TWO HARBORS
Investment Corp.
A Pine River Capital Managed Company

First Quarter 2016 Letter to Stockholders

NYSE: TWO

May 24, 2016

Dear Fellow Stockholders,

In the first quarter, investment opportunities for our target assets became more attractive. We opportunistically purchased Agency residential mortgage-backed securities (RMBS), while continuing to add commercial real estate assets and mortgage servicing rights (MSR). While still maintaining low overall interest rate exposure, we increased our debt-to-equity to 3.0x at March 31, 2016, from 2.5x at December 31, 2015. Subsequent to quarter-end, we continued to raise our debt-to-equity, bringing it into the mid-3's in April.

We reported book value of $9.70 per common share as of March 30, 2016, representing a (1.8%)[1] total return on book value for the quarter after accounting for the first quarter dividend of $0.23. We also repurchased 8.0 million shares in the quarter, representing 2.3% of our common stock outstanding at December 31, 2015. This was accretive to book value by over $0.05 per share. We continue to evaluate share repurchases with consideration to a number of factors, not the least of which is our prevailing share price relative to book value and available investment alternatives.

Opportunities in the commercial real estate market remain quite attractive, and we increased our capital allocation to 11% at March 31, 2016 from 8% at December 31, 2015. In the next few years, there will be a wave of maturities and transaction volumes are currently high. Additionally, regulatory requirements are constraining traditional lenders, leading more borrowers to seek balance sheet lenders, like Two Harbors, to provide financing. In the first quarter, we added three assets, bringing the total carrying value of the portfolio to $744 million. The assets in our portfolio are secured by a diverse group of properties located throughout the U.S., and the majority are floating rate, which provides potential upside to higher rates. Post quarter-end, we closed on another two loans for $125 million, bringing our total holdings to about $870 million. We initially targeted an equity capital allocation of $500 million to commercial real estate. We expect to complete that commitment sometime in the third quarter of 2016 and it is our anticipation that we will continue to deploy capital beyond that initial allocation.

This was an exciting quarter for MSR, as we increased our portfolio to $55 billion in unpaid principal balance (UPB) via both flow sale arrangements and a bulk purchase. Our focus continues to be on adding flow MSR sellers, and we added four in the quarter. We have seen an increase in monthly flow volume and anticipate that near-term volumes will be around $1.5 billion to $2.0 billion per month. The growth in our MSR investments improves the economics of our Rates[2] strategy, as MSR is a natural hedge to our Agency RMBS investments, providing positive yield and negative duration.

With respect to the mortgage loan conduit, our Agate Bay brand continues to gain traction, and we are seeing both repeat and new investors. In the first quarter, we sponsored two prime jumbo securitizations totaling approximately $628 million UPB. We have said in the past, we may retain some higher pieces of the capital structure of our securitizations when it is compelling. Late in the first quarter and into April, we saw improvement in AAA spreads and we sold some of these to meet market demand. Capital allocated to the conduit was lower this quarter, primarily due to both these sales and materially lower lock volumes. The combination of regulatory constraints and competitive pricing have led to a challenging market environment for aggregating loans for securitization. Our pipeline of prime jumbo loans and interest rate lock commitments was $558 million UPB at March 31, 2016.

In the quarter, we secured a second $250 million facility for financing senior commercial real estate loans, further expanding our financing capability. Our debt-to-equity on commercial real estate assets was 1.3x at March 31, 2016, up from about 0.7x at December 31, 2015. We expect our debt-to-equity ratio to trend higher as we fully utilize these facilities. Our FHLB advances totaled $4.0 billion at March 31, 2016, and in the quarter we added senior commercial real estate collateral. Our repurchase agreements totaled $6.2 billion at March 31, 2016, up from $5.0 billion at December 31, 2015, due to the purchase of Agency RMBS. Importantly, the repo market continues to function efficiently and in a normal manner for us. We have 20 active counterparties and continue to ladder our repo maturities to protect against a disruption in our financing. Subsequent to quarter-end we also introduced direct lending with one counterparty. We believe the addition of direct lending relationships can further diversify our funding sources as well as lower our overall repo costs. With a wide variety of available tools, we believe that we have the ability to navigate various regulatory and market impacts on financing.

From a macroeconomic perspective, interest rates in the first quarter moved lower as the Federal Reserve's commentary indicated caution with regard to future rate hikes. Currently, the market suggests that there is a 14% chance of a June rate hike, and a 45% probability of a September rate hike(3). Whatever the future holds, lower for longer seems increasingly likely.

We are optimistic about the current investment landscape, particularly for commercial real estate and MSR. One of the benefits of our recent conservative risk positioning and low leverage is that we are able to take advantage of better investment opportunities when they arise. Our hybrid model allows us the ability to dynamically allocate capital, which we believe drives returns for our stockholders.

Thank you for the confidence demonstrated by your investment in Two Harbors. As always, we welcome any questions you may have.

Sincerely,

Thomas Siering
President and Chief Executive Officer

(1) Return on book value for the quarter ended March 31, 2016 is defined as the decrease in book value from December 31, 2015 to March 31, 2016 of $0.41, plus the dividend declared of $0.23 per share, divided by December 31, 2015 book value of $10.11 per share.
(2) Assets in the "Rates" strategy include Agency RMBS, Agency Derivatives, MSR and Ginnie Mae buyout residential mortgage loans.
(3) Source: Bloomberg, as of May 2, 2016.