Basic earnings (loss) per share	<u>\$ 1.16</u>	<u>\$ (0.27)</u>	<u>\$ 0.37</u>
Diluted earnings (loss) per share	<u>\$ 1.10</u>	<u>\$ (0.27)</u>	<u>\$ 0.36</u>
Basic weighted average shares outstanding	<u>46,097,647</u>	<u>47,465,527</u>	<u>49,161,799</u>
Diluted weighted average shares outstanding	<u>48,442,140</u>	<u>47,465,527</u>	<u>50,682,582</u>

The accompanying notes are an integral part of these consolidated financial statements.

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

	Class A Number of Shares	Class A Amount	Class B Number of Shares	Class B Amount	Additional Paid-In Capital	Employee Stock Loan Receivable	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Deficit)	Total	Comprehensive Income (Loss)
Balances, January 1, 2000	14,304,026	\$143	35,799,729	\$358	\$208,678	—	\$ (8,341)	\$ (5,991)	\$ (5,878)	\$188,969	
Net income	—	—	—	—	—	—	—	—	18,082	18,082	\$ 18,082
Conversion of Class B shares to Class A shares	2,889,700	29	(2,889,700)	(29)	—	—	—	—	—	—	
Issuance of treasury stock	—	—	—	—	(33)	—	1,153	—	—	1,120	
Issuance of Class A common stock	261,680	3	—	—	1,519	—	—	—	—	1,522	
Other comprehensive income:											
Change in unrealized gain (loss) on available-for-sale investment securities	—	—	—	—	—	—	—	4,863	—	4,863	4,863
Comprehensive income	—	—	—	—	—	—	—	—	—	—	\$ 22,945
Balances, December 31, 2000	17,455,406	175	32,910,029	329	210,164	—	(7,188)	(1,128)	12,204	214,556	
Net loss	—	—	—	—	—	—	—	—	(12,714)	(12,714)	\$ (12,714)
Conversion of Class B shares to Class A shares	5,964,000	60	(5,964,000)	(60)	—	—	—	—	—	—	
Issuance of treasury stock	—	—	—	—	(405)	—	1,282	—	—	877	
Issuance of Class A common stock	48,997	—	—	—	238	—	—	—	—	238	
Purchase of stock (employee stock purchase and loan plan)	—	—	—	—	(27,500)	—	—	—	—	(27,500)	
Sale of stock (employee stock purchase and loan plan)	—	—	—	—	27,500	(22,000)	—	—	—	5,500	
Interest on employee stock purchase and loan plan	—	—	—	—	706	(706)	—	—	—	—	
Other comprehensive income:											
Change in unrealized gain (loss) on available-for-sale investment securities	—	—	—	—	—	—	—	4,354	—	4,354	4,354
Comprehensive loss	—	—	—	—	—	—	—	—	—	—	\$ (8,360)
Balances, December 31, 2001	23,468,403	\$235	26,946,029	\$269	\$210,703	\$(22,706)	\$(5,906)	\$ 3,226	\$ (510)	\$185,311	
Net Income	—	—	—	—	—	—	—	—	53,283	53,283	\$ 53,283
Conversion of Class B shares to Class A shares	970,580	9	(970,580)	(9)	—	—	—	—	—	—	
Issuance of treasury stock	—	—	—	—	(521)	—	1,763	—	—	1,242	
Issuance of Class A common stock	608,997	6	—	—	4,204	—	—	—	—	4,210	
Interest on employee stock purchase and loan plan	—	—	—	—	1,476	(1,476)	—	—	—	—	
Other Comprehensive Income:											
Change in unrealized gain (loss) on available-for-sale investment securities (net of taxes of \$2,766)	—	—	—	—	—	—	—	1,119	—	1,119	1,119
Comprehensive income	—	—	—	—	—	—	—	—	—	—	\$ 54,402
Balances, December 31, 2002	25,047,980	\$250	25,975,449	\$260	\$215,862	\$(24,182)	\$(4,143)	\$ 4,345	\$ 52,773	\$245,165	

The accompanying notes are an integral part of these consolidated financial statements.

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

	Years Ended December 31,		
	2002	2001	2000
Cash flows from operating activities:			
Net income (loss)	\$ 53,283	\$(12,714)	\$ 18,082
Non-cash items included in earnings—			
Incentive allocations and fees and net investment (income) loss from long-term investments	(19,861)	35,599	(16,720)
Depreciation, amortization and software impairment	4,234	8,711	4,886
Extraordinary gain	(1,413)	(1,148)	—
Income tax provision-deferred	2,173	(1,760)	4,163
Other	542	439	—
Changes in operating assets:			
Receivables-			
Investment banking	1,739	1,232	(423)
Asset management fees	(9,890)	(1,798)	1,416
Affiliates	(4,908)	(360)	(510)
Other	2,596	3,239	231
Due from clearing broker	1,475	(32,781)	1,632
Marketable and trading securities	7,408	2,741	(1,560)
Prepaid expenses and other assets	(2,352)	1,034	(2,228)
Changes in operating liabilities:			
Trading account securities sold but not yet purchased	6,555	12,447	(2,099)
Accounts payable and accrued expenses	(4,940)	6,867	2,479
Accrued compensation and benefits	13,480	4,926	(1,281)
Net cash provided by operating activities	<u>50,121</u>	<u>26,674</u>	<u>8,068</u>
Cash flows from investing activities:			
Purchases of long-term investments	(52,302)	(22,293)	(17,050)
Proceeds from sales of long-term investments	39,292	13,795	8,990
Purchases of available-for-sale securities	(38,106)	(784)	—
Proceeds from sales of available-for-sale securities	3,476	—	10,278
Receipt of principal payments on mortgage-backed securities	4,731	3,533	—
Bank loans, net	(2,593)	(10,811)	—
Purchases of fixed assets, net	(2,873)	(2,638)	(3,751)
MMA/Rushmore acquisition, net of cash acquired	—	(7,760)	—
Net cash used in investing activities	<u>(48,375)</u>	<u>(26,958)</u>	<u>(1,533)</u>
Cash flows from financing activities:			
Proceeds from short-term borrowings	21,352	20,195	—
Repayments of short-term borrowings	(15,577)	(776)	(583)
Net increase (decrease) in bank deposits	31,758	(4,341)	—
Repayments on long-term collateralized loan	(970)	—	—
Proceeds from issuance of common stock	3,689	238	1,489
Proceeds from issuance of treasury stock	1,763	877	1,153
Purchase of stock (employee stock purchase and loan plan)	—	(27,500)	—
Sale of stock (employee stock purchase and loan plan)	—	5,500	—
Net cash provided by (used in) financing activities	<u>42,015</u>	<u>(5,807)</u>	<u>2,059</u>
Net increase (decrease) in cash and cash equivalents	43,761	(6,091)	8,594
Cash and cash equivalents, beginning of year	46,246	52,337	43,743
Cash and cash equivalents, end of year	<u>\$ 90,007</u>	<u>\$ 46,246</u>	<u>\$ 52,337</u>

Note: See Note 2 for supplemental cash flow information.

The accompanying notes are an integral part of these consolidated financial statements.

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per-share amounts)

Note 1. Organization and Nature of Operations:

Organization

Friedman, Billings, Ramsey Group, Inc., a Virginia corporation (the Company or FBR Group), is a holding company of which the principal operating subsidiaries are Friedman, Billings, Ramsey & Co., Inc. (FBR & Co.), FBR Investment Services, Inc. (FBRIS), Friedman, Billings, Ramsey International, Ltd. (FBRIL), Friedman, Billings, Ramsey Investment Management, Inc. (FBRIM), FBR Venture Capital Managers, Inc. (VCM), FBR Fund Advisers, Inc. (FBRFA), Money Management Advisers, Inc. and FBR Bank & Trust (FBR Bank).

FBR & Co. and FBRIS are registered broker-dealers and members of the National Association of Securities Dealers, Inc. They act as introducing brokers and forward all transactions to clearing brokers on a fully disclosed basis. FBR & Co. and FBRIS do not hold funds or securities for, nor owe funds or securities to, customers. During the periods presented, FBR & Co.'s underwriting and corporate finance activities were concentrated primarily on technology, energy, real estate and financial services companies.

FBRIM and VCM are registered investment advisers that manage and act as general partners of proprietary investment limited partnerships. FBRIM also manages separate investment accounts and FBR Asset Investment Corporation (FBR Asset), a publicly traded real estate investment trust (REIT). FBRFA is a registered investment adviser that manages The FBR Family of Funds. FBR Bank offers mutual fund servicing (custody, transfer agency, shareholder servicing, and mutual fund accounting), and traditional banking services (lending, deposits, cash management and trust services).

Nature of Operations

The Company's principal business activities (capital raising, securities sales and trading, merger and acquisition and advisory services, proprietary investments, and venture capital and other asset management services) are linked to the capital markets. In addition, the Company's business activities are primarily focused on small and mid-cap stocks in the financial services, real estate, technology, healthcare, energy and diversified industries sectors. By their nature, the Company's business activities are conducted in markets which are highly competitive and are not only subject to general market conditions, volatile trading markets and fluctuations in the volume of market activity but to the conditions affecting the companies and markets in the Company's areas of focus.

The Company's revenues, particularly from investment banking, incentive allocations and fees and principal investment activities, are subject to substantial fluctuations due to a variety of factors that cannot be predicted with great certainty, including the overall condition of the economy and the securities markets as a whole and of the sectors on which the Company focuses. Fluctuations also occur due to the level of market activity, which, among other things, affects the flow of investment dollars and the size, number and timing of transactions. As a result, net income and revenues in any particular period may vary significantly from period to period and year to year.

The financial services industry continues to be affected by the intensifying competitive environment and by consolidation through mergers and acquisitions, as well as significant growth in competition in the market for on-line trading services. The relaxation of banks' barriers to entry into the securities industry and expansion by insurance companies into traditional brokerage products, coupled with the repeal of laws separating commercial and investment banking activities, have increased the competition for a similar customer base.

In order to compete in this increasingly competitive environment, the Company continually evaluates its businesses across varying market conditions for profitability and alignment with long-term strategic objectives, including the diversification of revenue sources. The Company believes that it is important to diversify and

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

strengthen its revenue base by increasing the segments of its business that offer a recurring and more predictable source of revenue.

Concentration of Risk

A substantial portion of the Company's revenues in a year may be derived from a small number of transactions or issues or may be concentrated in a particular industry. For the year ended December 31, 2002, investment banking accounted for 54% of the Company's revenues.

As of December 31, 2002 and 2001, respectively, the Company's investment in FBR Asset of \$74,776 and \$42,460 represented 50% and 35% of the Company's long-term investments. For the years ended December 31, 2002, 2001 and 2000, the Company recorded revenue from FBR Asset of \$43,320, \$7,776, and \$7,785 representing 16%, 5% and 4% of the Company's revenue, respectively. In addition, in 2002 and 2001, the Company recorded an extraordinary gain of \$1,413 and \$1,148, respectively, associated with the exercise of FBR Asset warrants (See Note 3). This concentration creates earnings volatility exposure and market risk exposure for the Company in the real estate/mortgage sector, and there is interest rate risk related to FBR Asset as a leveraged mortgage REIT.

Merger Agreement with FBR Asset

On November 15, 2002, the Company and FBR Asset announced that they had signed a definitive agreement to merge the two firms in a tax-free stock for stock exchange. Under terms of the transaction, each share of FBR Asset common stock outstanding at closing will be converted into 3.65 shares of Class A Common Stock, and each share of FBR Group will be converted into one corresponding Class A or Class B share of a new entity (New FBR) which will elect REIT status for tax purposes.

The transaction is subject to customary closing conditions, including regulatory approvals and the approval of both the Company's and FBR Asset's shareholders. A special meeting of the Company's shareholders will be held in the first quarter 2003 to vote on the proposed merger. If the shareholders of the Company and FBR Asset approve the merger agreement, the transaction is expected to close by the end of the first quarter of 2003. If approved, the merger will be accounted for as a purchase of FBR Asset by FBR Group using the purchase method of accounting.

Under the terms of the transaction, the board of directors of both FBR Group and FBR Asset will be merged, resulting in a nine member board of directors. Seven of the nine members of the reconstituted board will be outside directors.

If the Company's merger with FBR Asset is completed, the Company has entered into an undertaking with the Federal Reserve Board (the Board) to convert to an entity that would allow us to continue to provide trust and custody services, but that would remove New FBR from regulation by the Board as a financial holding company.

As of December 31, 2002, the Company had incurred approximately \$1,100 in costs associated with this proposed merger. These costs have been capitalized and reflected in other assets in the Consolidated Balance Sheet as of December 31, 2002. In addition, under the terms of its agreement with its financial advisor Goldman Sachs, the Company has agreed to pay Goldman Sachs a transaction fee of \$3,000 which is payable upon completion of the transaction. See also Note 13 *Shareholders' Equity — Treasury Stock* for information about the Company's stock repurchase plan and Note 3 *Investments* for further information regarding the Company's current investment in FBR Asset.

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 2. Summary of Significant Accounting Policies:*Principles of Consolidation*

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation. See also *Securities and Principal Investments* below for discussion of entities in which the Company uses the equity and cost methods of accounting. Certain amounts in the consolidated financial statements and notes for prior periods have been reclassified to conform to the current period presentation.

Cash Equivalents

Cash equivalents include demand deposits with banks, money market accounts and highly liquid investments with original maturities of three months or less that are not held for sale in the ordinary course of business. As of December 31, 2002 and 2001, respectively, approximately 65% and 61% of the Company's cash equivalents were invested in money market funds that invest primarily in U.S. Treasuries and other government securities, backed by the U.S. government.

Supplemental Cash Flow Information Including Non-cash Transactions

During 2001, as part of the acquisition of MMA/Rushmore, the Company financed a portion of the purchase price in the form of a non-interest bearing note. As of December 31, 2002 and 2001, respectively, the long-term portion of this note was \$5,266 and \$5,694 and the short-term portion of this note was \$970, of which \$980 and \$439 represented accrued non-cash interest expense as of December 31, 2002 and 2001, respectively. Also in 2001, the Company provided employees with an opportunity to purchase five million shares of FBR stock through the Employee Stock Purchase and Loan Program (ESPLP). Through the ESPLP, employees could purchase shares of FBR stock at \$5.50 per share by paying \$1.10 per share and financing the remaining \$4.40 per share with loans from the Company. These loans to employees are interest bearing, limited-recourse loans.

Cash payments for interest approximated interest expense for the years ended December 31, 2002, 2001 and 2000. Cash payments for taxes for the years ended December 31, 2002, 2001 and 2000 were \$2,300, \$140, and \$255, respectively. There were no significant non-cash investing and financing activities during the respective years, other than the receipt of shares and warrants in connection with certain capital raising activities. In 2002 securities received in exchange for services provided were \$4,000. There were no such amounts recorded in 2001 and 2000.

Securities and Principal Investments

Investments in proprietary investment partnerships including hedge, private equity and venture funds, in which FBR is the general partner or has a significant limited partner interest, and FBR Asset are accounted for under the equity method and the Company's proportionate share of income or loss (income allocation) is reflected in net investment income in the statements of operations. Investments in investment partnerships, in which FBR is not the general partner or does not have a significant limited partner interest and, therefore, does not exercise significant influence, are accounted for under the cost method. Under the cost method, the Company records income only when distributed by the partnership.

Securities owned by the Company's broker-dealer subsidiaries and securities sold but not yet purchased are recorded on a trade-date basis and carried at fair value. The resulting realized and unrealized gains and losses are reflected in principal transactions in the statements of operations.

Long-term marketable securities and mortgage-backed securities held in non-broker-dealer entities are classified as available-for-sale investments and pursuant to Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities," are carried at fair

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

value with resulting unrealized gains and losses reflected in other comprehensive gain or loss in the balance sheets.

Realized gains and losses on sales of securities are determined using the specific identification method. Declines in the value of available-for-sale investments that are other than temporary are recorded in net investment income in the statements of operations.

Substantially all financial instruments used in the Company's trading and investing activities are carried at fair value or amounts that approximate fair value. Fair value is based generally on listed market prices or broker-dealer price quotations. To the extent that prices are not readily available, fair value is based on internal valuation models and estimates made by management.

In connection with certain capital raising transactions, the Company has received and holds warrants for the stock of the issuing companies, which are generally exercisable at the respective offering price of the transaction. Similarly, the Company may receive and hold shares of the issuing companies. For restricted warrants and shares including private company warrants and shares the Company carries the securities at fair value based on internal valuation models and estimates made by management. Due to the restrictions on the warrants and the underlying securities, and the subjectivity of these valuations, these warrants may have nominal values. The Company values warrants to purchase publicly traded stocks, where the restriction periods have lapsed, using an undiscounted Black-Scholes valuation model. For the years ended December 31, 2002, 2001 and 2000, the Company recognized realized investment gains of \$500, \$5,500 and \$1,500, respectively relating to these warrants.

Fair Value of Financial Instruments

At December 31, 2002 and 2001, the Company's financial instruments that are carried at fair value include cash and cash equivalents, investments (excluding FBR Asset), due from clearing broker, and trading account securities sold but not yet purchased. The Company's financial instruments that are carried at amounts which approximate fair value include, bank loans, bank deposits, short-term loans payable and long-term collateralized loan. The Company's investment in FBR Asset is accounted for under the equity method of accounting. The fair value amounts for financial instruments are disclosed in each respective footnote.

Intangible Assets

The Company accounts for its intangible assets consisting of acquired mutual fund management contracts in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets." Under SFAS 142, the values of these contracts are amortized in proportion to their expected economic benefit of 15 years and tested for impairment by comparing expected future gross cash flows to the asset's carrying amount. If the expected gross cash flows are less than the carrying amount, the asset is impaired and is written-down to its fair value. During the years ended December 31, 2002 and 2001, no impairment charge was recorded.

Bank Loans

Bank loans are carried at cost less an allowance for loan losses as they are held for the foreseeable future. The allowance for loan losses was \$200 and \$100 as of December 31, 2002 and 2001, respectively. Interest on loans is accrued based on the outstanding principal amount using the effective interest rate method. An allowance for uncollected interest is provided on any loan that is contractually delinquent more than 90 days and on any other loan when the collectibility of the loan is in doubt and such allowance is netted against accrued interest receivable. Any such interest ultimately collected is recorded as interest income in the period of recovery. Although FBR Bank has experienced insignificant loan losses in the past, management continues to provide for loan losses as necessary based on changes in current economic conditions and other factors. Management periodically reviews and evaluates the loan portfolio to determine the adequacy of the allowance for loan losses.

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**

While management uses available information to estimate losses on loans, future additions to the allowance may be necessary based on changes in economic conditions beyond management's control. Loans receivable are accounted for in accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," which requires that impaired loans be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. The Company considers a loan impaired when FBR Bank will be unable to collect any of the interest and principal payments as scheduled in the loan agreement. A valuation allowance is maintained to the extent that the measure of the impaired loan is less than the recorded investment.

Building, Furniture, Equipment, Software and Leasehold Improvements

Building, furniture, equipment and software are depreciated using the straight-line method over their estimated useful lives of three to forty years. Leasehold improvements are amortized using the straight-line method over the shorter of the useful life or lease term. Amortization of purchased software is recorded over the estimated useful life of three years. The Company had capitalized certain software development costs associated with its launch of fbr.com. During 2001, the Company wrote-off \$2,700 which represented all of the unamortized fbr.com software costs as a result of determining such capitalized costs were impaired.

Bank Deposits

Bank deposits represent deposits held by FBR Bank for its customers. Interest expense is recognized based on the deposit balance and the stated interest rate paid.

Investment Banking Revenues

Underwriting revenues represent fees earned from public offerings of securities in which the Company acts as underwriter. These revenues are comprised of selling concessions, underwriting fees, and management fees. Corporate finance revenues represent fees earned from private placement offerings, mergers and acquisitions, mutual conversions, financial restructuring and other advisory services provided to clients. Underwriting revenues are recorded as revenue at the time the underwriting is completed. Corporate finance fees are recorded as revenue when the related service has been rendered and the client is contractually obligated to pay. Certain fees received in advance of services rendered are recognized as revenue over the service period.

Institutional Brokerage Revenues

Principal transactions consist of sales credits and trading gains or losses, and agency commissions consist of commissions earned from executing stock exchange-listed securities and other transactions as an agent. Revenues generated from securities transactions and related commission income and expenses are recorded on a trade date basis.

Asset Management Revenues

The Company records three types of asset management revenue: (1) Certain of the Company's subsidiaries act as investment advisers and receive management fees for the management of proprietary investment partnerships, mutual funds and FBR Asset, based upon the amount of capital committed or assets under management. This revenue is recognized over the period in which services are performed and is recorded in base management fees in the Company's statements of operations. (2) The Company also receives incentive income based upon the operating results of the partnerships, venture capital funds and FBR Asset. Incentive income represents a share of the gains in the partnerships and FBR Asset, and is recorded in incentive allocations and fees in the statements of operations. The Company recognizes incentive income from the partnerships based on what would be due to the Company if the partnership terminated on the balance

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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 private equity and venture funds. As of December 31, 2002, \$600 was subject to reversal. (3) The Company also records allocations, under the equity method of accounting, for its proportionate share of the earnings or losses of the partnerships and FBR Asset. Income or loss allocations are recorded in net investment income (loss) and technology sector investment and incentive income (loss) in the Company's statements of operations. The partnerships record their investments at fair value with changes in fair value reported in the partnerships' earnings at each reporting date. Accordingly, partners' capital accounts at each reporting date include all applicable allocations of partnership realized and unrealized gains and losses.

Compensation

A significant component of compensation expense relates to incentive bonuses. Incentive bonuses are accrued based on the contribution of key business units using certain pre-defined formulas. Since the bonus determinations in some cases are also based on aftermarket security performance and other factors, which include unrealized gains and losses, amounts currently accrued may not ultimately be paid. The Company's compensation accruals are reviewed and evaluated on a quarterly basis.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation." 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 the years ended December 31, 2002, 2001 and 2000, the exercise prices of all options granted equaled the market prices on the dates of grants, therefore, the Company did not record any compensation expense in 2002, 2001 and 2000 related to option grants.

	<u>2002</u>	<u>2001</u>	<u>2000</u>
Net income before extraordinary gain	\$52,406	\$(13,862)	\$18,082
Basic earnings (loss) per share before extraordinary gain	\$ 1.14	\$ (0.29)	\$ 0.37
Diluted earnings (loss) per share before extraordinary gain	\$ 1.08	\$ (0.29)	\$ 0.36
Stock based employee compensation	\$11,548	\$ 16,344	\$ 7,461
Pro forma net income before extraordinary gain	\$43,893	\$(30,206)	\$10,621
Pro forma basic earnings (loss) per share before extraordinary gain	\$ 0.95	\$ (0.64)	\$ 0.22
Pro forma diluted earnings (loss) per share before extraordinary gain	\$ 0.91	\$ (0.64)	\$ 0.21

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions used for options granted during 2002, 2001 and 2000, respectively: no dividend yield, expected volatility of 68%, 73%, and 81%, risk-free interest rate of 4.3%, 4.9%, and 6.2% and an expected life of five years for all grants. The weighted average fair value of options granted during 2002, 2001 and 2000 was \$4.42, \$3.90, and \$5.69, respectively, per share.

Income Taxes

Deferred tax assets and liabilities represent the differences between the financial statement and income tax bases of assets and liabilities, using enacted tax rates. The measurement of net deferred tax assets is

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

adjusted by a valuation allowance if, based on management's evaluation, it is more likely than not that they will not be realized.

Other Comprehensive Income (Loss)

Comprehensive income includes net income as currently reported by the Company on the consolidated statements of operations adjusted for other comprehensive income. Other comprehensive income for the Company represents changes in unrealized gains and losses related to the Company's available-for-sale securities (including the bank investment securities) and the Company's proportionate share of FBR Asset's investments accounted for as available-for-sale. These changes in fair value are recorded through equity.

Earnings (Loss) Per Share

Basic earnings (loss) per share includes no dilution and is computed by dividing net income or loss available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share includes the impact of dilutive securities such as stock options. For the year ended December 31, 2002 and 2000, the difference between basic and diluted earnings per share is due to certain dilutive stock options. For the year ended December 31, 2001, there was no difference between basic and diluted loss per share as the impact of options was anti-dilutive. For the years ended December 31, 2002, 2001 and 2000, options to purchase 2,535,400, 7,981,345, and 3,565,762 shares, respectively, of common stock were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares. See Note 13 for a detail of total stock options outstanding.

Restructuring Charge

During 2001, the Company adopted a restructuring plan in response to the downturn in the economy. In connection with the restructuring, 67 employees were terminated or left and were not replaced. These employees primarily were from the technology sector and administrative groups.

As a result of the restructuring plan, in 2001 the Company recorded a restructuring charge of \$2,410. The following is a summary of the costs comprising the total charge:

Employee severance and other termination costs	\$1,365
Non-cancelable lease and other facility costs	947
Other	<u>98</u>
Total	<u>\$2,410</u>

As of December 31, 2002, substantially all of this restructuring charge had been paid. There were no additional restructuring charges incurred during 2002.

Use of Estimates

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. Note 2 contains the Company's significant accounting policies. The Company believes its most critical policies that are both very important to the portrayal of the Company's financial condition and results of operations and require management's most difficult, subjective or complex judgments or estimates include 1) valuation of private and restricted public company investments, 2) recognition of incentive fee revenue, 3) valuation allowance

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

determination related to deferred taxes and 4) impairment assessments we apply to our long term investments in marketable equity securities. Actual results could differ from those estimates.

Recent Accounting Pronouncements

In April 2002, the Financial Accounting Standards Board (“FASB”) issued SFAS No. 145, “Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections” (“SFAS 145”), effective for the Company on January 1, 2003. SFAS 145 requires classification of gains and losses recognized from the extinguishment of debt to be included in continuing operations unless it meets the criteria of an extraordinary item. SFAS 145 also requires that certain lease modifications that have economic effects similar to sale-leaseback transactions be accounted for in the same manner as a sale-leaseback transaction. Adoption of SFAS 145 had no effect on the Company’s results of operations, financial position, or liquidity but may affect the accounting for future transactions.

The FASB has issued SFAS No. 146, “Accounting for Exit or Disposal Activities.” SFAS 146 addresses significant issues regarding the recognition, measurement, and reporting of costs that are associated with exit and disposal activities, including restructuring activities that are currently accounted for pursuant to the guidance that the Emerging Issues Task Force (“EITF”) of the FASB has set forth in EITF Issue No 94-3, “Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring).” The scope of SFAS 146 also included (1) costs related to terminating a contract that is not a capital lease and (2) termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred compensation contract. SFAS 146 will be effective for exit or disposal activities initiated after December 31, 2002. The Company does not expect that the adoption of SFAS 146 will have a material effect on the Company’s results of operations and financial position.

The FASB has issued SFAS No. 147, “Acquisitions of Certain Financial Institutions,” which is effective for certain transactions arising on or after October 1, 2002. SFAS 147 will have no impact on the Company.

The FASB has issued SFAS No. 148 “Accounting for Stock-Based Compensation — Transition and Disclosure.” SFAS No. 148 amends SFAS 123, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has adopted the disclosure requirements of SFAS 148. The Company currently accounts for stock-based employee compensation in accordance with APB 25 and related interpretations. Accordingly, the alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation mandated by SFAS 148 are not applicable to the Company at this time.

FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others — an interpretation of FASB Statements No. 5, 57, and 107 and rescission of FASB Interpretation No. 34,” (“FIN 45”) was issued in November 2002. FIN 45 elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 does not prescribe a specific approach for subsequently measuring the guarantor’s recognized liability over the term of the related guarantee. The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor’s fiscal year-end. The Company has adopted the disclosure requirements in FIN 45 which were effective for financial statements of interim or annual periods ending after December 15,

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

2002. The Company does not believe that the adoption of FIN 45 will have a significant effect on the Company's results of operations and financial position.

FASB Interpretation No. 46, "Consolidation of Variable Interest Entities — an interpretation of ARB 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 interest entity to decide whether to consolidate that entity. This Interpretation requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. FIN No. 46 is effective immediately for variable interest entities created after January 31, 2003, and to variable interest entities in which an enterprise obtains an interest after that date. The Interpretation applies in the first fiscal year or interim period beginning after June 15, 2003, to variable interest entities in which an enterprise holds a variable interest that it acquired before February 1, 2003. The Company does not anticipate that the adoption of FIN 46 will have a material effect on its financial position or results of operations.

Note 3. Investments:

Trading securities owned and trading account securities sold but not yet purchased consisted of securities at fair values for the years indicated:

	December 31,			
	2002		2001	
	<u>Owned</u>	<u>Sold But Not Yet Purchased</u>	<u>Owned</u>	<u>Sold But Not Yet Purchased</u>
Corporate stocks	\$8,145	\$19,931	\$15,355	\$13,357
Corporate bonds	<u>153</u>	<u>1</u>	<u>351</u>	<u>20</u>
	<u>\$8,298</u>	<u>\$19,932</u>	<u>\$15,706</u>	<u>\$13,377</u>

Trading account securities sold but not yet purchased represent obligations of the Company to deliver the specified security at the contracted price, and thereby, creates a liability to purchase the security in the market at prevailing prices. Accordingly, these transactions 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.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Long-term investments consisted of the following for the years indicated:

	December 31,	
	2002	2001
Equity method investments:		
Proprietary investment partnerships excluding technology sector	\$ 26,645	\$ 42,619
FBR Asset Investment Corporation	74,776	42,460
Marketable securities	3,498	4,894
Private debt investments	7,500	7,500
Cost method investments excluding the technology sector	750	—
Other	9,457	839
	<u>122,626</u>	<u>98,312</u>
Equity method investments — technology sector	20,004	14,584
Cost method investments — technology sector	7,817	7,086
	<u>27,821</u>	<u>21,670</u>
	<u>\$150,447</u>	<u>\$119,982</u>

Equity Method Investments*Investment Partnerships*

The investment partnerships, including venture capital funds, from which the Company earns management, incentive and investment income are non-registered investment companies that record their investments in securities at fair value. Certain investments consist of equity investments in securities of development-stage and early-stage privately and publicly held companies. The disposition of these investments may be restricted due to the lack of a ready market or due to contractual or regulatory restrictions on disposition. In addition, these securities may represent significant proportions of the issuer's equity and carry special contractual privileges not available to other security holders. As a result of these factors, precise valuation for the restricted public securities and private company securities is a matter of judgment, and the determination of fair value must be considered only an approximation and may vary significantly from the amounts that could be realized if the investment were sold or from the value that would have been used had a ready market existed for the securities and those differences could be material. The following methodology is employed by the partnerships in valuing their investments:

Nonrestricted public securities that are traded on a national securities exchange (or reported on the Nasdaq national market) are valued at the last reported sales price on the day of valuation.

Restricted public securities — Securities that have underlying public markets, but whose disposition is restricted, are valued at a discount from the current market value. Discounts are taken for regulatory restrictions and contractual lock-up agreements. If a security has either regulatory restrictions or is contractually locked up, a market blockage discount may be applied as well.

Private securities — The investment is originally recorded and carried at cost, and is subject to the following: the investment may be marked up or down to reflect changes in the fundamentals of the issuer, its industry sector, or the economy in general, since the date of the original investment. Events considered in this valuation are: (1) a subsequent third-party round of financing at a per share price that is higher or

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

lower than the current valuation, (2) an imminent public offering, (3) an imminent sale of the issuer, or (4) if the issuer's performance and potential have significantly deteriorated as of the valuation date.

VCM is the managing partner of FBR Technology Venture Partners, L.P. (TVP) and FBR Technology Venture Partners II (TVP II, consisting of five separate limited partnerships). FBRIM is the managing partner or member of FBR Ashton, L.P., FBR Weston, Limited Partnership, FBR Future Financial Fund, L.P., FBR Private Equity Fund, L.P., FBR Arbitrage, L.L.C., FBR Biotech Fund, L.P., FBR CoMotion Venture Capital I, L.P., FBR Pegasus Fund, L.L.C. and through a wholly-owned L.L.C., FBR Financial Services Partners, L.P. All of these partnerships were formed for the purpose of investing in public and private securities, therefore, their assets principally consist of investment securities accounted for at fair value. The Company accounts for its investments in these partnerships under the equity method. Although we do not manage these partnerships, as a significant investor in Braddock Partners, L.P., Capital Crossover Partners, ETP/FBR Genomic Fund, L.P. and ETP/FBR Genomic Fund II (QP), L.P. and, due to our percentage ownership in these partnerships, we also account for these investments under the equity method. The following table shows the Company's investments and percentage interest on which pro rata profit allocations (as distinct from carried interest incentive income) are based:

	December 31,			
	2002		2001	
<u>Non-Technology Sector</u>				
FBR Ashton, L.P.	\$ 6,692	16%	\$19,000	35%
FBR Arbitrage, L.L.C.	11,259	20%	11,415	16%
FBR Pegasus Fund, L.L.C.	2,685	11%	—	—
Braddock Partners, L.P.	—	—	5,613	11%
FBR Weston, Limited Partnership	2,890	9%	2,327	9%
FBR Private Equity Fund, L.P.	1,445	20%	1,878	20%
FBR Financial Services Partners, L.P.	634	6%	1,519	6%
FBR Future Financial Fund, L.P.	1,040	63%	867	59%
	<u>26,645</u>		<u>42,619</u>	
<u>Technology Sector</u>				
Capital Crossover Partners	\$12,736	13%	\$ 6,000	13%
FBR Technology Fund	752	28%	—	—
FBR CoMotion Venture Capital I, L.P.	1,886	8%	3,148	8%
FBR Technology Venture Partners II, L.P.	2,128	6%	2,771	5%
ETP/FBR Genomic Fund, L.P.	1,361	6%	1,411	5%
FBR Technology Venture Partners, L.P.	653	3%	1,068	3%
ETP/FBR Genomic Fund II (QP), L.P.	397	6%	100	6%
FBR Biotech Fund, L.P.	91	8%	86	8%
	<u>20,004</u>		<u>14,584</u>	
	<u>\$46,649</u>		<u>\$57,203</u>	

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The Company's significant equity method investments are:

<u>2002</u>	<u>TVP</u>	<u>TVPII</u>	<u>FBR Asset</u>	<u>Ashton</u>	<u>Other</u>	<u>Total</u>
Total assets	\$ 3,940	\$ 28,391	\$5,365,624	\$ 87,984	\$329,461	\$5,815,400
Total liabilities	963	1,682	4,613,455	45,823	54,904	4,716,827
Total equity	2,977	26,709	752,169	42,161	274,557	1,098,573
FBR's share of total equity ..	653	2,128	74,776	6,692	36,424	120,673
Total revenue	3	13	185,963	1,894	6,624	194,497
Total expenses	1,288	1,674	97,316	1,054	9,171	110,503
Realized gains (losses)	(5,944)	(17,995)	28,423	(299)	(23,801)	(19,616)
Unrealized gains (losses) . . .	5,343	7,555	—	(11,371)	(27,859)	(26,332)
Net income	(1,886)	(12,101)	117,070	(10,830)	(54,207)	38,046
FBR's share of net income- net investment income (loss)	(41)	(946)	20,913	(2,312)	(4,402)	13,212
FBR's share of net income- incentive allocations and fees	(373)	—	13,769	4	471	13,871
<u>2001</u>	<u>TVP</u>	<u>TVPII</u>	<u>FBR Asset</u>	<u>Ashton</u>	<u>Other</u>	<u>Total</u>
Total assets	\$ 5,885	\$ 41,248	\$1,325,125	\$ 60,094	\$394,629	\$1,826,981
Total liabilities	1,022	2,914	1,121,260	6,238	127,382	1,258,816
Total equity	4,863	38,334	203,865	53,856	267,247	568,165
FBR's share of total equity ..	1,068	2,771	42,460	19,000	34,364	99,663
Total revenue	13	360	39,087	1,975	11,116	52,551
Total expenses	1,390	3,460	18,879	1,372	15,597	40,698
Realized gains (losses)	49,536	(51,768)	3,330	3,550	27,955	32,603
Unrealized gains (losses) . . .	(89,033)	(42,082)	—	7,563	(28,152)	(151,704)
Net income	(40,874)	(96,950)	23,538	11,716	(4,678)	(107,248)
FBR's share of net income- net investment income (loss)	(917)	(5,003)	4,278	3,570	907	2,835
FBR's share of net income- incentive allocations and fees	(7,706)	—	1,656	—	1,707	(4,343)
<u>2000</u>	<u>TVP</u>	<u>TVPII</u>	<u>FBR Asset</u>	<u>Ashton</u>	<u>Other</u>	<u>Total</u>
Total assets	\$ 109,463	\$116,817	\$ 225,804	\$ 63,706	\$379,823	\$ 895,613
Total liabilities	511	3,347	138,963	10,794	131,335	284,950
Total equity	108,952	113,470	86,841	52,912	248,488	610,663
FBR's share of total equity ..	23,913	6,418	30,054	15,430	31,932	107,747
Total revenue	139	—	23,841	1,752	9,147	34,879
Total expenses	1,306	3,687	12,610	1,528	9,647	28,878
Realized gains (losses)	257,954	—	(2,867)	318	16,908	272,313
Unrealized gains (losses) . . .	(105,967)	16,419	—	16,654	14,014	(58,880)
Net income	150,820	12,732	8,364	17,196	30,422	219,534
FBR's share of net income- net investment income	3,242	705	7,079	4,765	5,454	21,245
FBR's share of net income- incentive allocations	30,186	—	—	—	1,736	31,922

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

FBR Technology Venture Partners, L.P.

FBR Technology Venture Partners, L.P. (TVP) is a limited partnership, formed on August 12, 1997, to engage in the business of investing in securities. FBR Venture Capital Managers, Inc., a wholly owned subsidiary of the Company, is the corporate general partner of TVP. TVP's investments as of December 31, 2002 included equity investments in securities of development-stage, early-stage, privately held, technology companies. TVP's investments as of December 31, 2001 included equity investments in securities of development-stage and early-stage, privately and publicly held, technology companies. The disposition of the privately held investments is generally restricted due to the lack of a ready market. TVP's investments may represent significant proportions of the issuer's equity and they may carry special contractual privileges not available to other security holders. As a result, precise valuation for the private and restricted investments is a matter of judgment and the determination of fair value must be considered only an approximation. As of December 31, 2002, TVP did not own any investments in public companies. As of December 31, 2001, public company investments were valued based on the year-end closing price.

FBR Technology Venture Partners II

FBR Technology Venture Partners II (TVP II) consists of five separate limited partnerships formed during 1999, to engage in the business of investing in securities. FBR Venture Capital Managers, Inc., a wholly owned subsidiary of the Company, is the corporate general partner of TVP II. TVP II's investments as of December 31, 2002 included equity investments in securities of development-stage, early-stage, privately held, technology companies. TVP II's investments as of December 31, 2001 included equity investments in securities of development-stage and early-stage, privately and publicly held, technology companies. The disposition of the privately held investments is generally restricted due to the lack of a ready market. TVP II's investments may represent significant proportions of the issuer's equity and they may carry special contractual privileges not available to other security holders. As a result, precise valuation for the private and restricted investments is a matter of judgment and the determination of fair value must be considered only an approximation. As of December 31, 2002, TVP II did not own any investments in public companies. As of December 31, 2001, public company investments were valued based on the year-end closing price less a discount to reflect restrictions on liquidity and marketability.

FBR Asset

FBR Asset is a REIT, formed in 1997, whose primary purpose is to invest in mortgage-backed securities, equity securities, public and private real estate companies and mezzanine and senior loans. As of December 31, 2002, 97% and 2% of FBR Asset's assets were invested in mortgage-backed securities and equity securities, respectively. As of December 31, 2001, 93% and 5% of FBR Asset's assets were invested in mortgage-backed securities and equity securities, respectively. FBR Asset classifies its investments as available-for-sale. Accordingly, unrealized gains and losses related to securities are reflected as other comprehensive gain or loss in FBR Asset's equity. The Company accounts for its investment in FBR Asset under the equity method. As a result, the Company recorded \$20,913, \$4,278, and \$7,079 in net investment income in the statements of operations for its proportionate share of FBR Asset's 2002, 2001 and 2000 net income, respectively.

In addition, in 2002 and 2001, respectively, the Company exercised 415,805 and 400,000 warrants to purchase FBR Asset common shares. Under the provisions of SFAS No. 141, "Business Combinations," if the fair value of net assets acquired is greater than an acquirer's purchase price the difference is recorded as an extraordinary gain. Accordingly, based on the fair value of net assets acquired and the exercise price of the warrants, these transactions resulted in extraordinary gains of \$1,413 and \$1,148 in 2002 and 2001, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

During 2002 and 2001, respectively, the Company reduced its carrying basis of FBR Asset for declared dividends of \$13,027 and \$5,007. The Company also recorded, in other comprehensive income, \$785, \$3,414 and \$2,746 of net unrealized gain on investments, which represented its proportionate share of FBR Asset's net unrealized gains related to available-for-sale securities and unrealized losses on cash flow hedges for the years ended December 31, 2002, 2001 and 2000, respectively. As of December 31, 2002 and 2001, respectively, net unrealized gain or loss related to FBR Asset and included in the Company's accumulated other comprehensive income was \$3,940 and \$3,155. The Company's ownership percentage of FBR Asset was approximately 10% as of December 31, 2002. As of December 31, 2002, FBR Asset's market value per share was \$33.90, which results in the Company's investment in FBR Asset having a fair value of \$88,140. The Company's ownership percentage of FBR Asset was 21% as of December 31, 2001. As of December 31, 2001, FBR Asset's market value per share was \$27.95, which results in the Company's investment in FBR Asset having a market value of \$49,477.

The Company has a management agreement with FBR Asset, expiring on December 17, 2003. The Company performs portfolio management services on behalf of FBR Asset. These services include, but are 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.

The Company is entitled to 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. The Company recorded \$8,638, \$1,842 and \$705 in base management fees during 2002, 2001 and 2000, respectively.

The Company is also entitled to receive incentive fees based on the performance of FBR Asset. The Company is entitled to an incentive fee calculated by reference to the preceding four-quarters, calculated as: 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 is calculated as the weighted average issuance price per share of all shares of FBR Asset, which was \$25.59 at December 31, 2002, 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. The Company recorded \$13,800, \$1,700 and \$0 in incentive fees during 2002, 2001 and 2000, respectively.

The Company had engaged Fixed Income Discount Advisory Company, Inc. ("FIDAC") to manage FBR Asset's mortgage asset investment program (the "Mortgage Portfolio") as a sub-adviser. As compensation for rendering services, FIDAC was entitled to a sub-advisory fee based on the average gross asset value managed by FIDAC. On March 22, 2002, the Company notified FIDAC that it had decided to terminate the sub-advisory agreement with FIDAC. The decision to terminate the sub-advisory agreement with FIDAC was based on the Company's determination, after consultation with FBR Asset's Board of Directors, that it would be in the best interests of FBR Asset and its shareholders to terminate the sub-advisory agreement in light of the increased size of FBR Asset's equity capital and mortgage-backed securities portfolio. The sub-advisory agreement ended in accordance with its terms on April 30, 2002. Concurrently with the end of the sub-advisory agreement, the Company and FBR Asset agreed to a reduction of the management fee that FBR Asset will be required to pay the Company under the management agreement from 0.25 percent to 0.20 percent per annum of the average book value of FBR Asset's Mortgage Portfolio during each calendar quarter.

The Company entered into an agreement in August 2001 with FBR Asset and its registered broker-dealer subsidiary, Pegasus Capital Corporation ("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 2002, pursuant to

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

this agreement, Pegasus earned \$6,400 in fees in connection with five investment banking transactions. In 2001, pursuant to this agreement, the Company paid \$2,900 in fees to FBR Asset in connection with three investment banking transactions and one unfunded commitment.

During 2002, the Company earned \$10,100 (net of expenses) in fees in its capital markets segment in connection with the Company's broker-dealer subsidiary underwriting three follow-on public offerings for FBR Asset. For the year ended December 31, 2001, the Company earned \$4,400 in fees in its capital markets segment in connection with one follow-on public offering for FBR Asset.

FBR Ashton, L.P.

FBR Ashton, L.P. (Ashton) is a limited partnership, formed on November 8, 1991, to engage in the business of investing in securities primarily in the financial services industry. Friedman, Billings, Ramsey Investment Management, Inc., a wholly owned subsidiary of the Company, is the corporate general partner of Ashton. Ashton's investments as of December 31, 2001 and 2000 were comprised of equity investments in securities of publicly held companies.

Marketable Securities and Mortgage-Backed Securities

The Company's available-for-sale securities consist primarily of equity investments in publicly traded companies that are held by an asset management subsidiary of the Company and mortgage-backed securities. In accordance with SFAS 115, the securities are carried at fair value with resulting unrealized gains and losses reflected as other comprehensive income or loss. During 2002, 2001 and 2000, respectively, the Company recorded \$(896), \$(1,945), and \$(2,519) of other than temporary losses in the statements of operations relating to marketable securities. These losses are reflect in the net investment income (loss).

During 2002 and 2000, respectively, the Company sold \$3,476 and \$10,278 of available-for-sale securities. The Company recorded \$34 and \$2,140 of gross realized gains and (\$155) and (\$326) of gross realized losses in 2002 and 2000, respectively. During 2001, there were no sales of available-for-sale securities.

For the year ended December 31, 2002, the weighted average coupon rate on the mortgage-backed securities was 4.90% and the weighted average effective yield was 4.90%. The weighted average life of the mortgage-backed securities based on assumptions used to determine fair value was 3.64 years as of December 31, 2002. The Company's available-for-sale securities as of December 31, 2002 and 2001 were:

	2002			Fair Value
	Amortized Cost	Unrealized		
		Gains	Losses	
Mortgage-backed securities	\$38,009	\$502	\$ (6)	\$38,505
Marketable securities	3,498	—	—	3,498
	<u>\$41,406</u>	<u>\$502</u>	<u>\$ (6)</u>	<u>\$42,003</u>
	2001			
	Amortized Cost	Unrealized		Fair Value
		Gains	Losses	
Mortgage-backed securities	\$ 7,918	\$ —	\$ (10)	\$ 7,908
Marketable securities	4,818	76	—	4,894
	<u>\$12,736</u>	<u>\$ 76</u>	<u>\$ (10)</u>	<u>\$12,802</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Private Debt

In May 1998, the Company organized a business trust designed to extend financing to middle-market businesses in need of subordinated debt or mezzanine financing. In connection therewith, the Company loaned \$7,500 and \$10,000, respectively, to two unrelated businesses. During 2001, the \$10,000 loan was repaid, with interest, for total proceeds of \$12,051 resulting in investment income of \$1,715. The remaining loan matures in June 2003 and is carried at cost. The Company also initially invested \$7,000 in an unaffiliated technology sector private company in the form of a preferred equity investment. During the year ended December 31, 2000, the Company recorded \$5,880 of investment losses related to this preferred equity investment.

Other

During 2000, the Company employed option strategies that were indexed to common equity shares held by certain of the Company's managed investment partnerships. The options are subject to fair value accounting. Total realized and unrealized gains of \$12,534 were recognized during 2000 and included in incentive allocations in the statements of operations.

Note 4. FBR Bank — MMA/Rushmore Acquisition:

On April 1, 2001, the Company completed the acquisition of Money Management Associates, LP (MMA) and Rushmore Trust and Savings, FSB (Rushmore). MMA was a privately held investment adviser with \$933,400 in assets under management as of March 31, 2001. Together, MMA and Rushmore were the investment adviser, servicing agent or administrator for more than 20 mutual funds. Upon closing, Rushmore was re-chartered as a national bank and was named FBR National Bank & Trust (FBR Bank). FBR Bank offers mutual fund servicing (custody, transfer agency, shareholder servicing and mutual fund accounting) and traditional banking services (lending, deposits, cash management, trust services). Under the terms of the agreement, the Company acquired MMA/Rushmore for \$17,500 in cash at closing and a \$9,700 installment note payable over a ten-year period.

The total purchase price of \$25,200, including capitalized transaction costs of \$1,500 and the present value of the installment note at an imputed rate of 9%, was allocated:

MMA management contracts	\$19,700
Bank equity	<u>5,500</u>
	<u>\$25,200</u>

The acquisition of MMA/Rushmore was accounted for using the purchase method of accounting under SFAS No. 141, "Business Combinations," 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. These Management Contracts are being amortized straight-line over 15 years. Accordingly, approximately \$1,300 per year will be amortized over the remaining life of this intangible asset. Income related to these management contracts is recognized as earned usually based on invested assets at a stated management fee percentage.

Bank Loans

Of the \$15,052 and \$12,459 of bank loans at December 31, 2002 and 2001, respectively, \$7,508 and \$6,444, respectively were made to employees of FBR Group. As of December 31, 2002 and 2001, \$13,721 and

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

\$10,331, respectively of the loans outstanding were first mortgage residential loans. Bank loan activity for 2002 and 2001 was:

	<u>Year Ended December 31, 2002</u>	<u>For the Period April 1, 2001 through December 31, 2001</u>
Beginning Balance	\$12,459	\$ 1,648
Originations	6,909	11,344
Prepayments, including normal principal repayments	<u>(4,316)</u>	<u>(533)</u>
	<u>\$15,052</u>	<u>\$12,459</u>

Note 5. Building, Furniture, Equipment, Software and Leasehold Improvements:

Building, furniture, equipment, software and leasehold improvements, summarized by major classification, were:

	<u>December 31,</u>		<u>Depreciable Lives</u>
	<u>2002</u>	<u>2001</u>	
Building, furniture and equipment	\$15,773	\$13,854	Forty, five and three years, respectively
Software	6,345	5,952	Three years
Leasehold improvements	5,501	4,985	Shorter of useful life or lease term
Land	<u>1,550</u>	<u>1,550</u>	
	29,169	26,341	
Less-Accumulated depreciation and amortization	<u>(20,013)</u>	<u>(17,138)</u>	
	<u>\$ 9,156</u>	<u>\$ 9,203</u>	

Note 6. Income Taxes:

As of December 31, 2001, the Company had a net operating loss (NOL) carryforward to offset future taxable income. As of that date the Company had provided a full valuation allowance against its NOL and other deferred tax assets based upon its ongoing assessment of realizability. The Company's 2002 operating results exceeded the NOL carryforward and its other deferred tax asset items. Consequently, all of the deferred tax asset valuation allowance was reversed and recorded in the income tax provision during the year ended December 31, 2002. Accordingly, in 2002 the Company provided for income taxes and recorded an income tax provision of \$3,035 (net of the reversal of the deferred tax asset valuation allowance) relating to the net income before extraordinary gain. Additionally, the Company recorded an income tax provision of \$536 related to an extraordinary gain. The Company's effective tax rate on net income before extraordinary gain for the year ended December 31, 2002 was 5 percent.

The provision for income taxes consists of:

Federal	\$2,398
State	<u>637</u>
	<u>\$3,035</u>
Current	\$3,628
Deferred	<u>(593)</u>
	<u>\$3,035</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Deferred tax assets and liabilities consisted of the following as of December 31, 2002 and 2001:

	<u>December 31,</u>	
	<u>2002</u>	<u>2001</u>
Tax deferred revenue	\$(4,042)	\$ (2,204)
Unrealized investment gains, recorded in accumulated other comprehensive income (loss)	(2,766)	(1,293)
Unrealized investment losses recorded in earnings, related to other than temporary declines in the value of available-for-sale securities	1,773	9,020
Accrued compensation	1,260	182
Unrealized investment losses on proprietary investment partnerships	127	339
Net operating loss carryforward	—	17,423
Other	<u>1,475</u>	<u>(589)</u>
	(2,173)	22,878
Less-valuation allowance recorded through earnings	<u>—</u>	<u>(22,878)</u>
Net deferred tax liability	<u><u>\$(2,173)</u></u>	<u><u>\$ —</u></u>

The provision (benefit) for income taxes results in effective tax rates that differ from the Federal statutory rates. The reconciliation of income tax attributable to net income (loss) before extraordinary gain computed at Federal statutory rates to income tax expense (benefit) was:

	<u>December 31,</u>		
	<u>2002</u>	<u>2001</u>	<u>2000</u>
Statutory Federal income tax rate	34%	(34)%	35%
State income taxes, net of Federal benefit	1	(4)	5
Nondeductible expenses	2	9	9
Other	3	—	—
Valuation allowance	<u>(35)</u>	<u>17</u>	<u>(30)</u>
Effective income tax rate	<u><u>5%</u></u>	<u><u>(12)%</u></u>	<u><u>19%</u></u>

Note 7. Profit Sharing Plan:

The Company maintains a qualified 401 (k) profit sharing plan. Eligible employees may defer a portion of their salary. At the discretion of the Board of Directors, the Company may make matching contributions and discretionary contributions from profits. There were no Company contributions made in 2002, 2001 or 2000.

Note 8. Borrowings:*Short-Term Loans Payable*

During 2002, the Company entered into short-term repurchase agreements to finance a portion its mortgage-backed securities investments. The repurchase agreements are collateralized by certain of the Company's mortgage-backed securities and bear interest at rates that have related closely to LIBOR for a corresponding period. At December 31, 2002, the Company had borrowings of \$16,352 outstanding under a repurchase agreement that matures in August 2003 and has a borrowing rate of 2.01%. For the year ended December 31, 2002, the weighted average borrowing rate of the Company's repurchase agreements was 1.94% and the weighted average repurchase agreement balance was \$15,318.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

During 2002, the Company completed a \$20,000 working capital line of credit with a commercial bank. The line of credit is secured by employee receivables and is subject to liquidity tests. As of December 31, 2002, \$5,000 was outstanding under this line and \$15,000 was available to the Company at interest terms of LIBOR plus 1.95%. This line of credit expires in June 2003.

As of December 31, 2002, the Company had \$4,600 outstanding on margin borrowings with one of its asset management subsidiaries with an interest rate of 1.75%.

As of December 31, 2002, the Company maintains a \$40,000 subordinated revolving credit line with an affiliate of FBR & Co.'s clearing broker that expires in August 2004. There were no amounts outstanding under this line as of December 31, 2002. The purpose of this line of credit is to make additional funds available to meet regulatory net capital requirements for participation in underwriting public offerings. Any loans outstanding under this line are available in computing net capital under the Securities and Exchange Commission's (SEC) Uniform Net Capital Rule. As of December 31, 2001, the Company had \$10,000 outstanding under a similar \$40,000 subordinated line of credit at 4.75% interest. This outstanding balance was repaid during 2002.

In addition, as of December 31, 2001, mortgage-backed securities with a carrying value of \$3,400 were pledged to secure a \$2,000 revolving credit facility agreement with the Federal Home Loan Bank. This loan was subsequently repaid on January 2, 2002.

Long-Term Collateralized Loan

As of December 31, 2002, the Company had outstanding long-term debt of \$5,266 associated with the Company's acquisition of MMA/Rushmore. This note, is collateralized by the capital stock of FBR Bank, matures on January 2, 2011. Interest on this note is imputed at 9%.

Note 9. Regulatory Capital Requirements:

FBR & Co. and FBRIS are registered with the SEC and are members of the National Association of Securities Dealers, Inc. Additionally, FBRIL is registered with the Securities and Futures Authority (SFA) of the United Kingdom. As such, they are subject to the minimum net capital requirements promulgated by the SEC and SFA. As of December 31, 2002 and 2001, FBR & Co. had net capital of \$44,600 and \$35,400 that was \$41,900 and \$32,900 in excess of its required net capital of \$2,700 and \$2,500. As of December 31, 2002, all of our broker/dealers had net capital of \$46,900 that was \$43,400 in excess of its required net capital of \$3,500.

FHC's are required to maintain capital levels in accordance with regulatory requirements. The minimum ratio of total capital to risk weighted assets is 8.0 percent and the minimum ratio of tier one capital to risk weighted assets is 4.0 percent. As of December 31, 2002, we had total and tier one capital ratios of 81.0 percent and 51.6 percent, respectively.

FBR Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failures 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 amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require FBR Bank to maintain minimum amounts and ratios (set forth in the table below) 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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

(as defined). Management believes, as of December 31, 2001, FBR Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2001, the most recent notification from the Office of the Comptroller of the 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 as set forth in the table. There are no conditions or events since that notification that management believes have changed FBR Bank's category.

FBR Bank's capital amounts and ratios as of December 31, 2002 were:

<u>2002</u>	<u>Actual</u>		<u>To be Considered Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
Tier I Leverage Capital (to average adjusted total assets) . . .	\$7,104	9.15%	\$3,883	5.00%
Tier I Risk Based Capital (to risk weighted assets)	\$7,104	35.41%	\$1,204	6.00%
Total Risk Based Capital (to risk weighted assets)	\$7,527	36.25%	\$2,006	10.00%

FBR Bank's capital amounts and ratios as of December 31, 2001 were:

<u>2001</u>	<u>Actual</u>		<u>To be Considered Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
Tier I Leverage Capital (to average adjusted total assets) . . .	\$6,102	16.51%	\$1,848	5.00%
Tier I Risk Based Capital (to risk weighted assets)	\$6,102	38.65%	\$ 947	6.00%
Total Risk Based Capital (to risk weighted assets)	\$6,188	39.20%	\$1,579	10.00%

Note 10. Financial Instruments with Off-Balance-Sheet Risk and Credit Risk:*Financial Instruments*

The Company's broker-dealer entities trade securities that are primarily traded in United States markets. The Company's asset management entities trade and invest in public and non-public securities. As of December 31, 2002 and 2001, the Company had not entered into any transactions involving financial instruments, such as financial futures, forward contracts, options, swaps or derivatives that would expose the Company to significant related off-balance-sheet risk.

In addition, the Company has sold securities it does not currently own in anticipation of a decline in the fair value of that security (securities sold, not yet purchased). When the Company sells a security short and borrows the security to make a delivery, a gain, limited to the price at which the Company sold the security short, or a loss, unlimited in size, will be realized upon the termination of the short sale.

Market risk is primarily caused by movements in market prices of the Company's trading and investment account securities and changes in value of the underlying securities of the venture capital funds and other proprietary investment partnerships in which the Company invests. The Company's trading securities and investments are also subject to interest rate volatility and possible illiquidity in markets in which the Company trades or invests. The Company seeks to control market risk through monitoring procedures. The Company's principal transactions are primarily long and short equity and debt transactions.

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Positions taken and commitments made by the Company, including those made in connection with venture capital and investment banking activities, have resulted in substantial amounts of exposure to individual issuers and businesses, including non-investment grade issuers, securities with low trading volumes and those not readily marketable. These issuers and securities expose the Company to a higher degree of risk than associated with investment grade instruments.

The Company's investment in FBR Asset is subject to leverage and interest rate risk. FBR Asset's debt-to-equity ratio can increase or decrease at any time based on the amount FBR Asset may borrow. As a result, as FBR Asset increases its debt, the possibility that it may be unable to meet debt obligations as they come due increases. Financing assets through repurchase agreements exposes FBR Asset to the risk that margin calls will be made that FBR Asset may not be able to meet.

Credit Risk

The Company's broker-dealer subsidiaries function as introducing brokers that place and execute customer orders. The orders are then settled by an unrelated clearing organization that maintains custody of customers' securities and provides financing to customers.

Through indemnification provisions in agreements with clearing organizations, customer activities may expose the Company to off-balance-sheet credit risk. Financial instruments may have to be purchased or sold at prevailing market prices in the event a customer fails to settle a trade on its original terms or in the event cash and securities in customer margin accounts are not sufficient to fully cover customer obligations. The Company seeks to control the risks associated with customer activities through customer screening and selection procedures as well as through requirements on customers to maintain margin collateral in compliance with various regulations and clearing organization policies.

The Company's equity and debt investments include non-investment grade securities of privately held issuers with no ready markets. The concentration and illiquidity of these investments expose the Company to a higher degree of risk than associated with readily marketable securities.

The Company's bank loan portfolio is evaluated based on the risk characteristics that considers such factors as past loan loss experience, financial condition of the borrower, current economic conditions, net realizable value of the collateral and other relevant factors.

General Partnership and Managing Member Interests

As general partner of investment partnerships (or managing member of limited liability companies), certain of the Company's subsidiaries may be exposed to liabilities that exceed the balance sheet value of the Company's investment in the relevant vehicles. The hedge funds and other partnerships that we manage through subsidiaries as a general partner or managing member had \$103,800 of liabilities as of December 31, 2002, primarily margin debt, not reflected on our balance sheet.

Note 11. Commitments and Contingencies:***Contractual Obligations***

The Company has contractual obligations to make future payments in connection with short and long-term debt and non-cancelable lease agreements as well as uncalled capital commitments to various investment

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

partnerships that may be called over the next ten years. The following table sets forth these contractual obligations by fiscal year:

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>Thereafter</u>	<u>Total</u>
Short-term debt(1)	\$26,940	\$ —	\$ —	\$ —	\$ —	\$ —	\$26,940
Long-term debt	—	970	970	970	970	3,880	7,760
Minimum rental commitments(2)	3,319	3,177	2,929	2,854	2,739	2,377	17,395
Capital commitments(3)	—	—	—	—	—	—	—
Total Contractual Obligations	<u>\$30,259</u>	<u>\$4,147</u>	<u>\$3,899</u>	<u>\$3,824</u>	<u>\$3,709</u>	<u>\$6,257</u>	<u>\$52,095</u>

- (1) The short-term debt obligation in 2002 includes: \$16,352 of repurchase agreements, \$4,618 in the form of a demand note that may be called at anytime, \$5,000 in the form of a drawdown on a line-of-credit and the short-term portion of long-term debt of \$970.
- (2) Equipment and office rent expense for 2002, 2001 and 2000 were \$5,077, \$4,970 and \$3,914, respectively.
- (3) The table above excludes \$6,447 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.

Clearing Broker

FBR & Co. clears all of its securities transactions through a clearing broker on a fully disclosed basis. Pursuant to the terms of the agreements between FBR & Co. and the clearing broker, the clearing broker has the right charge FBRC for losses that result from a counterparty's failure to fulfill its contractual obligations.

As the right to charge FBR & Co. has no maximum amount and applies to all trades executed through the clearing broker, the Company believes there is no maximum amount assignable to this right. At December 31, 2002, the Company has recorded no liabilities and during 2002 incurred no significant costs with regard to this right.

Litigation

As of December 31, 2002, the Company was not a defendant or plaintiff in any lawsuits or arbitrations, nor involved in any governmental or self-regulatory 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. 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 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

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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.

Other

As of December 31, 2002, the Company had \$6,447 of unfunded capital commitments to various investment partnerships that may be called over the next ten years. In addition, as of December 31, 2002, the Company had made commitments to purchase approximately \$360,000 of mortgage-backed securities.

Note 12. Executive Officer Compensation:

During 2002, certain of the Company's executive officers were eligible for incentive bonuses under the Key Employee Incentive Plan (the "Key Employee Plan"). The incentive bonus pool is calculated as up to twenty percent of tax profits. During the year ended December 31, 2002, the Company recorded \$14,213 of executive officer compensation, and, as of December 31, 2002, \$4,518 of this executive officer compensation is accrued.

During 2001, certain of the Company's executive officers were eligible for bonuses under the Key Employee Plan. During 2001, in accordance with a performance formula that included revenue, net income, return on equity and share price measures, the Company accrued \$877 of executive officer compensation, in accordance with the Key Employee Plan. Compensation related to the Key Employee Plan was paid subsequent to December 31, 2001.

During 2000, certain of the Company's executive officers were eligible for bonuses under the Key Employee Plan. During 2000, in accordance with an income-based performance formula, the Company accrued \$6,500 of executive officer compensation, in accordance with the Key Employee Plan, representing 22.4% of the Company's pre-tax income (before executive officer compensation accruals). Compensation related to the Key Employee Plan was paid subsequent to December 31, 2000.

Note 13. Shareholders' Equity:

The Company has authorized share capital of 100 million shares of Class B Common Stock, par value \$0.01 per share; 150 million shares of Class A Common Stock, par value \$0.01 per share; and 15 million shares of undesignated preferred stock. Holders of the Class A and Class B Common Stock are entitled to one vote and three votes per share, respectively, on all matters voted upon by the shareholders. Shares of Class B Common Stock convert to shares of Class A Common Stock at the option of the Company in certain circumstances including (i) upon sale or other transfer, (ii) at the time the holder of such shares of Class B Common Stock ceases to be affiliated with the Company and (iii) upon the sale of such shares in a registered public offering. The Company's Board of Directors has the authority, without further action by the shareholders, to issue preferred stock in one or more series and to fix the terms and rights of the preferred stock. Such actions by the Board of Directors could adversely affect the voting power and other rights of the holders of common stock. Preferred stock could thus be issued quickly with terms that could delay or prevent a change in control of the Company or make removal of management more difficult. At present, the Company has no plans to issue any of the preferred stock.

Stock and Annual Incentive Plan (the Plan)

Under the Plan, the Company may grant options, stock appreciation rights, performance awards and restricted and unrestricted stock to purchase up to 14.9 million shares of Class A Common Stock to eligible participants in the Plan. Participants include employees and officers of the Company and its subsidiaries. The Plan has a term of 10 years and options granted have an exercise period of up to 10 years. Options may be

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incentive stock options, as defined by Section 422 of the Internal Revenue Code, or nonqualified stock options. Details of stock options granted are as follows:

	<u>Number of Shares</u>	<u>Exercise Price</u>
Balance as of December 31, 1997	4,383,400	\$20.00
Granted in 1998	2,160,280	\$5.875 – \$19.625
Forfeitures in 1998 upon departure of employees	<u>(293,200)</u>	\$5.875 – \$20.00
Balance as of December 31, 1998	6,250,480	\$5.875 – \$20.00
Granted in 1999	3,507,148	\$5.1875 – \$13.0625
Forfeitures in 1999 upon departure of employees	<u>(468,025)</u>	\$5.875 – \$20.00
Balance as of December 31, 1999	9,289,603	\$5.1875 – \$20.00
Granted in 2000	452,340	\$6.125 – \$16.875
Forfeitures in 2000 upon departure of employees	<u>(1,446,162)</u>	\$5.8125 – \$20.00
Exercised in 2000	<u>(240,518)</u>	\$5.875 – \$8.625
Balance as of December 31, 2000	8,055,263	\$5.1875 – \$20.00
Granted in 2001	4,567,721	\$4.61 – \$7.77
Forfeitures in 2001 upon departure of employees	<u>(1,512,641)</u>	\$5.8125 – \$20.00
Exercised in 2001	<u>(3,128,998)</u>	\$5.8125 – \$6.1875
Balance as of December 31, 2001	7,981,345	\$4.61 – \$20.00
Granted in 2002	488,500	\$5.19 – \$11.13
Forfeitures in 2002 upon departure of employees	<u>(313,174)</u>	\$5.81 – \$20.00
Exercised in 2002	<u>(600,333)</u>	\$5.45 – \$8.63
Balance as of December 31, 2002	<u>7,556,338</u>	\$4.50 – \$20.00

All options granted in 1997 and 70,780 of the options granted in 1998 become exercisable as follows: 10%, 40%, and 50% at the end of three, four and five years, respectively. The remainder of the grants in 1998, 2,089,500 options, and all grants in 1999, 2000, 2001 and 2002 become exercisable ratably over the first three years. As of December 31, 2002, 6,118,883 of the total options outstanding were exercisable. As of December 31, 2002 and 2001, respectively, the weighted average exercise price was \$10.47 and \$10.07 and the remaining contractual life of options outstanding was 5.4 years and 6.3 years, respectively.

Director Stock Compensation Plan

Under the Director Stock Compensation Plan (the Director Plan), the Company may grant options or stock (in lieu of annual director fees) up to 200,000 shares of Class A Common Stock to all non-employee directors as a group. Options granted under the Director Plan will vest upon the first anniversary of the grant and are exercisable up to 10 years from the date of grant. All options and stock awarded under the Director Plan are nontransferable other than by will or the laws of descent and distribution. During 2002, 2001 and 2000, respectively, the Company granted 19,000, 9,000, and 16,000 options under the Director Plan.

Employee Stock Purchase Plan

Employees began participating in the 1997 Employee Stock Purchase Plan (the Purchase Plan) on September 1, 1998. Under this Purchase Plan, one million shares of Class A Common Stock are reserved for issuance. The Purchase Plan permits eligible employees to purchase common stock through payroll deductions at a price equal to 85% of the lower of the market value of the common stock on the first day of the offering period or the last day of the offering period. The Purchase Plan does not result in compensation expense.

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During 2002, 241,574 shares were issued under the Purchase Plan for \$1,763. During 2001, 175,708 shares were issued under the Purchase Plan for \$878.

Employee Stock Purchase and Loan Plan

On June 26, 2001 and August 10, 2001, the Company repurchased 4,228,000 and 772,000 shares, respectively, of Class B common stock from an executive officer of the Company for \$5.50 per share. The shares were converted to Class A common stock and sold to other Company employees at the same price. Upon settlement of the repurchase and sales transactions on July 5, 2001 and August 15, 2001, respectively, the Company received 20% (\$1.10 per share) of the purchase price in cash from the employees, and received five-year, limited recourse promissory notes from the employees with interest accruing at 6.5% accreting to principal for the remaining purchase price. The notes are collateralized by all of the stock purchased under the plan.

For accounting purposes, the portion of the employee share purchase financed by the Company (80%) is considered a stock option, and deducted from shareholders' equity. These shares are deducted from shares outstanding, similar to treasury stock, in computing book value and earnings per share. As a result, both the \$24,182 financed (including accrued interest) by the Company and the 4,000,000 common shares related to the financing are reflected as a receivable in shareholders' equity. As the employees repay the loans, shareholders' equity and shares outstanding will increase. In addition, the interest earned on the employee loans was added to paid-in-capital and excluded from net income.

Treasury Stock

In July 1998, the Company's Board of Directors approved a plan to repurchase up to 2.5 million shares of the Company's Class A Common Stock from time to time (the Repurchase Plan). In accordance with the Repurchase Plan, a portion of the stock acquired may be used for the three stock-based compensation plans described previously. As of December 31, 2002 and 2001, the Company's treasury stock consists of stock purchased in the open market at cost. Treasury stock issuances relate to issuances of common stock pursuant to the Employee Stock Purchase Plan. Differences between the average cost of the treasury stock and the sales price of the shares issued are charged to additional paid-in capital. As of December 31, 2002, the Company had the ability under the Repurchase Plan to repurchase approximately 1 million shares of the Company's Class A common stock. The Company's treasury stock transactions were:

	<u>Shares</u>	<u>Cost</u>
Balance as of December 31, 1997.....	—	\$ —
Open market purchases	1,036,092	8,062
Employee Stock Purchase Plan issuances	<u>(126,055)</u>	<u>(981)</u>
Balance as of December 31, 1998.....	910,037	7,081
Open market purchases	431,935	2,712
Employee Stock Purchase Plan issuances	<u>(198,945)</u>	<u>(1,452)</u>
Balance as of December 31, 1999.....	1,143,027	8,341
Employee Stock Purchase Plan issuances	<u>(157,857)</u>	<u>(1,153)</u>
Balance as of December 31, 2000.....	985,170	7,188
Employee Stock Purchase Plan issuances	<u>(175,708)</u>	<u>(1,282)</u>
Balance as of December 31, 2001.....	809,462	5,906
Employee Stock Purchase Plan issuances	<u>(241,574)</u>	<u>(1,763)</u>
Balance as of December 31, 2002.....	<u>567,888</u>	<u>\$ 4,143</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

During the first quarter of 2003, pursuant to the Repurchase Plan, the Company purchased 976,600 shares of its Class A Common Stock at a cost of \$8,200.

Note 15. Segment Information:

The Company considers its capital markets and asset management operations to be two, separately reportable segments. During the third and fourth quarters of 2001, in response to market conditions the Company significantly scaled-down the online financial services segment and recorded impaired capitalized software costs associated with this segment. Therefore, beginning in 2002 the online financial services segment was combined with the capital markets segment. The accounting policies of these segments are the same as those described in Note 2. There are no significant revenue transactions between the segments. The Company's revenues from foreign operations totaled \$9,200, \$7,900, and \$4,700 in 2002, 2001 and 2000, respectively. The following tables illustrate the financial information for its segments for the years indicated.

	<u>Capital Markets</u>	<u>Asset Management</u>	<u>Consolidated Totals</u>
2002			
Total revenues	\$206,275	\$61,928	\$268,203
Compensation and benefits	123,857	23,215	147,072
Total expenses	170,878	41,884	212,762
Pre-tax income before extraordinary gain	35,397	20,044	55,441
Extraordinary gain	—	1,413	1,413
Pre-tax income after extraordinary gain	35,397	21,457	56,854
Total assets	135,067	271,118	406,185
Total net assets	71,476	173,689	245,165
2001			
Total revenues	\$139,851	\$20,938	\$160,789
Compensation and benefits	96,731	11,381	108,112
Total expenses	148,354	28,057	176,411
Pre-tax loss before extraordinary gain	(8,503)	(7,119)	(15,622)
Extraordinary gain	—	1,148	1,148
Pre-tax loss after extraordinary gain	(8,503)	(5,971)	(14,474)
Total assets	104,126	187,832	291,958
Total net assets	38,349	146,962	185,311
2000			
Total revenues	\$112,879	\$68,011	\$180,890
Compensation and benefits	74,457	35,311	109,768
Total expenses	114,067	44,578	158,645
Pre-tax income (loss)	(1,188)	23,433	22,245
Total assets	85,041	167,178	252,219
Total net assets	72,408	142,148	214,556

FRIEDMAN, BILLINGS, RAMSEY GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Note 16. Quarterly Data (Unaudited):

The following tables set forth selected information for each of the fiscal quarters during the years ended December 31, 2002, 2001 and 2000. The selected quarterly data is derived from unaudited financial statements of the Company and has been prepared on the same basis as the annual, audited financial statements to include, in the opinion of management, all adjustments (consisting of only normal recurring adjustments) necessary for fair presentation of the results for such periods.

	Total Revenues	Net Income (Loss) Before Income Taxes	Net Income (Loss) Before Extraordinary Items	Net Income (Loss) After Extraordinary Items	Basic Earnings (Loss) Per Share Before Extraordinary Items	Diluted Earnings (Loss) Per Share Before Extraordinary Items	Basic Earnings (Loss) Per Share After Extraordinary Items	Diluted Earnings (Loss) Per Share After Extraordinary Items
2002								
First Quarter	\$ 54,370	\$ 8,889	\$ 8,889	\$ 10,302	\$ 0.19	\$ 0.19	\$ 0.23	\$ 0.22
Second Quarter . . .	73,254	17,779	17,779	17,779	0.39	0.36	0.39	0.36
Third Quarter	81,712	17,992	15,649	15,113	0.34	0.32	0.33	0.31
Fourth Quarter	58,867	10,781	10,089	10,089	0.22	0.21	0.22	0.21
Total Year	<u>\$268,203</u>	<u>\$ 55,441</u>	<u>\$ 52,406</u>	<u>\$ 53,283</u>	<u>\$ 1.14</u>	<u>\$ 1.08</u>	<u>\$ 1.16</u>	<u>\$ 1.10</u>
2001								
First Quarter	\$ 22,453	\$ (6,139)	\$ (6,139)	\$ (6,139)	\$(0.12)	\$(0.12)	\$(0.12)	\$(0.12)
Second Quarter . . .	55,152	5,110	5,110	5,110	0.10	0.10	0.10	0.10
Third Quarter	21,783	(22,390)	(22,390)	(22,390)	(0.49)	(0.49)	(0.49)	(0.49)
Fourth Quarter	61,401	7,797	9,557	10,705	0.21	0.21	0.24	0.24
Total Year	<u>\$160,789</u>	<u>\$(15,622)</u>	<u>\$(13,862)</u>	<u>\$(12,714)</u>	<u>\$(0.29)</u>	<u>\$(0.29)</u>	<u>\$(0.27)</u>	<u>\$(0.27)</u>
2000								
First Quarter	\$ 66,243	\$ 8,556	\$ 6,417	\$ 6,417	\$ 0.13	\$ 0.12	\$ 0.13	\$ 0.12
Second Quarter . . .	43,536	6,065	5,280	5,280	0.11	0.11	0.11	0.11
Third Quarter	44,702	6,193	4,954	4,954	0.10	0.10	0.10	0.10
Fourth Quarter	26,409	1,431	1,431	1,431	0.03	0.03	0.03	0.03
Total Year	<u>\$180,890</u>	<u>\$ 22,245</u>	<u>\$ 18,082</u>	<u>\$ 18,082</u>	<u>\$ 0.37</u>	<u>\$ 0.36</u>	<u>\$ 0.37</u>	<u>\$ 0.36</u>

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Shareholders of FBR Asset Investment Corporation:

We have audited the accompanying consolidated statements of financial condition of FBR Asset Investment Corporation and subsidiaries (the "Company") as of December 31, 2002 and 2001, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the years in the three year period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FBR Asset Investment Corporation and subsidiaries as of December 31, 2002, and 2001, and the results of their operations and their cash flows for each of the years in the three year period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

McLean, Virginia
January 29, 2003

FBR ASSET INVESTMENT CORPORATION
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
As of December 31, 2002 and 2001

	<u>As of December 31, 2002</u>	<u>As of December 31, 2001</u>
ASSETS		
Mortgage-backed securities, at fair value	\$5,208,616,030	\$1,238,365,511
Investments in equity securities, at fair value	103,171,251	61,692,660
Cash and cash equivalents	17,049,984	6,630,379
Dividends, interest and fees receivable	36,341,740	10,241,837
Deposits	4,662	—
Note receivable	—	8,000,000
Prepaid expenses and other assets	440,664	194,831
Total assets	<u>\$5,365,624,331</u>	<u>\$1,325,125,218</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Repurchase agreements	\$4,535,881,000	\$1,105,145,000
Interest rate swaps	18,007,914	1,159,167
Interest payable	9,831,082	2,177,892
Dividends payable	40,539,215	10,645,659
Management and incentive fees payable	7,960,512	1,117,458
Accounts payable and accrued expenses	1,125,406	505,549
Income taxes payable	93,375	473,403
Other	16,606	35,544
Total liabilities	<u>4,613,455,110</u>	<u>1,121,259,672</u>
Shareholders' Equity:		
Preferred stock, par value \$.01 per share, 50,000,000 shares authorized	—	—
Common stock, par value \$.01 per share, 200,000,000 shares authorized, 26,154,332 and 8,502,527 shares issued and outstanding as of December 31, 2002 and December 31, 2001, respectively . . .	261,543	85,025
Additional paid-in capital	701,929,172	206,916,930
Accumulated other comprehensive income	64,939,642	15,154,257
Retained deficit	<u>(14,961,136)</u>	<u>(18,290,666)</u>
Total shareholders' equity	<u>752,169,221</u>	<u>203,865,546</u>
Total liabilities and shareholders' equity	<u>\$5,365,624,331</u>	<u>\$1,325,125,218</u>

The accompanying notes are an integral part of these statements.

FBR ASSET INVESTMENT CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
For the Years Ended December 31, 2002, 2001 and 2000

	Year Ended December 31,		
	2002	2001	2000
Revenue:			
Interest	\$176,204,590	\$32,390,594	\$18,758,866
Dividends	3,366,711	3,820,985	5,082,191
Fees	6,391,479	2,875,780	—
Total revenue	<u>185,962,780</u>	<u>39,087,359</u>	<u>23,841,057</u>
Expenses:			
Interest	67,557,800	14,612,625	10,935,130
Management and incentive fees	22,410,940	3,494,357	1,078,713
Professional fees and other	4,858,281	772,152	596,374
Total expenses	<u>94,827,021</u>	<u>18,879,134</u>	<u>12,610,217</u>
Realized gain on sale of mortgage-backed securities, net ...	11,786,103	1,106,598	67,358
Realized gain on sale of equity securities, net	16,637,023	2,768,534	2,692,304
Recognized loss on available-for-sale equity securities	—	(544,880)	(5,626,022)
Net income before taxes	<u>119,558,885</u>	<u>23,538,477</u>	<u>8,364,480</u>
Income tax provision	(2,488,895)	(473,403)	—
Net income	<u>\$117,069,990</u>	<u>\$23,065,074</u>	<u>\$ 8,364,480</u>
Basic earnings per share	<u>\$ 5.73</u>	<u>\$ 4.27</u>	<u>\$ 1.84</u>
Basic weighted-average common and equivalent shares	<u>20,431,759</u>	<u>5,402,150</u>	<u>4,543,532</u>
Diluted earnings per share	<u>\$ 5.72</u>	<u>\$ 4.17</u>	<u>\$ 1.84</u>
Diluted weighted-average common and equivalent shares ..	<u>20,454,850</u>	<u>5,525,270</u>	<u>4,543,532</u>

The accompanying notes are an integral part of these statements.

FBR ASSET INVESTMENT CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
For the Years Ended December 31, 2002, 2001 and 2000

	Common Stock	Additional Paid In Capital	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Total	Comprehensive Income
Balance, December 31, 1999	\$ 58,063	\$132,930,479	\$ (15,463,462)	\$ (12,982,359)	\$ 104,542,721	
Repurchase of common stock	(19,219)	(25,401,416)	—	—	(25,420,635)	
Net income	—	—	8,364,480	—	8,364,480	\$ 8,364,480
Other comprehensive income						
Change in unrealized loss on available-for-sale securities	—	—	—	12,233,668	12,233,668	12,233,668
Dividends	—	—	(12,879,650)	—	(12,879,650)	—
Balance, December 31, 2000	<u>38,844</u>	<u>107,529,063</u>	<u>(19,978,632)</u>	<u>(748,691)</u>	<u>86,840,584</u>	<u>\$ 20,598,148</u>
Issuance of common stock	50,300	107,575,383	—	—	107,625,683	
Repurchase of common stock	(4,119)	(8,330,016)	—	—	(8,334,135)	
Options granted	—	142,500	—	—	142,500	
Net income	—	—	23,065,074	—	23,065,074	\$ 23,065,074
Other comprehensive income						
Change in unrealized gain (loss) on available-for-sale securities	—	—	—	17,062,115	17,062,115	17,062,115
Change in unrealized loss on cash flow hedge	—	—	—	(1,159,167)	(1,159,167)	(1,159,167)
Dividends	—	—	(21,377,108)	—	(21,377,108)	—
Balance, December 31, 2001	<u>85,025</u>	<u>206,916,930</u>	<u>(18,290,666)</u>	<u>15,154,257</u>	<u>203,865,546</u>	<u>\$ 38,968,022</u>
Issuance of common stock	176,518	495,012,242	—	—	495,188,760	
Net income	—	—	117,069,990	—	117,069,990	\$117,069,990
Other comprehensive income						
Reclassification adjustment for gains from disposition included in net income	—	—	—	(6,789,432)	(6,789,432)	(6,789,432)
Change in unrealized gain (loss) on available-for-sale securities	—	—	—	73,032,314	73,032,314	73,032,314
Change in unrealized loss on cash flow hedges	—	—	—	(16,457,497)	(16,457,497)	(16,457,497)
Dividends	—	—	(113,740,460)	—	(113,740,460)	—
Balance, December 31, 2002	<u>\$261,543</u>	<u>\$701,929,172</u>	<u>\$ (14,961,136)</u>	<u>\$ 64,939,642</u>	<u>\$ 752,169,221</u>	<u>\$166,855,375</u>

The accompanying notes are an integral part of these statements.

FBR ASSET INVESTMENT CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2002, 2001 and 2000

	For the Year Ended December 31		
	2002	2001	2000
Cash flows from operating activities:			
Net income	\$ 117,069,990	\$ 23,065,074	\$ 8,364,480
Adjustments to reconcile net income to net cash provided by operating activities:			
Realized and recognized (gain) loss on mortgage-backed and equity securities, net	(28,423,126)	(3,330,252)	2,866,360
Amortization	—	—	4,717
Premium amortization on mortgage-backed securities	26,981,853	4,779,118	296,626
Compensation expense related to stock option grants	293,092	142,500	—
Changes in operating assets and liabilities:			
Dividends, interest and fees receivable	(26,099,903)	(8,428,358)	1,227,197
Due from custodian	—	—	806,093
Prepaid expenses and other	(245,833)	26,797	31,888
Management and incentive fees payable	6,843,054	1,038,731	(158,440)
Accounts payable and accrued expenses	619,858	268,329	107,539
Interest payable	7,653,190	1,333,051	357,619
Income taxes payable	(380,028)	473,403	—
Other	(23,600)	(139,241)	(3,519)
Net cash provided by operating activities	<u>104,288,547</u>	<u>19,229,152</u>	<u>13,900,560</u>
Cash flows from investing activities:			
Purchase of mortgage-backed securities	(6,039,012,781)	(1,340,540,932)	(40,917,985)
Investments in equity securities	(80,480,030)	(30,269,000)	(1,801,410)
Investments in notes receivable	(33,137,333)	(12,000,000)	(4,000,000)
Repayment of notes receivable	41,137,333	8,000,000	27,000,000
Proceeds from sale of mortgage-backed securities	780,480,734	96,938,432	101,529,084
Proceeds from sale of equity securities	44,211,458	14,201,575	29,239,857
Receipt of principal payments on mortgage-backed securities	<u>1,350,755,663</u>	<u>158,183,398</u>	<u>23,720,735</u>
Net cash (used in) provided by investing activities	<u>(3,936,044,956)</u>	<u>(1,105,486,527)</u>	<u>134,770,281</u>
Cash flows from financing activities:			
Proceeds from (repayments of) repurchase agreements, net	3,430,736,000	971,249,000	(87,818,000)
Proceeds from issuance of common stock	494,895,668	107,625,683	—
Dividends paid	(83,846,904)	(14,463,360)	(12,039,107)
Proceeds from termination of eurodollar futures contracts	391,250	—	—
Repurchase of common stock	—	(8,334,135)	(25,420,635)
Net cash provided by (used in) financing activities	<u>3,842,176,014</u>	<u>1,056,077,188</u>	<u>(125,277,742)</u>
Net increase (decrease) in cash and cash equivalents	10,419,605	(30,180,187)	23,393,099
Cash and cash equivalents, beginning of the period	6,630,379	36,810,566	13,417,467
Cash and cash equivalents, end of the period	<u>\$ 17,049,984</u>	<u>\$ 6,630,379</u>	<u>\$ 36,810,566</u>
Supplemental disclosure:			
Cash payments for interest	<u>\$ 59,904,610</u>	<u>\$ 13,279,574</u>	<u>\$ 10,577,511</u>
Cash payments for income tax	<u>\$ 2,868,923</u>	<u>\$ —</u>	<u>\$ —</u>

The accompanying notes are an integral part of these statements.

FBR ASSET INVESTMENT CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Organization and Nature of Operations

FBR Asset Investment Corporation (“FBR Asset” or the “Company”) was incorporated in Virginia on November 10, 1997. FBR Asset commenced operations on December 15, 1997, upon the closing of a private placement of equity capital.

FBR Asset is organized as a real estate investment trust (“REIT”) whose primary purpose is to purchase mortgage-backed securities and make investments in debt and equity securities of companies engaged in real estate-related and other businesses. The Company invests in mortgage loans and mortgage-backed securities, that represent a 100 percent interest in the underlying conforming mortgage loans and are guaranteed by the Government National Mortgage Association (“Ginnie Mae”), the Federal Home Loan Mortgage Corporation (“Freddie Mac”), and the Federal National Mortgage Association (“Fannie Mae”), or by private issuers that are secured by real estate (together the “Mortgage Assets”). The Company also acquires indirect interests in those and other types of real estate-related assets by investing in public and private real estate companies, subject to the limitations imposed by the various REIT qualification requirements. Funds not immediately allocated are generally temporarily invested in readily marketable, interest-bearing securities. To seek yields commensurate with its investment objectives, the Company leverages its mortgage-backed security portfolio primarily with collateralized borrowings. The Company uses derivative financial instruments to hedge a portion of the interest rate risk associated with its borrowings.

During 2001, FBR Asset acquired a registered broker-dealer from Friedman, Billings, Ramsey, Group Inc. (“FBR Group”) called Pegasus Capital Corporation (“Pegasus”). At this time the Company made a taxable REIT subsidiary election for Pegasus, established another taxable REIT subsidiary and created a holding company to hold the two subsidiaries.

The Company is managed by Friedman, Billings, Ramsey Investment Management, Inc. (“FBR Management”), a subsidiary of FBR Group.

Merger Agreement with FBR Group

On November 15, 2002, the Company and FBR Group announced that they had signed a definitive agreement to merge the two firms in a tax-free stock for stock exchange. Under terms of the transaction, each share of FBR Asset common stock outstanding at closing will be converted into 3.65 shares of Class A Common Stock, and each share of FBR Group will be converted into one corresponding Class A or Class B share of a new entity which will elect REIT status for tax purposes.

The transaction is subject to customary closing conditions, including regulatory approvals and the approval of both the Company’s and FBR Group’s shareholders. A special meeting of the Company’s shareholders will be held in the first quarter 2003 to vote on the proposed merger. If the shareholders of the Company and FBR Group approve the merger agreement, the transaction is expected to close by the end of the first quarter of 2003. If approved, the merger will be accounted for as a purchase of FBR Asset by FBR Group using the purchase method of accounting.

Under the terms of the transaction, the board of directors of both FBR Group and FBR Asset will be merged, resulting in a nine member board of directors. Seven of the nine members of the reconstituted board will be outside directors. The transaction was approved by the Special Committee of the FBR Asset Board of Directors, consisting of all of the directors of FBR Asset who are not affiliated with FBR Group. The FBR Asset Special Committee was advised by Lehman Brothers Inc.

As of December 31, 2002, the Company had incurred approximately \$2.4 million in costs associated with this proposed merger. These costs are reflected in professional fees and other in the Consolidated Statements of Income for the year ended December 31, 2002. In addition, if the merger is consummated, under the terms of its agreement with Lehman Brothers, FBR Asset has agreed to pay Lehman Brothers a fee equal to 0.30%

FBR ASSET INVESTMENT CORPORATION
NOTES TO FINANCIAL STATEMENTS — (Continued)

of the FBR Asset Market Value at the time the merger is consummated, as defined. If the merger was consummated on January 31, 2003 this fee would have been approximately \$2.4 million.

Note 2 Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include the Company and its subsidiaries. All significant inter-company accounts and transactions have been eliminated in the consolidation.

Investments in Mortgage-Backed Securities

Mortgage-backed security transactions are recorded on the date the securities are purchased or sold. Any amounts payable or receivable for unsettled trades are recorded as “due to or due from custodian” in the Company’s Statement of Financial Condition.

The Company accounts for its investments in mortgage-backed securities as available-for-sale securities. The Company does not hold its mortgage-backed securities for trading purposes, but may not hold such investments to maturity. Securities classified as available-for-sale are reported at fair value, with temporary unrealized gains and losses excluded from earnings and reported as a separate component of shareholders’ equity. Realized gains and losses on mortgage-backed securities transactions are determined on the average cost.

Unrealized losses on mortgage-backed securities that are determined to be other than temporary are recognized in income. Management regularly reviews its investment portfolio for other than temporary market value decline. There were no such adjustments for mortgage-backed investments during the periods presented.

The fair value of the Company’s mortgage-backed securities are based on market prices provided by certain independent dealers who make markets in these financial instruments. The fair values reported reflect estimates and may not necessarily be indicative of the amounts the Company could realize in a current market transaction.

Income from investments in mortgage-backed securities is recognized using the effective interest method, using the expected yield over the life of the investment. Income includes contractual interest accrued and the amortization or accretion of any premium or discount recorded upon purchase. Changes in anticipated yields result primarily from changes in actual and projected cash flows and estimated prepayments. Changes in the yield that result from changes in the anticipated cash flows and prepayments are recognized over the remaining life of the investment with recognition of a cumulative catch-up at the date of change from the date of original investment.

Investments in Equity Securities

Investments in securities that are listed on a national securities exchange (or reported on the Nasdaq National Market) are stated at the last reported sale price on the day of valuation. Listed securities for which no sale was reported are stated at the mean between the closing “bid” and “asked” price on the day of valuation. Investments which are not listed on a national securities exchange (or reported on a national securities exchange) are carried at cost.

Consistent with the intention to have the Company operate as a REIT, management concluded that its investments in equity securities are being held for long-term yield, capital appreciation, and cash flow. Accordingly, management has classified such investments as available-for-sale.

Realized gains and losses are recorded on the date of the transaction using the specific identification method. The difference between the purchase price and market price (or fair value) of investments in

FBR ASSET INVESTMENT CORPORATION
NOTES TO FINANCIAL STATEMENTS — (Continued)

securities is reported as an unrealized gain or loss and a component of comprehensive income. Dividend income is recognized on the ex-dividend date.

Management regularly reviews any declines in the market value of its equity investments for declines that are other than temporary. Such declines are recorded in operations as a “recognized loss on available-for-sale securities.”

Note Receivable

Notes Receivable are carried at cost as the Company has the intent to hold such notes receivable for the foreseeable future. Interest income is recognized using the effective interest method which recognizes any fees or costs related to the Note over its life. If it becomes probable the Company will not collect the scheduled payments on the Notes Receivable then the Note Receivable is considered impaired and written down to fair value if applicable.

Cash and Cash Equivalents

All investments with original maturities of less than three months are cash equivalents. As of December 31, 2002, cash and cash equivalents consisted of \$4.2 million of cash deposited in two commercial banks and \$12.8 million in three separate domestic money market funds. As of December 31, 2001, cash and cash equivalents consisted of \$1.4 million of cash deposited in two commercial banks and \$5.2 million in three separate domestic money market funds. The carrying amount of cash equivalents approximates their fair value.

Comprehensive Income

Comprehensive income includes net income as currently reported by the Company on the statement of income adjusted for other comprehensive income. Other comprehensive income for the Company is changes in unrealized gains and losses related to the Company’s mortgage-backed securities and equity securities accounted for as available-for-sale with changes in fair value recorded through shareholders’ equity and changes in unrealized gains and losses related to the Company’s use of cash flow hedges.

Net Income Per Share

FBR Asset presents basic and diluted earnings per share. Basic earnings per share excludes potential dilution and is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that would share in earnings. This includes stock options for the Company which were dilutive for the periods presented.

Use of Estimates

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 as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Income Taxes

FBR Asset has elected to be taxed as a REIT under the Internal Revenue Code. To qualify for tax treatment as a REIT, FBR Asset must meet certain income and asset tests and distribution requirements. FBR Asset generally will not be subject to federal income tax at the corporate level to the extent that it

FBR ASSET INVESTMENT CORPORATION
NOTES TO FINANCIAL STATEMENTS — (Continued)

distributes at least 90 percent of its taxable income to its shareholders and complies with certain other requirements. Failure to meet these requirements could have a material adverse impact on FBR Asset's results or financial condition. Furthermore, because FBR Asset's investments include stock in other REITs, failure of those REITs to maintain their REIT status could jeopardize FBR Asset's qualification as a REIT.

Income generated by the Company's taxable REIT subsidiaries will generally be taxed at normal corporate rates and will generally not be distributed to our shareholders. For the years ended December 31, 2002 and 2001, FBR Asset recorded \$2.5 million and \$.5 million of income tax provisions from income attributable to the taxable REIT subsidiaries.

Stock Compensation

The Company accounts for its stock-based compensation in accordance with SFAS No. 123 "Accounting for Stock Based Compensation." Pursuant to SFAS No. 123, the Company applies the provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" (APB No. 25) for stock options issued to employees and non-employee directors. Under APB No. 25, compensation expense is recorded to the extent the fair market value of the Company's stock exceeds the strike price of the option on the date of grant.

Financial Instruments

Management believes that insignificant differences exist between the carrying value and the fair value of financial instruments except as otherwise noted in the footnotes to the financial statements.

Note 3 Mortgage-Backed Securities

The following tables summarize FBR Asset's mortgage-backed securities as of December 31, 2002 and 2001:

<u>Total Mortgage Assets</u>	<u>December 31, 2002</u>	<u>December 31, 2001</u>
Mortgage-backed securities, available-for-sale(1)	\$5,048,575,748	\$1,211,550,848
Unamortized net premium	<u>80,940,852</u>	<u>25,385,118</u>
Amortized cost	5,129,516,600	1,236,935,966
Gross unrealized gains	79,234,339	4,092,851
Gross unrealized losses	<u>(134,909)</u>	<u>(2,663,306)</u>
Estimated fair value	<u>\$5,208,616,030</u>	<u>\$1,238,365,511</u>

(1) Includes principal receivable of \$136,084,057.

As of December 31, 2002 and 2001, respectively, \$4.5 billion and \$1.2 billion of the mortgage-backed securities were pledged as collateral for the repurchase agreements and interest rate swaps. As of December 31, 2002, FBR Asset had made commitments to purchase \$1.4 billion of hybrid ARM securities.

During 2002, FBR Asset received proceeds of \$780.5 million from the sale of mortgage-backed securities. The Company recorded \$12.1 million in gross realized gains and \$0.3 million in gross realized losses related to these sales. For the year ended December 31, 2002 the weighted average coupon rate on mortgage-backed securities was 5.43% and the weighted average effective yield was 4.63%. The weighted average life of the mortgage-backed securities based on assumptions used to determine fair value was 2.35 years at December 31, 2002.

During 2001, FBR Asset received proceeds of \$96.9 million from the sale of mortgage-backed securities. The Company recorded \$1.1 million in gross realized gains related to these sales and incurred no realized

FBR ASSET INVESTMENT CORPORATION
NOTES TO FINANCIAL STATEMENTS — (Continued)

losses. For the year ended December 31, 2001 the weighted average coupon rate on mortgage-backed securities was 6.38% and the weighted average effective yield was 5.81%. The weighted average life of the mortgage-backed securities based on assumptions used to determine fair value was 4.37 years at December 31, 2001.

During 2000, FBR Asset received proceeds of \$101.5 million from the sale of mortgage-backed securities. The Company recorded \$1.7 million in gross realized losses and \$0.3 million in gross realized gains related to these sales. Concurrent with these sales, FBR Asset terminated a related hedge position and recorded a \$1.5 million gain. For the year ended December 31, 2000 the weighted average coupon rate on mortgage-backed securities was 7.00% and the weighted average effective yield was 6.68%. The weighted average life of the mortgage-backed securities based on assumptions used to determine fair value was 4.20 years at December 31, 2000.

Note 4 Equity Investments

At December 31, 2002, FBR Asset's equity investments had an aggregate cost basis of \$99.7 million, a fair value of \$103.2 million, unrealized gains of \$6.7 million and unrealized losses of \$3.2 million.

At December 31, 2001, FBR Asset's equity investments had an aggregate cost basis of \$46.8 million, fair value of \$61.7 million, and unrealized gains of \$14.9 million.

Equity Investments	December 31, 2002			December 31, 2001		
	Shares	Cost Basis	Fair Value	Shares	Cost Basis	Fair Value
American Financial Realty Trust(1) ..	3,763,441	\$35,000,001	\$ 35,000,001	—	\$ —	\$ —
Americredit Corp.	5,000,000	35,250,000	38,700,000	—	—	—
Annaly Mortgage Management, Inc. . .	—	—	—	800,000	7,144,000	12,800,000
Anworth Mortgage Asset Corporation	—	—	—	500,000	3,890,625	4,550,000
Capital Automotive REIT.....	—	—	—	920,115	12,835,604	18,301,087
Franklin Bank Corp.(1)	600,000	5,580,000	5,580,000	—	—	—
MCG Capital Corporation	625,000	9,934,375	6,731,250	625,000	9,934,375	11,125,000
Oxford Finance Corp.(1)	500,000	4,650,000	4,650,000	—	—	—
RAIT Investment Trust	—	—	—	344,575	3,704,181	5,616,573
Saxon Capital, Inc.	1,000,000	9,300,000	12,510,000	1,000,000	9,300,000	9,300,000
Total		<u>\$99,714,376</u>	<u>\$103,171,251</u>		<u>\$46,808,785</u>	<u>\$61,692,660</u>

(1) American Financial Realty Trust, Franklin Bank Corp., and Oxford Finance Corp. shares are not currently registered for public trading. As of December 31, 2002 these investments were carried at cost.

During 2002, FBR Asset received proceeds of \$44.2 million from the sale of equity securities. The Company recorded \$16.6 million in gross realized gains and no realized losses related to these sales. During 2001, FBR Asset received proceeds of \$14.2 million from the sale of equity securities. The Company recorded \$3.0 million in gross realized gains and \$0.2 million in gross realized losses related to these sales. During 2000, FBR Asset received proceeds of \$29.2 million from the sale of equity securities. The Company recorded \$2.9 million in gross realized gains and \$0.2 million in gross realized losses related to these sales.

Warrants

FBR Asset owns warrants to acquire 131,096 shares of Kennedy-Wilson common stock at a price of \$7.5526 per share. The warrants expire in June 2003. As of December 31, 2002, the market price of Kennedy-Wilson common stock was \$3.69 per share. As of December 31, 2001, the market price of Kennedy-Wilson common stock was \$4.24 per share.

FBR ASSET INVESTMENT CORPORATION
NOTES TO FINANCIAL STATEMENTS — (Continued)

Note 5 Repurchase Agreements

FBR Asset has entered into short-term repurchase agreements to finance a significant portion of its mortgage-backed investments. The repurchase agreements are secured by certain of FBR Asset's mortgage-backed securities and bear interest at rates that have historically related closely to LIBOR for a corresponding period.

At December 31, 2002, the Company had borrowings of \$4.5 billion outstanding under repurchase agreements with a weighted average borrowing rate of 1.35% and a remaining weighted-average term to maturity of 20 days. For the year ending December 31, 2002, the weighted average borrowing rate of the Company's repurchase agreements was 1.73% and the weighted average repurchase agreement balance was \$3.5 billion. At December 31, 2001, the Company had borrowings of \$1.1 billion outstanding under repurchase agreements with a weighted average borrowing rate of 1.87% and a remaining weighted-average term to maturity of 15 days.

Financing assets through repurchase agreements exposes us to the risk that margin calls will be made (when the loan to value increases above the lenders limit) and that we will not be able to meet those margin calls. Although we have not in the past received any margin calls, there can be no assurance that we will not receive margin calls in the future or, if received, that we will be able to meet those future margin calls. To meet margin calls the Company may sell mortgage-backed securities and those sales of mortgage-backed securities could result in realized losses.

Note 6 Derivative Financial Instruments and Hedging Activities

FBR Asset may from time to time enter into interest rate swap agreements to offset the potential adverse effects of rising interest rates under certain short-term repurchase agreements. The interest rate swap agreements have historically been structured such that FBR Asset receives payments based on a fixed interest rate. The variable interest rate on which payments are received is calculated based on the three-month LIBOR. FBR Asset's repurchase agreements generally have maturities of 30 to 90 days and carry interest rates that correspond to LIBOR rates for those same periods. The swap agreements effectively fix FBR Asset's borrowing cost and are not held for speculative or trading purposes. The Company utilizes derivative financial instruments to hedge the interest rate risk associated with its borrowings.

At December 31, 2002, FBR Asset was party to four interest rate swap agreements. These derivative contracts are with primary broker dealers. 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.

The notional amount of each agreement is matched against a like amount of current and anticipated borrowings under repurchased agreements to hedge the variability in interest payments associated with the repurchase agreements. The interest rate swap agreements are highly effective hedges and qualify as cash flow hedges under SFAS No. 133, "Accounting for Derivative Instruments and for Hedging Activities," as amended ("FAS 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.

FBR ASSET INVESTMENT CORPORATION
NOTES TO FINANCIAL STATEMENTS — (Continued)

Derivative Financial Instruments at December 31, 2002:

Interest Rate Swaps

<u>Current Notional Amount</u>	<u>Average Fixed Rate</u>	<u>Three-month LIBOR Rate</u>	<u>Termination Date</u>	<u>Fair Value</u>
\$3,000,000,000	2.149%(1)	1.768%(1)	July 21, 2003(1)	\$(14,587,307)
<u>50,000,000</u>	4.970%	1.830%	July 27, 2004	<u>(3,420,607)</u>
<u>\$3,050,000,000</u>				<u>\$(18,007,914)</u>

(1) Average of three, one billion dollar notional swaps

Derivative Financial Instruments at December 31, 2001:

<u>Current Notional Amount</u>	<u>Average Fixed Rate</u>	<u>Three-month LIBOR Rate</u>	<u>Termination Date</u>	<u>Fair Value</u>
\$50,000,000	4.970%	2.280%	July 27, 2004	\$(1,159,167)

During the third quarter of 2002, the Company purchased two Eurodollar futures contracts. As part of the Company's interest rate risk management, on October 15, 2002, the Company closed out its Eurodollar futures contracts. These transactions resulted in a deferred gain of approximately \$0.4 million. This deferred gain is currently recorded in other comprehensive income and will be amortized into income over the original hedge period of July through December 2003. Further, of the December 31, 2002 value of the interest rate swaps, all but approximately \$1.1 million will flow through the Company's income statement over the next twelve months.

The total change in the fair value of the Company's derivative financial instruments was \$16.8 million for the year ended December 31, 2002. The changes in fair value of these derivatives have been reported in other comprehensive income.

Note 7 Shareholders' Equity

Equity Offerings

On August 2, 2001, the Company completed a follow-on offering of 4,500,000 shares of common stock at a price of \$23.00 per share. The lead underwriter for the offering was Friedman, Billings, Ramsey & Co., Inc. ("FBR") a wholly owned subsidiary of FBR Group. The proceeds after expenses to the company were \$97.1 million.

On January 28, 2002, the Company completed a follow-on offering of 5,520,000 shares (including over allotment option) of common stock at a price of \$26.50 per share. The lead underwriter for the offerings was FBR. The net proceeds after expenses to the Company were \$138.6 million.

On April 3, 2002, the Company completed a follow-on offering of 4,600,000 shares (including over allotment option) of common stock at a price of \$27.90 per share. The lead underwriter for the offering was FBR. The net proceeds after expenses to the Company were \$121.7 million.

On June 28, 2002, the Company completed a follow-on offering of 6,000,000 shares of common stock at a price of \$33.35 per share. The lead underwriter for the offering was FBR. The net proceeds after expenses to the Company were \$189.9 million.

On December 6, 2002, the Company completed a follow-on offering of 1,100,000 shares of common stock at a price of \$33.65 per share directly to two investors. The net proceeds after expenses to the Company were \$37.0 million.

FBR ASSET INVESTMENT CORPORATION
NOTES TO FINANCIAL STATEMENTS — (Continued)

Dividends and Share Repurchases

The Company has declared the following dividends.

<u>Year</u>	<u>Per Share</u>
2002	\$5.30
2001	\$3.30
2000	\$2.95

The Company has repurchased the following shares of its common stock.

<u>Year</u>	<u>Shares</u>	<u>Cost</u>	<u>Average price per share</u>
2002	—	\$ —	\$ —
2001	411,900	\$ 8,334,135	\$20.23
2000	1,921,909	\$25,420,635	\$13.23

Options

On February 14, 2002, a subsidiary of FBR Group exercised its remaining options to purchase 415,805 shares of FBR Asset common stock for \$8.3 million, or \$20 per share. FBR Group also advised FBR Asset that it has no current intention to sell any of the shares acquired via option exercises or any of its other shares held for investment purposes.

As of December 31, 2002 and December 31, 2001, 66,095 and 481,900 options to purchase common stock were outstanding, respectively. These options have terms of eight to ten years and an exercise price of \$20 per share. As a result, 23,091 and 123,120 shares were included as diluted shares for EPS purposes during the years ended December 31, 2002 and 2001. The shareholders approved an increase of 450,000 shares available for issuance under the stock incentive plan in 2002 and as of December 31, 2002, 444,000 options were available for future grant.

	<u>Number of Shares</u>	<u>Exercise Price</u>
Balance as of December 31, 1999	1,021,900	\$20.00
Granted in 2000	—	—
Balance as of December 31, 2000	1,021,900	\$20.00
Granted in 2001	15,000	\$15.00
Forfeitures in 2001 upon departure of employees	(25,000)	\$20.00
Exercised in 2001	(530,000)	\$15.00 – \$20.00
Balance as of December 31, 2001	481,900	\$20.00
Exercised in 2002	(415,805)	—
Balance as of December 31, 2002	66,095	\$20.00

In accordance with the disclosure requirements of SFAS No. 123, the Company does provide pro forma net income disclosures for options granted to employees and non-employee directors as if the fair value method, as defined in SFAS No. 123, had been applied for the purpose of computing compensation expense. The issued and outstanding employee options under the fair value method had no impact on the Company's net income or basic and diluted net income per share as reported in the statement of income for the year ended December 31, 2002 and was not material to 2001 and 2000.

FBR ASSET INVESTMENT CORPORATION
NOTES TO FINANCIAL STATEMENTS — (Continued)

During 2002, pursuant to the approval of the Company's Board of Directors, the Company issued 16,000 shares of restricted stock to employees of Friedman, Billings, Ramsey Investment Management, Inc. (FBRIM) who provide services to the Company. These shares vest over three years. For the year ended December 31, 2002, the Company recorded \$293,092 of compensation expense relating to these grants.

Note 8 Related Party Transactions

FBR Group Ownership Interest

As of December 31, 2002, FBR Group, through various subsidiaries and affiliates, owned 2,844,700 shares or 10.88% of the outstanding common stock of the Company. As of December 31, 2001, FBR Group, through various subsidiaries and affiliates, owned 2,349,186 shares or 27.63% of the outstanding common stock of the Company.

Management Agreement

The Company has a management agreement with FBRIM, a wholly owned subsidiary of FBR Group, expiring on December 17, 2003. FBRIM performs portfolio management services on behalf of the Company. These services include, but are not limited to, making investment purchases and sales, collecting market information, submitting reports pertaining to the Company's assets, interest rates, and general economic conditions, and periodic review and evaluation of the performance of the Company's portfolio of assets.

On March 22, 2002, FBRIM notified Fixed Income Discount Advisory Company ("FIDAC"), that it had determined to terminate the sub-advisory agreement with FIDAC based on FBRIM's determination, after consultation with the Company's Board of Directors, that it would be in the best interests of the Company and its shareholders to terminate the sub-advisory agreement in light of the increased size of the Company's equity capital and mortgage-backed securities portfolio. The sub-advisory agreement ended in accordance with its terms on April 30, 2002. Concurrently with the end of the sub-advisory agreement, FBR Asset and FBRIM reduced the management fee that the Company will be required to pay from 0.25% to 0.20% per annum of the average book value of the Company's mortgage assets during each calendar quarter.

FBRIM is entitled to 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 the Company 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 the Company's invested assets during each calendar quarter. The Company recorded \$8.6 million in management fees during the year ended December 31, 2002 and \$1.8 million for the year ended December 31, 2001.

FBRIM is also entitled to receive incentive compensation based on the performance of the Company. FBRIM is entitled to an incentive fee calculated based upon the preceding four quarters. FBRIM is entitled to an incentive fee calculated as: Funds from operations, plus net realized gains or losses from asset sales, less the threshold amount (all computed on a weighted average outstanding share basis), multiplied by 25 percent. The threshold amount is calculated as the weighted average issuance price per share of all shares of the Company, which was \$25.59 at December 31, 2002, multiplied by a rate equal to the average of the weekly closing rate of the ten-year U.S. Treasury note during the previous 52-week period plus five percent per annum. The Company recorded \$13.8 million in incentive fees during the year ended December 31, 2002 and \$1.7 million for the year ending December 31, 2001.

Fees

The Company and its registered broker-dealer subsidiary, Pegasus entered into an agreement in August 2001 with FBR regarding the Company's extension of credit to or investment in entities that are or may be FBR investment banking clients. In circumstances where FBR determines that a commitment by the

FBR ASSET INVESTMENT CORPORATION
NOTES TO FINANCIAL STATEMENTS — (Continued)

Company to make a loan to or investment in an entity (each an “investment opportunity”) would facilitate a possible investment banking transaction, FBR presents the investment opportunity to the Company. The Investment Committee of the Company, which is comprised of Richard J. Hendrix, the Company’s President and Chief Operating Officer and Eric F. Billings, the Company’s Chairman and Chief Executive Officer, reviews the investment opportunity and decides whether or not to recommend a commitment by the Company to make a loan or an investment based on its investment criteria. Mr. Billings is also an executive officer of FBR Group, FBR Management and FBR, and Mr. Hendrix is also a Managing Director of FBR and FBR Management. The approval of the Contracts Committee of the Company’s Board of Directors (comprised of the Company’s three independent directors), which requires the affirmative vote of at least two of the Company’s independent directors, is required before any investment or loan is made in or to a client or proposed client of FBR. If the Company decides to make a loan or investment commitment to an entity, the commitment is not contingent on FBR being engaged to provide investment banking services by the entity. If, however, FBR is engaged to provide investment banking services to the entity, Pegasus is provided the opportunity to act as financial adviser to FBR in connection with structuring the transaction and, in return for its services, it will receive 10% of the net cash investment banking fees received by FBR as a result of the engagement. The payments Pegasus receives from FBR will generally be taxed at normal corporate rates and will generally not be distributed to the Company’s shareholders.

During the year ended December 31, 2002, pursuant to this agreement, the Company earned \$6.4 million in fees from FBR in connection with five investment banking transactions. Fees are recognized when the related investment banking transaction is completed. In 2001, pursuant to this agreement, the Company earned \$2.9 million in fees from FBR in connection with three investment banking transactions and one unfunded commitment.

FBR served as lead underwriter for three follow-on public offerings by the Company during the year ended December 31, 2002, and earned approximately \$10.1 million (net of expenses) in underwriting fees in connection with the offerings.

TRANSFER AGENT AND REGISTRAR

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40 Wall Street, 46th Floor
New York, New York 10005

INDEPENDENT PUBLIC ACCOUNTANTS

PricewaterhouseCoopers LLP
250 W. Pratt Street
Baltimore, Maryland 21201

STOCK LISTINGS

New York Stock Exchange: FBR
Common stock trading range in 2002: \$5.05 to \$12.88

ANNUAL REPORT ON FORM 10-K

This Annual Report contains much of the financial information that is included in our 2002 Annual Report on Form 10-K that has been filed with the U.S. Securities and Exchange Commission. Our Annual Report on Form 10-K includes other information on our business and on the risk factors affecting our business, operating results and financial condition; it also contains the separate financial statements of FBR Technology Venture Partners, L.P. and FBR Asset Investment Corporation. Our 2002 Annual Report on Form 10-K is available on our web site, www.fbr.com or, at no charge, by sending a written request to Investor Relations, Friedman, Billings, Ramsey Group, Inc., 1001 Nineteenth Street North, Arlington, Virginia 22209, fax 703.469.1081.



Board of Directors*

*Emanuel J. Friedman, Co-Chairman and Co-Chief Executive Officer*¹
*Eric F. Billings, Co-Chairman and Co-Chief Executive Officer*²
*Daniel J. Altobello, Director; Chairman, Compensation Committee*⁵
*Wallace L. Timmeny, Director; Chairman, Risk Policy and Compliance Committee*⁴
*John T. Wall, Director*⁹
*W. Russell Ramsey, Director*³

*Additional board members as of March 31, 2003,
 as a result of the merger of FBR Group and FBR Asset*

*Peter A. Gallagher, Director*⁸
*Stephen D. Harlan, Director; Chairman, Audit Committee*⁷
*Russell C. Lindner, Director; Chairman, Nominating & Corporate Governance Committee*⁶

Strategic Management Committee*

Emanuel J. Friedman, Co-Chairman & Co-CEO
(Alternative Assets / PCG)

Eric F. Billings, Co-Chairman & Co-CEO
(Capital Markets / Mutual Funds / Principal Investments)

Robert S. Smith, COO

J. Rock Tonkel, Executive VP and Head of Investment Banking, Friedman, Billings, Ramsey & Co., Inc.

Richard J. Hendrix, Chief Investment Officer

ARLINGTON, VA – FBR HEADQUARTERS

**EXECUTIVE OFFICERS**

Emanuel J. Friedman
Co-Chairman and Co-Chief Executive Officer

Eric F. Billings
Co-Chairman and Co-Chief Executive Officer

Robert S. Smith
Chief Operating Officer

Kurt R. Harrington
Chief Financial Officer

William J. Giniyan
Chief Legal Officer

Richard J. Hendrix
Chief Investment Officer

J. Rock Tonkel
*Executive Vice President and Head of Investment Banking**

Robert J. Kiernan
Controller and Chief Accounting Officer

ATLANTA, GA

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Director of Research

Michael E. Hoffman
Deputy Director of Research

David M. Hilal
Managing Director, Technology Research

BOSTON, MA

**SALES & TRADING***

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Co-Director, Institutional Sales

Timothy H. Burns
Managing Director, Sales Trading

Scott E. Dreyer
Managing Director, Trading

Philip C. Gardner
Senior Vice President, Sales, San Francisco

Michael J. Hanley
Managing Director, Sales, Boston

Thomas M. Healy
Senior Vice President, Sales, New York

Claire F. Newman
Co-Director, Institutional Sales

Dorian A. Prosdocimi
*Managing Director, European Sales
(Friedman, Billings, Ramsey International, Ltd.)*

CHARLOTTE, NC



CHICAGO, IL

**ASSET MANAGEMENT****

Winsor H. Aylesworth
Portfolio Manager, Senior Vice President, Mutual Funds

Sothara Chin
President, FBR Investment Services, Inc. (FBRIS)

David H. Ellison
President, FBR Fund Advisers; President, FBR Family of Funds

Robert Feinstein
Managing Director, Private Client Group, FBR & Co., Inc.

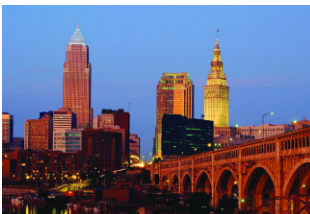
Webb C. Hayes, IV
*Managing Director, Private Client Group, FBR & Co., Inc.;
Chairman, FBR National Bank & Trust*

John F. Mangan
Managing Director, Arbitrage

George L. McCabe Jr.
Managing Director, Private Equity

Linda R. Paisley
President, FBR National Bank & Trust

CLEVELAND, OH



DALLAS, TX



Mario V. Shaffer
Managing Director, Venture Capital
Neal J. Wilson
Managing Director, Alternative Assets

INVESTMENT BANKING*

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Executive Vice President and Head of Investment Banking

N. David Doyle
*Managing Director
and Co-Head of Real Estate Investment Banking*

Philip J. Facchina
Managing Director and Head of Technology Investment Banking

Richard J. Hendrix
*Managing Director and Head of Diversified Industries
and Co-Head of Real Estate Investment Banking*

Patrick J. Keeley
Managing Director and Head of Energy Investment Banking

James C. Neuhauser
*Managing Director
and Head of Financial Services Investment Banking*

William L. Boyan, III
Managing Director, Financial Institutions Investment Banking

Charles R. Crowley
Managing Director, Financial Institutions Investment Banking

James T. Hill
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Mindi Harris-McClure
Managing Director, Financial Institutions Investment Banking

Joseph R. Nardini
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Francis Fuller O'Connor
Managing Director, Real Estate Investment Banking

Kenneth P. Slosser
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William F. Strome
Managing Director, Diversified Industries Investment Banking

Peter N. R. van der Meer
Managing Director, Insurance Investment Banking

SYNDICATE*

James R. Kleebblatt
Managing Director, Syndicate

PRINCIPAL INVESTMENT**

Richard J. Hendrix
Chief Investment Officer

Edward M. Wheeler
Managing Director, Merchant Banking

Brian J. Bowers
Portfolio Manager, Mortgage Backed Securities

ENTERPRISE OPERATIONS

Jerry R. Carlsen
Chief Information Officer

Robert D. Leahy
*Senior Vice President
and Director of Corporate Marketing & Communications*

Doris H. McGhee
Senior Vice President and Director of Human Resources

Nicholas J. Nichols
Chief Compliance Officer

* Friedman, Billings, Ramsey & Co., Inc. (except as noted)

** Friedman, Billings, Ramsey Investment Management, Inc. (except as noted)

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Friedman, Billings, Ramsey Group, Inc. provides investment banking, institutional brokerage, asset management, and private client services through its operating subsidiaries and invests in mortgage backed securities and merchant banking opportunities. FBR focuses capital and financial expertise on six industry sectors: financial services, real estate, technology, healthcare, energy and diversified industries. FBR, headquartered in the Washington, D.C. metropolitan area, with offices in Arlington, VA and Bethesda, MD, also has offices in Atlanta, Boston, Charlotte, Chicago, Cleveland, Dallas, Denver, Irvine, London, New York, Portland, San Francisco, Seattle, and Vienna. FBR has elected REIT status for tax purposes. For more information, see <http://www.fbr.com>.