



TWO HARBORS
Investment Corp.



Two Harbors Analyst & Investor Day

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Two Harbors Investment Corp: Transcript of
Two Harbors' Analyst & Investor Day

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Welcoming Remarks

July Hugen: Good afternoon everybody. Before management begins its presentation, I would like to review our Safe Harbor statement. For our listeners joining via Webcast, I'm July Hugen, Director of Investor Relations.

Safe Harbor Statement

We wish to remind you that remarks made by Two Harbors' management during this event may include forward-looking statements. Forward-looking statements reflect our views regarding future events and are typically associated with the use of words such as anticipate, target, expect, estimate, believe, assume, project and should or other similar words.

We caution investors not to rely unduly on forward-looking statements. They imply risks and uncertainties and actual results may differ materially from expectations. We urge you to carefully consider the risks described in our filings at the Securities and Exchange Commission, which may be obtained on the SEC Web site at www.sec.gov.

We do not undertake any obligation to update or correct any forward-looking statements if later events cause them to change or become inaccurate.

With that, I'd now like to turn the program over to Tom Siering, Two Harbors' President and Chief Executive Officer.

Thomas Siering, Executive Overview

Thanks July. I have to say that following the Ivy on stage is kind of like following Lynyrd Skynyrd after they sing Free Bird, but I'd like to start off by thanking some people, and I would like to start by thanking our Chairman of the Board, Brian Taylor who unfortunately could not be with us. My other partners at Pine River and the employees of Pine River. Without Pine River, Two Harbors would not exist. I'd like to thank Two Harbors employees, many of whom are here today. Also the Silver Bay employees, and I'd like to thank them for their efforts.

For all our investors I say thank you, and we have a number of analysts here. Thank you for your thoughtful coverage of our stock.

Lastly I'd like to thank our Board of Directors, one of our independent directors, Bill Johnson, is in the room with us today.

Compelling Market Drivers

I'm now going to talk about some of the market conditions that Ivy discussed in the context of Two Harbors business and opportunity. I'll begin with the compelling market drivers. We saw them when we first launched Two Harbors in October 2009.

Following the credit crisis of 2008, there was a massive dislocation of the \$11 trillion RMBS market. The GSEs who had been acting as the largest hedge funds in the world were essentially taken over by the Federal government and were mandated to reduce their portfolios. This disinvestment caused inefficiency and opportunity in the market. The Treasury became a large owner of non-Agency RMBS through financial rescue packages, and commercial banks and proprietary trading desks exited the market due to mounting capital and regulatory hurdles.

The combination of these factors created the perfect opportunity for private capital to step in and provide liquidity to the mortgage market, and that's exactly what happened.

Looking ahead, we expect private capital will play an increasingly important role in the mortgage market, and this will create new and sustained opportunities for mortgage REITs such as Two Harbors.

The systemic dislocation of the market created an opportunity for Two Harbors to become a permanent source of capital to the mortgage sector and these conditions are still intact today. It will take many years to address all these issues.

From a public policy standpoint reducing credit exposure to the taxpayers seems to be a reasonable objective for the GSEs. Underwriting limits simply seem too high to us in the current context.

Refinancing and other policy considerations are always important, and we monitor these developments closely. There's still a lot to be sorted out including the role of the GSEs in both the primary and secondary mortgage markets.

What we do know is that the Fed is committed to keeping short-term interest rates low for the sustainable future, and that provides us with access to historically-attractive financing and good funding visibility.

Mission-Based Strategy

Let's talk about our strategy.

After identifying the significant market opportunity in 2009, we structured Two Harbors as a hybrid mortgage REIT so that we can invest in both Agency mortgages, which are those backed by the guarantees from Fannie, Freddie and Ginnie, and non-Agency mortgages, where there are no credit guarantees and the bonds consist of pools of non-conforming loans.

We chose this hybrid strategy for two reasons. Firstly, it's just sound portfolio management to lower risk through a diversification and with the objective of maximizing returns. Owning both Agency and

non-Agency bonds allows us to better manage risk. Those various risks include interest rate risk, repayment risk and credit risk.

Secondly, we have more flexibility to manage our portfolio by opportunistically allocating capital. Our mission is ambitious but straightforward. We strive to be widely recognized as the leading hybrid mortgage REIT. Our objective is to generate attractive risk-adjusted returns to our shareholders over the long-term, primarily through dividends, but also through capital appreciation.

Two Harbors Today

Let's talk about Two Harbors today. We've come a long way in three years. Today Two Harbors is the largest hybrid mortgage REIT. Our portfolio has grown to over 15 billion in assets today. Our market capitalization presently is \$3.4 billion. We've built a deep bench of talent which I'll talk about in more detail in a bit.

As our external advisor, PRCM Advisers and its parent company, Pine River, provide us with significant expertise in managing our target assets through a variety of credit and interest rate environments. We have put in place a best in class operational and risk management platform.

Now let me give you an update on two important operational items.

You may recall that we had \$33 million outstanding warrants struck at \$11 per share and with a November 7th, 2013 expiry. To date, approximately 16 million warrants have been exercised for proceeds of approximately \$175 million.

Lastly, we have announced the proposed contribution of our single family homes in Silver Bay Realty Trust concurrent with its IPO.

As of September 30th TWO had purchased approximately 1,670 single-family residential homes, representing a total investment of approximately \$190 million.

Talented and Deep Bench

Let me talk about my team, I'm quite proud of them.

We believe the depth and breadth in our talent across all our core disciplines is unmatched. Our investment team is led by Co-Chief Investment Officers Bill Roth and Steve Kuhn.

Bill Roth has 30 years of experience; he began his career at Salomon Brothers/Citi, where he was a key member of Ranieri's team, which is the first group to ever sell mortgage-backed securities.

Steve Kuhn has 20 years of experience. Steve created Pine River's mortgage platform, previously he was on the Goldman Sachs team that managed approximately \$40 billion of mortgage-backed securities.

We have a Risk Committee that operates independent of the trading function. We have a first rate legal team that is led by our General Counsel and Secretary, Tim O'Brien, and our Secretary and Deputy General Counsel, Rebecca Sandberg. Accounting and tax was led by our CFO, Brad Farrell, who you will also hear from today.

This team is focused on providing best in class financial reporting and disclosure. We have a dedicated business diversification team which is charged with identifying new opportunities to deliver shareholder value.

We have recently added some senior talent to our team. We're pleased to welcome Nick Smith who joined us in September. Nick was previously the Chief Investment Officer of Capital Markets at Green Tree, and before that he was at GMAC ResCap.

We also announced the hiring of Dan Koch, who joined us on October 1st. Dan previously worked at Redwood Trust and has an extensive background in sourcing from prime jumbo loan acquisitions and the development of new loan origination. They just joined Diane Wold on that team.

We have a top-rate investor relations team with extensive credentials in finance, communication, transparency and disclosure. You've met July who takes the reins from Christine who moved to the Silver Bay team to be its CFO. You also know Anh Huynh who's with us today.

This team is dedicated to being an outstanding resource for our investors and analysts. We are very proud of the caliber and the talent we have attracted and the breadth and depth of their skills. We have a full and committed bench that will be critical to leading Two Harbors in the future.

Building a Strong Franchise

We believe we've built a very strong franchise. This is a snapshot of our history. We started very humbly with \$124 million, and we have grown the market cap by 27 times.

In 2011 we reached the \$1 billion market cap mark, one year later we reached the \$3 billion mark.

We believe the substantial increase in our market value over the past years is a direct reflection of the strong franchise we have built and the hard work of our team and the market's embrace of our acumen and vision.

Delivering Total Return

Well this is why we're here, to deliver value to our shareholders. We measure total return as a combination of dividends, in capital appreciation, both of which contributes to our strong performance.

Since inception, Two Harbors has consistently outpaced the universe of hybrid REITs, mortgage REITs and the S&P 500, delivering a total return of 95 percent since inception, and 46 percent year-to-date in 2012. We are particularly proud of the returns we have delivered to our shareholders and remain committed to delivering strong returns in the future.

Dividend History

Let's talk about dividends, obviously a big part of our story.

Shareholders who have been with us from the start have received \$4.50 per share in dividends. This represents approximately 50 percent of our initial book value. Later, Brad will detail some of the considerations we make in respect to our dividend payout.

As a result of lower interest rates and a flattening yield curve, we have begun to see net interest margins narrow. So with the same amount of leverage, our overall risk level, yields will decline. That being said, we expect to continue to bolster the dividend component of our return with opportunistic capital gains.

Looking ahead, we believe that both the Agency and the non-Agency sectors will continue to attract investment opportunities and we will continue to degenerate strong risk-adjusted returns for our shareholders.

Book Value History

Book value. Often this is overlooked by a lot of investors, but it certainly shouldn't be because that is ultimately the driver of dividend generation. In addition to delivering returns through strong dividends, we've also increased book value per share over time through portfolio appreciations and active portfolio management. We also strive to limit the volatility in our book value per share over time.

Unfortunately Bill didn't do a good job at that this quarter, a little tongue in cheek, as during the third quarter our book value rose substantially well north of \$11 per share. It was a heck of a quarter for our investment team.

The good news about book growth is that our Agency and non-Agency assets have increased in value. The bad news is that reinvesting in those assets today is at lower yields and spreads than we have achieved historically.

Positioned for Continued Performance

We're positioned for strong performance.

Before I turn my presentation over to Bill, I would like to summarize my remarks.

Above all else we strive to deliver superior shareholder value and our track record certainly supports this I feel.

Our hybrid structure focuses on the relative value of various sectors with an intense focus on security selection. Hedging in our view is a form of insurance in our portfolio, and we use sophisticated and effective tools to protect our portfolio against significant changes in interest rates.

We have an independent risk committee which is separate from the trading function. We have a strong focus on our operational foundation and support of our business.

Our business diversification strategy leverages new identified opportunities to increase incremental shareholder value. With 11 covering analysts and 238 institutional investors, we have established a strong base, Wall Street support and access to capital.

Finally, we continue to demonstrate our commitment to financial stewardship, governance and transparency.

Now it is my pleasure to introduce Bill Roth.

William Roth, Portfolio Update

Thank you Tom and welcome everybody. I hope you guys didn't eat as much of that chocolate dessert as I did.

Today I'd like to spend some time talking about the overall market landscape, some parts of it that apply particularly to Two Harbors, and then talk somewhat about the portfolio, the way we've constructed it, and share some details about results from our capital raise from this past July.

U.S. Financial & Mortgage Market

Just as a quick review, the U.S. housing market and mortgage market is a very, very substantial and large part of the U.S. financial landscape. You can see on the left the housing market is roughly 17.5 trillion, well in excess of all fixed income sectors, and in fact the U.S. mortgage market is almost tied with Treasury for the second largest market at 10.2 trillion, so a very, very large part of our financial world. Yet at the same time, it's probably one of the most under-researched in terms of the securities, certainly compared to the U.S. equities, which is part of the opportunity that we have.

Agency Market Overview

Taking a look at the Agency market of 5.5-trillion, a little bit under half of this is composed of Fannie Mae Securities as you can see, with Ginnie and Freddie roughly neck and neck.

I think the important takeaways from this slide are a few, on the right, and I apologize if you can't see this that well. But at the top we show in the dark blue and then the – I guess it would be medium blue, the government involvement, which is basically the Fed and the Treasury at the top and then the GSEs and State and local governments below that.

What's interesting is we can see that the Fed and the Treasury weren't involved at all before the crisis, although the GSEs held 25 to 30 percent of the securitized market.

Since then, the Treasury got involved, and although they've sold off their holding, the Fed has also gotten involved and as we'll talk about in a minute, is even getting more involved as we live through this – the part of QE3.

You can see in the medium blue, the decline of the holdings of the GSEs, and we know that those are going to decline further. So while the government today is almost a third in terms of the investor participation, it's our anticipation that going forward, the government involvement will be less.

The other thing on this slide that's worth noting, is a little teeny sliver at the bottom in red, is the mortgage REIT participation. Despite the fact that mortgage REITs have raised tens of billions of dollars of capital over the last several years to take advantage of the opportunity, the mortgage space, they're still a relatively small part of the investor universe and Agency mortgages.

Non-Agency Market Overview

Non-Agencies. Today's non-Agencies actually just recently ticked under a trillion dollars. And you can see that graph on the right shows historical outstandings and non-Agency securities.

In the last several years the markets contracted by over 50 percent, and given the lack of new origination and new securitizations, will continue to contract over the remaining years as the securities pay down. This is a result of bad loans and these deals being liquidated, prepayments or refinancings as people move, as well as normal amortization.

Market Update

So let's talk about some topics that are particularly pertinent today.

Everyone here knows about QE3, I won't spend a lot of time on it. But one thing I would like to note, is while their purchases, including pay-downs is about 70 billion a month of the roughly a hundred billion of new originations, that sounds like 70 percent. But in fact what is missing is all the specified pools that traded prices above TBAs. So whether they're loan balanced pools or pools with low FICOs or investor units or – anything that trades above TBA, that actually takes the Fed's effective purchased amounts substantially higher than 70 percent.

Tom mentioned the commitment about keeping funds rate low for the next two or three years, and as we heard from Ivy, she would probably disagree with stabilizing it, I think she's a little bit more bullish than that. But certainly at the lower end of the market we are also seeing firmness in pricing.

On the Agency side, spreads have obviously tightened and we'll see graphically what that looks like in a minute.

In terms of prepayment speeds, rates are at historic lows, borrowers who can refinance are doing so, and we'll see what speeds look like on pool, the borrowers have the ability and the wherewithal and the incentive to prepay.

Also, HARP is working. Through July of this year over half a million borrowers have gone through the HARP Program, affectionately known as HARP 2.0, and we see no reason why the large services won't continue to pursue that, given the profitability and the benefit to the borrower.

And finally G-Fees – of the G-Fees as well as on the FHA sides have increased and are expected to continue to do so.

On non-Agency side, this year has been the pleasant side of the equation in terms of a rally. All credit-sensitive assets have rallied, which is sort of the flipside – flip of last year, but a lot of this on the mortgage side is due to actual performance improving. And despite this rally, as we'll see in a minute, loss-adjusted yields on non-Agencies are still attractive relative to other asset classes.

Current Market Trends

In terms of some graphs just to demonstrate, you can see on the top left, historically Agency mortgages carry a spread over treasuries, and that was true well back before 2006. As you can see, most recently that spread has contracted such that the current coupon yield versus ten-year treasuries, pretty close to zero.

You see the forward LIBOR rate which reflects funding, one thing I think is particularly interesting, and we've been very grateful and fortunate to have experienced a very steep yield curve for the last few years. Part of the attractions to our business model as well as others is the ability to take advantage of that, and you can see that the two-year ten-year Treasury spread was quite outsized versus the long-term average. Nonetheless, despite the flattening we are roughly at the long-term average today.

Agency Spreads Are Tighter

And I'll skip the next one because Ivy, I think, spent enough time on housing stabilization.

In terms of spreads, this chart shows different parts of the quantitative easing cycle in terms of the effect on the mortgage rate, and you can see that in QE1, which is the first light-blue shaded line, that actually had a pretty significant impact on mortgage spread, driving them roughly 50 basis points lower.

QE2 actually didn't do that much. But if you look at the inset on the top-right you'll see QE3 has had a tremendous impact. Spreads have tightened well over 50 basis points and despite mortgage basis having lined out here the last few days, still reflects the fact that the Fed is highly intent on keeping the mortgage rate low and getting borrowers to be able to refinance.

HARP is Working

So let's talk about prepayments. Since rates are so low, what does this mean for prepayment? Well clearly if you have a high coupon mortgage you would love to get into a 3.5 or even a 4 percent if you had to lower your payment. Many of the borrowers, however, are trapped with high LTVs or are under water, and thus the HARP Program.

What we see here is, is that HARP is actually working, and in fact the large servicers in particular are focused on this, which is no surprise. You can see that the top line there represents Chase prepaids on HARP-eligible pools, 5.5 coupon and higher from '06 to '08.

At one point this summer, those speeds exceeded 60 CPR, and over the course of the year they've been running clearly in the mid-40s.

Even B of A, which is the grey line at the bottom, who got off to a slow start, has recently exceeded the cohorts, as you can see in the last several months their pools have picked up.

So numerically what does this look like? On the right you'll see what speeds were on these types of pools in the three months before HARP was implemented, basically low to mid20s, which if you have a 5.5, 6, 6.5 coupon and you can get 4, just kind of doesn't make sense.

The advent of the HARP program has enabled these people to get through the door, and you can see that speeds have ramped up significantly, are running 10 to 15 CPR faster.

Given that this program extends through the end of 2013, we expect that these speeds, while they have slowed down slightly, to continue to be elevated.

Generics Remain Fast

So let's go away from those who would like to refi but have to go through a government program. Let's just talk about someone who Ivy may have represented, has a seven hundred and something FICO and a low LTV, or otherwise known as cheapest to deliver or what we're going to call generics.

On the top of this slide, you will see a blue line representing 4.5 percent Fannie Mae pools that were originated in 2008. So these are borrowers with roughly a 5 percent mortgage that they took out in 2008, and generally, at that time if you recall, it was almost impossible to get a mortgage unless you were pristine credit. So these guys are very, very capable of refinancing. And in fact, that's exactly what they're doing.

Since a year and half ago, roughly the speeds on this have gone from mid-teens up to north of 50 CPR.

For a bond price that's roughly 108 to 109, depending on the day, it's not too great. On the other hand, let's take a look at pools that have some degree of prepayment protection. On the bottom you'll see we've chosen two examples out of many. One is the MHA 4.5's from 2010. So these are MHAs: making home ownership affordable, which is actually the true name of HARP. And so that's the program by which you access. So a borrower who went through the HARP program, this is that borrower from 2010.

Alternatively, the LLB or low loan balance, these are pools from 2010, same borrower, same coupons, but their loan balance, no loan in the pool was greater than \$85,000, and in fact the average typically is in the 60s. So while rates are low, their incentives in terms of how much they can save on a monthly basis versus the cost of refinancing is substantially lower.

This past month the difference in the speed, as you can see, on an annualized basis was 40 percent. Now what does this mean? At Two Harbors, as many of you know, almost our entire portfolio on the Agency side is made up of pools that have some sort of prepayment protection. And it's precisely for the reasons that we just saw on the last two slides that we take that strategy. It's not just about sustaining the yield, it's about the stability of cash flows.

Specified Pool Payups vs. TBA

But achieving this, it comes at a price. And people will say, well Bill, pay-ups have gone up, because you can't get so much slower prepay when everything else is paying fast without paying for it. And in fact we've taken a look at this slide at just the loan balance part of the market, and I'm not going to read all the footnotes, but the bottom line is that each one of these jagged lines on the right represents pools with a maximum loan of anywhere from \$85,000 up to \$175,000.

In the red line, you'll see the average pay-up has gone up from roughly 0.6 percent to over 2.5 percent over the course of the year.

The other thing that's interesting is if you look at the yellow line, which represents the ten year treasury, basically hasn't moved. The mortgage rate has come down, which is what drives prepay. But this has been the impact. So this has been terrific for the pools that we own, and thus the question is well, are these still good or are they not?

So whether you decide that you like yields where they are today or whether you decide you don't, we'll leave that for a different discussion. But let's take a look at the generic and compare it to these couple of different subsets. So you see that the generic Fannie 4's and 4.5's are roughly bracketed around 108.

The pay-up to that as of September 30th, as I mentioned, had gone up substantially, so the prices of whether they're LLBs or other loan balance pools or MHA pools, are anywhere from 110 to 113. That's a little scary until we see what the – what are the yields and the option-adjusted spread of these assets?

Well if we take a look at the yield as determined by the Barclays prepayment model, the yields on Fannie 4's and 4.5's remind me of a little bit more than we get in our money market account, whereas the yield on the prepay-protected assets are substantially higher, and then frankly more stable. And both of those are borne out on the bottom where we see the OAS of these securities.

At this point in time, I'm going to take a commercial break because July has asked me to let everyone know that with regards to the bottom part of this slide, OAS, as well as other interesting prepayment and convexity measures, that we will be having prepayment Webinar Series Two, Advanced Prepayments, or whatever she decides to call it, which will be coming out – and I don't know how many of you saw our first one, but stay tuned.

Now back to regular scheduled programming.

Prepayment Protected Pools Offer Value & Credit Rally in 2012

So let's turn over to credit. I don't have to tell everyone in this room what 2011 was like, and I'm sure most of you have been smiling a little bit more this year. So let's take a look at credit-sensitive assets.

In 2012 the world's at a different place. The economy's been more stable, all of the fears, they surfaced in 2011, didn't necessarily go away but they subsided a bit, and more interestingly on the mortgage side performance has continued to improve.

As a result, mortgage credit assets as represented here by just one of the ABX indices has had a really nice run this year, but also so have other products.

So let's dig a little bit into the mortgage performance and why we've seen particularly strong performance on the credit side.

Non-Agency Delinquencies

What you see here is 60+ State delinquencies across a variety of sectors. Prime, Option-ARM, Alt-A and Sub-Prime. And most interestingly, especially since the bulk of our book is comprised of Sub-Prime, is the inset on the top-right. From a high of over 50 percent, 60-plus delinquencies have come down into the low 40s.

Now somebody may say, well, you know, low 40s delinquency on a pool? I mean that's awful. And I'll admit, it's not a low number. But what's most important, frankly, is the trend. Bad borrowers are exiting the pool, which is as a result of either modifications, so people can start paying again, or liquidations. And all of these feed through the capital structure of the bonds that we own, and the fact that the trend is getting better is highly, highly important to these securities.

Non-Agencies Remain Attractive

And in fact let's take a look. On this slide we see various yields on different sectors that are available in the fixed income markets for investors. It's a little shocking to me having been in the business for 30-plus years that the scale on the left is what it is, basically zero to six.

But nonetheless, we see that the alternatives in fixed income range anywhere from close to 0 up to roughly 3 percent until you get into the credit-sensitive part of the market, which is high yield, and those yields by the way are not including any expectations for losses. And then the non-Agency mortgage sector, where yields on a loss-adjusted basis, without making – let's take Ivy's super bullish assumptions off the table for a minute.

So if you make more moderate assumptions, the Street generally see yield in this range. So clearly while yields are lower, as Tom mentioned, that what we saw earlier this year, they're still well in excess of what's available in other fixed income sectors.

Portfolio Overview

So with this as a backdrop, let's take a look at our portfolio, some strategy thoughts as well as a little bit of an update post our July deployment. And I apologize that we don't have more information on the September 30th, but given the date of this – of this day, we're going to give you a little sneak preview anyway.

So as of June, you can see that our Agency/non-Agency split was a little over 80-20, and you can see at the bottom that Agencies have floated up into the mid-80s, and non-Agencies have floated down somewhat.

Our capital allocations, some of you may recall at the end of June was in the low 50s versus mid-high 40s on non-Agency, and our Agencies have floated up I guess from the low 50s to the mid-50s. Non-Agencies have floated down somewhat, and the residential real properties take up the balance.

In terms of our focus, as many of you know, we like to maintain a leverage ratio on the Agencies of six to seven, and we have a huge focus on prepayment stability for several reasons. First of all, the more stable your cash flow, the easier it is and the more effective your hedging technique. And secondly, given how low rates are, maintaining low prepayments sustains our yield for a longer period of time.

On the non-Agency side, I'm going to spend a little bit more time talking about Sub-Prime. But as many of you know, despite Sub-Prime pools having high delinquencies, the fact of the matter is, is that most of these bonds have huge amounts of credit support, as well as excess spread. And so as a result, the big discount to par as well as this huge credit support in the structure really give it some margin of safety. Furthermore, the improving performance is obviously a benefit as well as anything that helps borrowers that are in these pools, whether it's modifications or policy initiatives.

Agency Portfolio

So on the Agency side let's dig a little deeper.

The dark blue portion of the pie, which as I say, once again reminds me of how much I ate that chocolate bomb on the table, is largely representative of the prepayment protections that we have. On the right you'll see the two biggest slices there, or I guess the biggest one and the one below it. Over 40 percent are in pools with some degree of low loan balance, whether it's the LLBs, which is 31 percent, or other loan balance.

About 20 percent are in MHA pools, and then another 17 percent are in home equity conversion pools, known as HECMs or reverse mortgages. And as a reminder, these are pools where the borrower does not make a monthly payment, and therefore, does not have an incentive to lower their monthly payment since their payment is zero. So the refinancing function there is virtually non-existent.

On the bottom-right, you'll see what Two Harbors speeds have been compared to the GSE cohorts, and you'll see that not only ours are substantially lower, but very, very stable.

TWO Prepayment Protected Securities

So let's take a look – a little brief look at what the portfolio looks like at the end of September.

We increased our 30-year fixed holdings, and now that comprises roughly 70 percent of our portfolio. In terms of seasoning, most of these pools are new or relatively new, meaning within a few years of creation, and the dominant prepayment characteristic is loan balance and MHA.

I'm not going to read every line all the way down, but you can see that the age runs from new to super seasoned, and the seasoned and super seasoned, they're particularly interesting because the borrowers that are left in those pools, they've had so many opportunities to refinance that basically you realize what's called – what we call out burnout. In other words, if a guy who's got an 8 percent mortgage from 1999 hasn't refi'ed yet, they're probably not going to refi. So speeds on these types of pools are very slow and consistent.

And one other thing I'd like to highlight is the Other-Fixed 6% is primarily multi-family pools with hard prepayment protection, or what we call prepayment lockout.

Non-Agency Portfolio

OK, the non-Agency side. As many of you know, we've increased dramatically our exposure to the Sub-Prime space, and we'll talk a little bit more about this in a minute.

It wasn't always the case that we were so enamored to Sub-Prime. If you go back to our beginnings, in fact Sub-Prime was only about a quarter of what we held in the portfolio.

But the relative improvement of Sub-Prime pools – basically, Sub-Prime was the first to go bad, and it was the first that got people's attention, and it's where all the modification efforts have been, because that's where all the big delinquencies were.

So what happened was as the prices went down dramatically, it represented what had happened in the past, but what we saw was what was going to happen in the future, as fewer borrowers would go delinquent, and as these pools would get flushed out and improve over time, that the returns that we saw available we thought were going to be very attractive.

And as one example of this, if you look on the bottom-right, you'll see that one thing we look at – which is 12-month perfect pay. So keep in mind, these are Sub-Prime borrowers who don't necessarily make up their payment every month or on time.

But basically, the number of people who've made 12 monthly payments without missing continues to float higher. This is a direct result of the bad borrowers exiting the pool from liquidations, and the fact that modification efforts that we've seen in the last few years really being effective.

State Performance

This is a slide that Ivy probably could have stuck in or I could have stolen from her but the gist of it is, is that we wanted to show here is that the hardest hit States are in fact showing recovery, as shown on the left. These are California, Florida and Arizona. And I actually like her slide on the lower tiers doing better, but the point is the same, is that the lower tier, which is shown in the dark-blue on the left, is definitely showing signs of improvement primarily because of the affordability quotient. And if you think about it, the lower tier is generally the tier that's in Sub-Prime bonds. As opposed to the prime borrowers where there's \$5-6-800,000 loan, that part of the housing market is still more challenged on a relative basis.

Non-Agency Discount Bond Example

The next few slides, this one in particular is an update from a slide I think many of you have seen. We've had in our investor deck this example of a non-Agency bond. So let me bring – without going through this slide in great detail, this is a last pay senior Sub-Prime bond, 2006-3, the 2A4 bond.

And so what I wanted to do is focus on just a couple of things on this slide and then give you some history of performance of this.

So many of you may recall in the early days when we put this slide out, the base case yield was attractive. The downside cost of several hundred basis points, but the upside was really quite rewarding.

You'll see it when you look here down at the bottom, loss-adjusted yields are sort of really frankly very stable. This is a result of what happens in this market as bonds season over time, and we'll see this in a minute.

And before we switch to the next slide, two things I'd like to point out. On the left, in the middle you see the A3 bond, there's 19 million Current Face of that remaining, and it's about a half-year average life, which means that's going away very quickly.

The other thing I'd like to point out is that on the very bottom-right, even in a severe downturn, this bond recovers a hundred percent.

Delinquencies and MTM LTVs

OK, so let's take a look at some delinquency data on this security. And this is consistent with what we saw on a prior slide, that basically three years ago almost half of this pool was delinquent. But we can see that the delinquency trends have been positive, and while they have flattened out recently, serious delinquencies have come down quite substantially on this pool.

Also equally as important is – and if you think about it, when we run analytics on this, we're going to default this 34 percent as delinquent, and we're going to default a whole lot more that are paying. And so the question is, how much are we going to recover when that house gets liquidated?

The slide on the right shows the mark-to-market LTV of different buckets in the pool. And so what's interesting is that particularly on the top two lines, is that even from '09 through '11, when housing was not doing well, the mark-to-market LTV of delinquent or liquidated borrowers was relatively stable. On the other hand, current borrowers as shown – and this is clean borrowers, in other words, borrowers who have never missed a payment in the life of the deal, they were actually – their houses are getting marked down, not a ton, but still nonetheless, about 10 percent.

But look what's happened here in the past year, is that the mark-to-market LTVs on all buckets have come down.

What this is encouraging to us about is that this implies that future severities will be lower. And if you think back here on the average severity in our base case of 73 percent, if you look in the top-right, middle, they've only been running in the high 60s. So severity has only been in the high 60s, our assumptions are driving 73, but yet the value of the homes is going up. So we think that there's some upside to those assumptions.

Credit Enhancement and Market Price

Other things that are particularly interesting and why we end up with a bond now that's very stable, is the dark blue on the left is the amount of the 2A3 bond that's outstanding. If you go back several years, this 2A4 bond was extremely long, because the 2A3 bond had to pay off in front of it. It's gone from over 80 million remaining to under 20, and will probably be paid off in the first quarter of 2014.

Additionally the credit enhancement has stayed fairly stable at around 40 percent. So the 2A4 bond effectively is way more protected now because you have the same credit enhancement and you have way less bonds to pay off before we start getting our cash flow.

And finally, just wanted to show the price path of this bond going back about a year and a half. We bought this bond in April in the low 60s, we enjoyed the ride down, which frankly was – didn't feel very good, but many of you may recall that we raised money near the bottom of that price chart there, because the data we were seeing on these prior slides led us to believe that the market price was offering us much higher yield than were warranted for what the performance was. And despite the big run-up in the price since then, we still have a security that yields on a mark-to-market basis in the sevens.

Before I turn it over to Brad, I want to spend a minute on our hedging philosophy.

Hedging Interest Rate Exposure Is Key

We talked a lot about selecting Agency assets, we talked a little bit about Sub-Prime. At Two Harbors we just don't take a lot of interest rate exposure, and many of you are familiar with that and have seen that in our presentations. But for those of you who maybe haven't been around for three decades, I want to take a blast – step back to the early 90s and just take a look at what happens – or what can happen despite what appears to be a stable market.

We had the Fed on hold forever at 3 percent and the two-year treasury bounced around 4 percent, pretty much for – actually a longer time than this shows, but nonetheless, the two-year treasury in three months, went up over 200 basis points, even though the Fed made one move higher. So, they basically went from 3 to 3.5.

Now we see that ultimately we ended up hundreds of basis points higher. But the point here is that the Fed has told us what they're going to do, but they've also said that as conditions change, as things get better, as employment gets better, everything is subject to change.

We're not in the business of taking big interest rate bets, as a result we like to have a stable profile on our hedging, which we'll see in a minute. But the message out of this slide is that when things move, they can move extremely quickly and violently, and if you aren't hedged beforehand it's usually too late to hedge once the door is open.

Protecting Book Value

So let's take a closer look, and I'm really pleased that we're able to share some of this information with you today. This is information that we don't release in our 10Qs, but I thought it was very instructful to take a look at what happens in more than a 100 basis point move. Our rates are very low, and I think most people in this room would agree that if and when they move, they're probably going to move a lot.

So our objective in hedging, frankly, is to protect book value. And as a result, we use a multifaceted approach, and this particular slide, we're going to focus on swaptions.

So on the bottom-left you see, as of July 31st, and we – this data is available to us and we look at it every day. Up 100 basis points, our book value impact from a change in rates running through our Agency strategy and hedges, would cost us about a little over 2 percent. More interestingly though is up 200 basis points, the impact is only 2.8 percent.

So if someone say, well, Bill, that doesn't make any sense because you're buying assets that are mortgages, and when rates go up prepays slow down and the assets extend, so those got to go down a lot more, right? This is true. And in fact we would expect to see many mortgage securities particularly the generic kind that are paying fast slow down and extend.

So the first part of our approach is by selecting assets that are very stable. Their average lives are stable. If a pool's going to pay between 5 and 15, it's not going to be that volatile in average life. And so the price path is much more predictable than a pool will pay at 5 or say 55.

So how do we – the way to observe this is if you look in the red at the top-left, you'll see that our total Agency book as of July 31st, this is an excerpt from our daily risk report by the way, would cost us \$354 million. But what's interesting is that if rates go up another hundred, the incremental is only 372 million, or 5 percent more, which is frankly de minimis in a portfolio of our size. Now offsetting that - So basically our assets' price path is very stable.

Now nonetheless, there is some negative convexity to even this mortgage portfolio, and in fact that's where swaptions come in. So you'll see that up 100, our swaptions make about \$87 million. But the

delta to up 200 is substantially higher. So in effect, the swaptions are greatly muting the impact of higher rates, which is why that as rates go higher, the impact on our book value is much more stable.

Attractive Returns With Lower Risk

So what does this all add up to? And I apologize that these are not third quarter numbers, obviously no one's reported yet.

Our dividend is very much in line with our target – delivering an attractive return with a lower risk quotient. You see that our leverage, while typically ranging between 4 and 4.5 is well below the peers. Our interest rate exposure, we just discussed, and you can see that historically it's just frankly very low, and that's the way we like to keep it.

And finally, that our prepayments are not only low but very stable.

At this point I'd like to once again thank you very much for coming in and invite Brad to come up and share some remarks.

Brad Farrell, Financial Review

Good morning.

So two-and-a-half hours into the day, and they put the CPA in front of the audience. I apologize. Hopefully not too many people were going to the exit. But I will endeavor to keep my comments brief, and most importantly, allow time for Q&A.

While the role of the Chief Financial Officer continues to evolve against the backdrop of a challenging and volatile macro world, I will focus the majority of my prepared comments on my role as financial steward.

Financial Stewardship

CFOs today have the opportunity to shape strategy, company culture and vision. While those are leadership attributes I value and strive to achieve, I believe that it's also critical the CFO remains grounded in the fundamental financial wellbeing of a company. A few of those fundamentals are listed that I believe provide stability to an organization such as Two Harbors.

Having been exposed to large organizations which face liquidity, accounting and disclosure challenges, these fundamentals have been ingrained in my philosophy. I will expand upon several of these.

Financing Profile

Let us first talk about the financing profile.

As of June 30th, 2012, we had 23 repo counterparties, providing financing of approximately \$9.4 billion in the form of repurchase agreements. We have been successful in increasing the number of counterparties as we have raised capital and grown our portfolio.

We spend a great deal of time focusing on liquidity management. We have historically disclosed what we believe to be a prudent duration and laddering of repo maturities across both our Agency and non-Agency portfolios.

Internally, we have a dedicated margin team and robust proprietary tools that allow us to monitor and project excess liquidity on a daily basis, and frequently stress-test our portfolio against a number of potential shifts in market value, and/or shifts in counterparty advance rates. We believe our focus on liquidity and stress testing is an important facet of our risk management process.

While the increased quantity of our counterparties is valuable, we also believe the quality of those counterparties is equally important. In our Agency portfolio, we have spread our counterparty exposure across 20 counterparties.

Importantly, not only do we have a number of counterparties, our exposure to each is balanced as you will see on the left of this slide. With more liquid assets, diversification and credit quality are both valuable financing attributes.

In our non-Agency portfolio, our focus is heavily weighted to credit quality of our counterparties, as depicted on the right. With a less liquid asset, nearly 80 percent of our financing is held with counterparties that have CDS spreads of 50 to 200.

This is something our counterparty management team monitors on an ongoing basis, and something I'm quite proud of.

Counterparty Risk Management

We have seen in the past few years that market events, such as the European crisis, and company-specific events such as MF Global's collapse can create short-term, and in some cases, medium term strain in the financing marketplace.

Prior to these events, we had taken a very proactive approach to monitoring these risks. Through Pine River, we have a team of experts focused solely on establishing benchmarks on the health and solvency of our existing counterparties, reviewing credit qualities for new potential counterparties, and negotiating contractual terms with counterparties that mitigate the company's risk.

Through these efforts, we have weighted our counterparty exposures to North American entities and established dashboards to evaluate our exposure.

Core vs. GAAP EPS

On this slide is an illustrative example of some of the things we evaluate.

I often receive questions concerning the reconciliation between Core Earnings, GAAP Net Income and Comprehensive Income. So I thought it would be useful to take a few minutes and drill down on a couple of items that I think might be helpful to a wider audience to understand what drove the presentation differences on our financial statements.

Please refer to Circle A. We have elected to account for our swaps as economic hedges, or in other words, we have not elected cash flow hedge accounting as some of our peers. We made this insightful decision in 2009 as we believed it was critical to establish a fluid, laddered maturity profile on our repurchased agreements. The objective to establish that type of financing profile makes cash flow hedge accounting very challenging. The result is that the mark to market price movement on the swap runs to the Income Statement while the hedged RMBS portfolio is recognized in the equity statement.

Please refer to Circle B on the slide. In agreement with our auditors, we believe SEC guidance requires all components of a derivative to be captured in a single financial statement line item within the income statement.

The disclosure challenge with this is it can spread out interest income and interest expense components across the income statement. And it's something I hear quite frequently from Bill about it doesn't make sense, I understand.

But this illustration in this presentation tries to reconcile those components and how we think about the derivatives across our income statement. For example, 7.7 million is the net interest spread on swaps, which viewed in industry as a component of Core Earnings. And the 7.6 million is the interest income on inverse interest-only securities, which are treated as derivatives due to the underlying index.

Please refer to Circle C. As noted in our Q2 2012 earnings call, we incur a cost of hedging in an effort to protect book value. This cost of hedging can negatively impact Core Earnings while it provides value to the overall economic return or comprehensive income. The 3.9 million is the amortization and spread on CDS protection and illustrates this paradigm.

Operating Expense Management

We are extremely pleased with our downward trend in our expense ratio. As our capital base has grown, we have been able to achieve economies of scale with our personnel and our systems. While we feel like 0.8 percent is an approximate run rate for our business model, it should be noted that our expense base supports not only variable expenses that are driven by the size of our investment portfolio, but also new business initiatives which can ultimately drive shareholder return.

Dividend Distribution

While there are several factors that go into our dividend, I would stress a few takeaways from this slide. Since 2009, we have been able to achieve a relatively consistent quarterly dividend while growing book value per share and increasing our capital base through several secondary offerings.

At the same time, while we have seen some volatility in our Core Earnings EPS due to the impact of deploying proceeds from capital raises, including the third quarter of 2012, whereby we raised over 25 percent of our capital base, we have complied with our dividend distribution requirements within the REIT, as illustrated on the right-hand side of this slide.

Digging a bit deeper into our dividend considerations, management, in support of our Board of Directors, weighed several factors such as Core Earnings, movement in book value, taxable income and current market conditions.

These factors are not always correlated and create paradigms in our recommendation. A few examples are the hedging of our non-Agency portfolio utilizing CDS protection, and the difference in the income recognition on non-Agency bonds between GAAP and tax.

As part of our overall hedging strategy, we enter into CDS protection within our taxable REIT subsidiary. This trade creates a series of items to consider: (1) the trade in a period of credit deterioration can lead to a reduction in Core Earnings while a favorable protection of book value. (2) At the same time, the trade is contained within the taxable subsidiary and while the cost of insurance impacts Core Earnings, it does not impact the REIT's taxable income and its dividend distribution requirements. So in summary, this trade creates a negative impact on Core Earnings, a positive impact on book value and a neutral impact on REIT taxable income.

On the non-Agency front, we generally acquire bonds with significant discounts to par. On average, we have paid roughly 47 percent of par across our non-Agency portfolio as of June 30th. We expect the majority of these bonds will incur credit losses, and for GAAP, a credit reserve has been established to reduce the accounting income recognition.

For tax, future credit losses cannot be recognized into the yield recognition, which results in a higher yield until losses are incurred. This effect results in what often is referred to as phantom income, a situation where taxable income can be significantly higher than Core Earnings. This impact is largely a timing difference which will reverse when losses are experienced and/or the bond is sold. So in summary, this non-Agency portfolio creates a higher taxable income than Core Earnings.

These are only a few examples, but these illustrate some of the items that management considers when distributing its dividends.

I want to thank you, it was a pleasure speaking with you today, and I'll now turn the podium over to Tom.

Q&A

Thomas Siering: Thank you for your attention and attendance today and we are delighted to take Q&A.

Guest: See on the slide where you had the 3 to 6 percent range for non-Agency loss-adjusted returns, is that in a Sub-Prime – other assets if any color on what gets you to the high end versus the low end?

William Roth: Sure. OK. So we're good with the question, you have the microphone. You want to go back to that slide for a minute? And now I have time to think of the answer.

So the – what we wanted to do is show sort of the range of the – from Prime up to Sub-Prime. So prime assets are typically trading around 3 percent plus or minus, and I'm just going to caution that if you gave the same bond to three different dealers or three different investors, they're going to come up with different expected loss-adjusted yields, but generally within the range Prime is on the lower end. Alt-A and Option-ARM are generally in the middle and Sub-Prime is sort of in the 6 percent plus or minus.

I mean certainly the assets that we continue to prefer are on the Sub-Prime side, not just for the yield, frankly, but also because of all of the dynamics that we discussed that lean towards continued improvement in that part of the housing market and in the borrower behavior.

Guest: You mean like turnover in a non-Agency book?

William Roth: So the question is what's the turnover in a non-Agency book?

We don't have a target for turnover. In fact, I would say that if they were all par tomorrow, you might see turnover at a lot higher level than it's been historically, but that's not going to happen.

The way we think about turnover in the book in general, which is, I think, probably more instructive, is that our goal is to find assets that we think have attractive risk reward qualities to them, whether they're low loan balance pools or HECM pools or non-Agency, you know, whatever it might be. We try to buy them as cheap as we can and assess the risk and hedge out risks where appropriate.

If those securities then change in valuation, then there are two questions. Are they still cheap; are they still attractive or can you just not stand looking at them anymore? I'm sure the equity investor you know how that feels.

And so they're certainly, in general, we're not a trading vehicle, we're an investment vehicle, but there are certainly times, and we've done this in the past, where there are securities that to us just didn't make sense where they were priced. So at that point, if there's something better to do with the money, which inevitably in that case there would be, we would sell some set of securities and reinvest the proceeds.

We have done that in the past, but if we buy a bond at 60 and it goes for 65, that doesn't necessarily mean it's a sell candidate.

Guest: OK.

William Roth: Sure.

Thomas Siering: Additionally there are pretty restrictive provisions on turnover for REITs. You know, the SEC does not want them to be hedge funds in drag.

Guest: Doug?

Thomas Siering: Doug?

Guest: Yes, can you talk about the economics of new loan securitization today?

William Roth: So the question was can we talk about the economics of new loan securitization today?

I would love to talk about it, and so – but I will just caution you that there's been about a billion dollars or so done in the last 12 months. So it's not a large sample size. But let me just tell you dynamically what's going on there.

What we've seen is that loan rates on originations are roughly 50 basis points plus or minus behind conforming. So conforming loan rates, as Ivy mentioned, are around 3.5. Jumbo loan rates roughly 4 percent, let's call it.

And I would say that the dynamics today are substantially – well, keep in mind, there have not really been many deals. What we have seen is the dynamics have changed in several aspects. First of all, the amount of credit enhancement required by the rating Agency has come down, not by a lot, but by very little. At one point when this early dealer deals were done they were 8, 8.5 percent and now they are in the 7's. We can have a separate debate over drinks as to what we think the right number should be given the credit quality of the loans, but that's neither here nor there, the fact is that credit enhancement to the AAAs have come down.

The second dynamic is that AAA pricing which was at one point 230 over swaps is well inside 200 over swaps today. So that if you think about what that does for the credit bonds, if you had a little bit less credit enhancement and you have a tighter AAA, that means the math on the subordinate bonds is clearly more attractive because that's what your leveraging off.

Deals that were done within the last year or so, there are some research reports out there that suggest that the yields on those subordinate packages were somewhere in the 7, 8, 9 percent. I think if you ran the same math today you'd see that the yields on those bonds are north of 10 percent easily.

Now the second part of the question which you didn't ask is, well, you know, how easy is it to do a securitization? Well, we know that housing activity is low, we know that jumbo production is really low because the loan limits are really, really much higher, housing's come down and loan limits are still very high, and we also know that banks happen to like an asset of that quality that yields 4 percent because frankly you can see from looking at this chart that there's not much out there at that yield level. So banks aren't really incented to sell these. So the availability of the products despite the math being substantially better, the availability of the product is still very low. Yes sir?

Guest: I have two questions about your Agency part of the portfolio. The first is you bought a lot of 30-year fixed about 9 billion in the third quarter, it seems like most of it was pay-ups. Are you similar to

some other Agency REITs deploying this strategy of pre-buying what the Fed was expected to buy in QE3 current production and then maybe selling it to the Fed, that's question one.

And the second on your HECM and Inverse IO, your HECM is about 2 billion now, do you foresee any kind of scale limits given that it's a very, still a constrained kind of product? And finally on your IOs and Inverse IOs do you view them as purely hedges or also value producing given their negative convexity? Thanks.

William Roth: Sure. Yes, maybe and yes. The – so, so just so we're clear, I'm going to get up because I want to do this here. I just want to clarify one thing that you said just so everyone's clear.

You mentioned buying 9 billion in the third quarter. Our portfolio on the Agency side was 9 billion as of the end of the second quarter, and then you can see here that our portfolio over 15 – or actually take it back, here you can see that our portfolio is about 12.8, so we actually we didn't buy 9 billion during the quarter, it was 9, it went up to between 12.5 and 13.

So in terms of – you know, that's a great question. As I mentioned before we're not a trading vehicle, we're not trying to be a hedge fund, we're trying to extract value in the market. So our approach is a little bit different. We're trying to find securities that we think have a good yield profile, are relatively stable, easy to hedge, because that's makes protecting book value easier.

In terms of trying to guess what the Fed might buy or trading, the tactical nature of it, that's certainly something that we or anybody else could do but we don't view that as our mandate. So typically when we raise money it's because we think there's something smart to do with it, whether it's in Agencies or non-Agencies, or as we mentioned before, in the residential space, buying houses. We're not inclined to raise money to try and guess which way the basis is going to go.

The second part of your question revolves around HECM. So the HECM is just, it's just an awesome cash flow. I mean it just really is, the borrowers get – somebody sends you a check for \$150,000, you don't ever make a payment, and then when you go to a nursing home or pass away the house is sold and it pays the loan. I mean that's great, there's no – the cash flow is very stable. That being said, and keep – and just for everyone's reference, it's – these are first rate in credit, these are all Ginnie Mae securities. So there's no question about getting our principle back.

However, the market is relatively small, production is not robust, and as a result, we need to be mindful about what percentage of the portfolio we want to have in assets where – I mean we're not a huge part of the market by any means, but it's certainly not the Fannie (or Freddie) market.

Now the good thing is being a REIT and having long dated capital, we can sell some liquidity, but certainly we think about how much of – whether it's HECM or anything else, how much do we want to own relative to the market, and we're very comfortable with the product and we're comfortable with our sizing, but I don't think you should expect us to come to market and raise a billion dollars and say we're going to go buy 10 billion HECMs because that's just not – that's not reasonable.

Your final question in terms of IOs, IOs have – they have a lot of fabulous qualities, at the same time you really need to get your price right and know what you're buying because your – it's really highly magnified prepayment risk. So there are times when IOs are cheap and there's times when they're not so cheap. And so the way we look at it is if we like the price and we like the collateral then you're

looking at what's the convexity characteristic. So is it a good hedge for our portfolio? An asset doesn't have to be hedged to be cheap but we have to make sure that we know how to hedge it. So generally that being said, IOs generally being negative duration, if we get the price and the prepayment right, that asset has value because it's a negative duration instrument at a positive OAS, which means it cost less than other hedges.

On Inverse IO, it's basically the same except that the coupon is LIBOR, which we can hedge out, I mean you can use futures of swaps to hedge out the LIBOR component and extract some of that IO value. So that's kind of the way we think about it, it just so happens that many times IOs have or Inverse IOs have positive yield and we – but keep in mind the risk metrics that we showed in that slide for up 100, up 200, that includes all the IO and Inverse IO price moves as a result of that. So we're blending that in to all of our hedging as we add or subtract to the equation there.

I hope that answered your question.

Guest: Yes. I just had a question about the single family residential portfolio. Just kind of given Ivy's bullish comments about housing, it just kind of strikes me why you feel this is the right time to be selling that portfolio, and then specifically if you could also talk about the appraisal process for that portfolio to determine what price it's going to be sold to, to Silver Bay.

Thomas Siering: Sure. Well, I'm very limited in what I can say about Silver Bay because we're in a quiet period, but I think your characterization of what we're doing needs to be addressed. So we are spinning this out to our shareholders and so our shareholders will ultimately be receiving shares, so we are not selling this portfolio to Silver Bay we're contributing it to Silver Bay.

In respect of the valuation process or method, that's something that I cannot get into today because of SEC considerations, but there'll be a full disclosure of that before the IPO occurs.

July Hugen: We have one more question before I'm going to turn it over for closing remarks, over here.

William Roth: We'll take both. Hey Danny. Hey, can you comment on how the recent – (inaudible)

Thomas Siering: We have three – the other, here we go.

Guest: Just how the evolving dynamics in mortgage servicing is impacting your investment decisions, how much your Sub-Prime books will fund new investments and your existing portfolio.

William Roth: Yes, sure. So basically if you think about the non-Agency sector, and we spend a lot of time thinking about servicing, each servicer behaves somewhat differently, and if we go back, and I'm going get up again because I want give you – go back to a slide here that I think is really worth pointing this out on.

OK, so let's look at – we've got two bonds here and we've got on the middle left the A3 bond which current pay, so cash flow that come into the trust today greatly impacts that bond. That bond pays LIBOR plus, I'm not even sure, maybe 15 or 20, it's priced at a discount to generate some yield.

So if \$19 million comes into the trust tomorrow, that bond – at par it's gone, so the owner that is – they're high fiving on the trading floor. The A4 would also be happy because now it becomes current pay.

On the other hand, the A3 bond, if the servicer decides, well, we're going to do a lot of modifications, we're not going to liquidate these guys, we're going to get – let's say it's a servicing transfer, for example, which is happening a lot. Let's say that one servicer has been liquidating and the new servicer decides, well, all these advances, we're going to take those back out and we're going to start modifying because the trust is going to perform better. Well now all of a sudden the A3 is getting noble no cash flow, right? As a result that's a really bad day for the A3.

On the other hand, the A4, now in this example the A4 is not going to take losses in what we're showing, but let's assume for a minute that this bond was only going to – is priced at 50 and would only recover 80. If you have a servicer who's doing good modifications and is not advancing so much, that means losses to the trust will be lower, which means the A4 bond will recover more. So what we're focused on is what – how are different servicers behaving and how will that affect the cash flows to the trust, and more specifically, to individual bonds.

And so what's going on in the servicing world, I mean that's beyond the scope of today, but the gist of it is that there's a few guys that are hovering in large amounts of servicing and they're behaving in a certain way and there's some others who are having trouble servicing bad loans.

And so as the dynamics play out we pay particularly close attention to how it affects individual security in the structure. Mark, you had a question?

Guest: Yes, thanks.

William Roth: And then we'll wrap up? I think that will –

Guest: Sorry if you covered this already, but what are hedges' asset spreads on Agencies right now?

William Roth: I didn't address that, and I'm happy to do so, but I will tell you that the mortgage basis has been really volatile lately, and so if you wind 10, 15 basis points (inaudible) we've seen both ways, that's a hundred basis points ROE, right there, right, 15 basis points. But if you think about it, yields that I showed on that slide were in the low twos, right, hedges are virtually, I don't want to say costless, but swap rates are so low that you're looking at 50, 60 basis points.

You can expect – now the problem with that is that doesn't hedge your long end risk, which is why we throw in swaptions. But the gist of it is the way we see it is that spreads right now are probably mid-100s maybe, plus or minus, but it's particularly challenging because the risk you're taking is not just that spread but the fact that the assets are 108, 109, 110.

So the certainty of that spread is less than if those assets were 103. Just to point on that, like most of the people in here are focused on the equity market. There are some times where you're not really doing much, where we're in a situation right now where the Fed's buying Agencies and pushing spreads very tight. It's probably not going to last forever.

If we had a huge amount of prepayments come in and we had to reinvest them tomorrow, it would obviously be much more challenging than what we've seen.

Fortunately we're in a situation where while it's been good for book value as Tom mentioned, spreads are challenged today, but we don't expect that to last forever, I mean the government's basically made the statement they want to get further out, and I don't know if you saw the strategy release by the FHFA that came out yesterday, they're talking about the strategy for the next four years and what the GSEs are going to do.

The point is that I think that while spreads today, while we sit here, are challenged, market – you know, the market gives and the market takes, and so we're fortunate we don't have a lot of monthly cash flow that we can pick (our spot).

Guest: (Inaudible).

William Roth: Yes, sure.

Thomas Siering: You know, Bill and the team did a really good job though getting ahead of this last push by the Fed and so we had deployed substantially all of our capital prior to this last round, the timing, and secondly, Mark, as you know, because our prepayment speeds are so slow that we just don't have a heck of a lot of money to reinvest, and that's an additional beauty of that portfolio.

Guest: Just to wrap up, just one more follow-up. Are rates getting to such a low – absolute low amount that the generic collateral that gets originated in the next year or so actually becomes attractive on an (inaudible) basis?

William Roth: Well, the price – I mean the price that Fannie 3's are on the screen, reflects the fact that the Fed's buying them to keep the mortgage rate low. I think before I left they were on high 104's. I don't know what they're going to prepay at, but those are very dangerous coupons, in my opinion, because clearly normally bonds when they get to 104, they're going to refinance, but yet that's the new coupon, it's 3.5.

So if the mortgage rate ends up coming down to 2.75, those guys might refi again. Now I don't know if it'll get there but, I mean just to give you an anecdote, Wells lowered their rate to 3-3/8, and then one day later because they got so slammed with applications they raised it to 3.5 and then the next day they went to 3 5/8.

So while the Fed wants to keep the mortgage rate low, I'm not really sure where the primary rate is going to end up, but generic bonds at 104 are not really our favorite bonds, they're very challenging bonds. Now there will be a time when those are attractive, I'm just not sure it's today.

Thomas Siering: Andy, did you have a question?

Guest: Just (inaudible) share in the market is (inaudible) attractive at some point (inaudible)?

William Roth: Wow. Well, second liens, and I don't know where the banks are marketing them these days, but I'm guessing that they're probably – I'm not sure they're at a price that we would necessarily like them.

They're not that many securitized second lien deals, let's start there. There are a lot of second lien, they're typically on bank balance sheets as lines of credit, I'm sure there's people in here that have taken advantage of some of these super low rates or teaser rates.

The fact is that banks don't really sell their second liens. There are some second lien deals, they are very challenging because intellectually you'd think that they would all disappear, but that's probably not going to happen. So getting your arms around valuation, we haven't owned them, I'm not sure that we will go there, just because the first lean market is massive and there's plenty to go around, so I think it's unlikely that you'll see us go there.

Thomas Siering: I'd like to once again thank everyone for coming, we hope you found it to be informative. I'd like to thank July and her team for putting this event together, you've done a super job.

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