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TWO - Q2 2014 Two Harbors Investment Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Two Harbors' second-quarter 2014 financial results call.

(Operator Instructions)

As a reminder, this conference is being recorded.

I would like to introduce your host for today's conference Ms. July Hugen. Ma'am, you may begin.

July Hugen - *Two Harbors Investment Corporation - IR*

Thank you, Vincent, and good morning. Welcome to our second-quarter 2014 financial results conference call. With me this morning are Tom Siering, President and Chief Executive Officer; Brad Farrell, Chief Financial Officer; and Bill Roth, Chief Investment Officer. After my introductory comments Tom will provide a recap of our second-quarter 2014 results, Brad will highlight some key items from our financials and Bill will review our portfolio performance.

The press release and financial tables associated with today's conference call were filed yesterday with the SEC. If you do not have a copy, you may find them on our website and the SEC's website. This call is being broadcast live over the Internet and may be accessed on our website in the investor relations section under the events and presentations link. We encourage you to reference the accompanying presentation to this call which can also be found on our website. Reconciliation of non-GAAP financial measures to GAAP can also be found in the presentation.

We wish to remind you that remarks made by Management during this conference call and the supporting slide presentation 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 with the SEC which may be obtained on the SEC's website at www.sec.gov. We do not undertake any obligation to update or correct any forward-looking statements if later events prove them to be inaccurate. I will now turn the call over to Tom.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Thank you, July. Good morning, everyone, and thank you for joining our earnings conference call. Let me start with a summary of our financial results. Please turn to slide three. We are off to a great start to the year, delivering a total return on book value of 6% in the second quarter and 9.9% through the first six months of the year. For the quarter we delivered comprehensive income of \$230.8 million or \$0.63 per weighted average diluted share representing a return on average equity of 23%.

Additionally, we reported core earnings of \$0.24 per share and GAAP earnings of \$0.11 per share. As you know, we believe GAAP earnings are less instructive as to our performance.

Next I'd like to provide a brief update on our mortgage loan conduit and MSR progress. Our conduit continues to gain momentum and I'm pleased to announce that we had over \$1 billion of prime jumbo holdings and pipeline locks on our combined base -- on a combined basis at quarter end. Obviously we've done a lot to advance our originator relationships. Subsequent to quarter end, we also completed another securitization and we intend to complete others as market conditions allow.

From a financing perspective, we expect to utilize the home loan bank to support our conduit activities more in the future which allows us to provide consistent pricing to our originator partners and is an important way for us to optimize our overall funding mix.

With regard to MSR, we are exploring opportunities to expand our investment in this asset class with a variety of partners including those associated with our mortgage loan conduit. During the quarter, we acquired MSR through bulk and flow transactions. MSR continues to be an excellent asset for our portfolio on a yield basis and in respect of mitigation of interest rate and spread risk.

Our Agency securities benefit from tighter Agency spreads in the quarter. Our non-Agency securities also continued to appreciate. Last night we released case study of our non-Agency portfolio located at www.twoharborsinvestment.com under the Investors and Webinar links. This webinar focuses on home price appreciation, or HPA, as one of the primary drivers of non-Agency performance over time. It profiles a particular subprime bond that we've held in our portfolio for several years.

Those of you who have followed us closely will recognize that as an example we have highlighted in past presentations. We recently sold this bond at a price close to par thus having little additional upside. That said, as you will see in the webinar, home prices remain well off peak levels. Also, home affordability is quite high because of this and considering the effect of low mortgage rates.

Unemployment improved through the quarter dropping to 6.1% in June. Furthermore, according to CoreLogic, home prices were up 7.5% on a rolling 12-month basis as of June 30. These are also positives for credit performance and the potential for further non-Agency price appreciation. We hope you find this webinar to be instructive.

As we turn to page 4, let's take a look at some of the other aspects of the micro -- of the macroeconomic environment. Interest rates continued to fall in the second quarter with 5 and 10-year yields dropping approximately 10 and 20 basis points respectively quarter-over-quarter. Over the last 12 months, our total return on book value was 16% which is considerably better than the 10-year treasury which returned only 3.7% over the same period. This illustrates our investment teams can ability to manage our portfolio across various interest rate and mortgage environments and to hedge effectively.

While it has been speculated for some time, the Fed announced in the June meeting minutes that the final reduction in its asset purchases will occur following its October 2014 meeting assuming the economy progresses as expected. The Fed also noted that it would likely maintain its

current Fed funds target range of 0 to 25 basis points for a considerable time after the asset purchase program ends, especially if inflation remains below its target of 2%. We believe the end to the Fed purchases will impact the mortgage market over the coming months.

We continue to monitor a variety of issues that would impact the housing and mortgage market over the long term. The most important of those in the -- is the future role of the GSEs. As many of you are aware, a number of proposals have been presented over the past several months regarding GSE reform. We maintain our belief that it's unlikely that meaningful strides towards this reform will be accomplished in 2014. That being said, it is promising that there has been widespread recognition of the need for private capital to support the US housing market.

We believe mortgage REITs like Two Harbors, as a source of permanent capital dedicated to the mortgage market, will play an integral part in reducing the government footprint in the mortgage market over the long term. To that end, we have maintained a dialogue with many in Washington to help create solutions to the challenges facing the mortgage market. Now I will turn the call over to Brad for a discussion of our financial results.

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Thank you, Tom and good morning to those on the call. Let's turn to slide 5 to go through our book value roll forward. Our book value increased \$11.09 per share. Our comprehensive income, or economic return equivalent, was \$230.8 million, or \$0.63 per weighted share offsetting our dividend declaration of \$0.26 per share were \$95.2 million. As we have said before, book value growth and comprehensive income are two important metrics in reflecting our ability to generate cash returns and distribute dividends over the long term.

Please turn to slide 6 for an overview of our financial results. Core earnings of \$0.24 per weighted share represented an 8.9% annualized return on average equity. This result was in line with our expectations when we set the dividend.

In the second quarter, we continued to recognize favorable yields on our Agency RMBS and MSR due to slower CPR. Our implied debt-to-equity ratio including our TBA position was 3 times, which is an increase from 2.7 times at March 31, as we increased our FHLB borrowings as well as decreased our short TBA position.

Our expense ratio was 1.5% of average equity, in line with the first quarter. As a reminder, this metric will be dependent upon the transactional activities of our conduit and MSR businesses, so we expect variation quarter-over-quarter. On the bottom right-hand side of the slide, we have noted some accounting topics of importance. We released approximately \$25 million of credit reserves on our non-Agency RMBS. We release reserves as a result of specific holdings that are surpassing our performance assumptions, and we review this on an ongoing basis. It is important to note that our general view of fundamentals remains unchanged.

The acceleration of our prime jumbo pipeline drives two noteworthy accounting topics. In accordance with ASC 815, we recognize interest rate lock commitments on mortgage loans held-for-sale as derivatives and account for them at fair value on the balance sheet. At June 30, fair value on the derivative was \$3.4 million but the financial impact may become more relevant at some point in time.

The expansion of our prime jumbo pipeline also impacts the presentation of core earnings given we will have incremental risk to hedge. In the near term, this may negatively impact core earnings results due to the timing difference between the swap expense and the income associated with the loan. For example, swaps have an immediate cost, whereas unsettled loans do not provide immediate income but rather income once they've settled.

Our MSR assets increased from a fair market value of approximately \$477 million as of March 31 to \$501 million at June 30 largely due to the acquisition of a bulk pool in April. During the quarter, we recognized \$33.9 million of servicing income, \$6.2 million of servicing expense and a \$29.6 million decrease in the fair value of our MSR, which includes implied amortization of \$13.9 million.

Please turn to slide 7. I would next like to spend some time discussing our financing profile, including the Federal Home Loan Bank of Des Moines and an update on the repo market. As of June 30, we had secured advances of approximately \$1.5 billion with a weighted average maturity of approximately 47 months. While today our advances are primarily collateralized by Agency securities, as we fund our mortgage pipeline we intend



to shift the collateral mix further to A-rated or better non-Agency RMBS and prime jumbo whole loans. Over time, we expect the flexible nature of the FHLB facility to help us to diversify and optimize our funding mix, especially as it relates to our conduit initiative.

Moving to the repo markets, despite drawing some media attention, they are functioning in a normal manner for us and we have not experienced any meaningful shifts in financing haircuts or rates. Historical events in the repo market highlight the importance of having a diversified counter-party mix, which has always been our practice.

In addition to having 24 active counterparties, we maintain a lengthy maturity profile with an average of 68 days to maturity at June 30. This is a decrease from the 84 days at March 31 which is due to our increased use of FHLB advances as well as some July-maturity repo that was renewed subsequent to quarter end. On an aggregate basis, we have 238 average days to maturity across our repo and FHLB advances. Now let me turn the call over to Bill.

Bill Roth - *Two Harbors Investment Corporation - CIO*

Thanks, Brad, and good morning, everyone. This was an excellent quarter with respect to our total return on book value of 6% as well as the significant progress on our mortgage loan conduit which I'll cover later.

Please turn to slide 8 which details the specifics of our second-quarter results. Our rates strategy performed well with yields increasing 10 basis points quarter-over-quarter to 3.8% driven by higher realized yields on certain of our Agency assets including IOs and inverse IOs. Tighter spreads on higher coupon Agency MBS and ARMs contributed to overall book value performance.

Our MSR yield was 10.6%, consistent with the first quarter. We are pleased with the stable performance of our MSR assets given the backdrop of lower interest rates and strong mortgage prices. As usual, I would note that Agency and MSR yields will be driven by prepayment activity.

Our credit strategy had another strong quarter with legacy non-Agency bond prices moving higher thus contributing nicely to our increase in book value. Turning to the right-hand side of the page, you can see that this quarter we have provided additional details on our credit portfolio, which is becoming important as our Credit holdings are beginning to move towards new issue securities, especially from our conduit activities.

Yields on legacy non-Agencies, which include bonds issued prior to 2009 and primarily reflect our subprime bond holdings, were generally consistent with the first quarter. These remain about 90% of our non-Agency exposure, though that is down from around 95% last quarter. The yield on our net economic interest and securitization trust decreased quarter-over-quarter as we sold a rich IO that had generated a very high yield in the first quarter.

After this sale, our retained interest, which now also includes over \$180 million in AAA bonds, still generated a yield of over 5%. Finally, we purchased some other recently issued AAA non-Agencies yielding in the 3% to 4% range.

Our aggregate portfolio generated an annualized net interest spread of 3.38% roughly in line with the first quarter. Our cost of funds was slightly higher due primarily to a modestly higher overall swap expense. This was largely driven by an increased amount of swaps needed to hedge the substantially higher loan lock commitments during the quarter. As Brad mentioned, these locks do not generate income until the loans have come onto our balance sheet.

Please turn to slide 9. Our portfolio as of June 30 was \$14.5 billion including \$10.8 billion in rates and \$3.7 billion in credit. Consistent with the first quarter, approximately 57% of capital is allocated to rate which is comprised of 44% Agencies and 13% MSR. Opportunities in the Agency RMBS space remained generally unappealing as yields and spreads tightened during the quarter. As such, we have kept leverage on our Agency RMBS portfolio below our targeted levels.

We maintained our position in higher coupon bonds and other shorter duration assets, as this keeps our basis risk exposure fairly low and aims to minimize any book value impact from wider spreads that could be a consequence of the Fed ending its asset purchases later this year. The increased MSR holdings are also helpful in this regard as they are a natural basis risk hedge.



One item I would like to highlight from the quarter is that we sold about half of the ARMs that we had acquired in the middle of 2013. These ARMs were purchased in a time of distress in the market when they widened about 50 basis points in spread. Today they are back to the tight levels we saw before the widening, so we have cut back on these holdings to manage this potential downside risk.

Within our credit portfolio, we still have a substantial emphasis on legacy non-Agencies, particularly subprime. We believe these deeply discounted bonds can benefit as the economy and housing markets continue to improve over time. There remains upside optionality to lower delinquencies, higher recoveries and faster prepays. I would also like to point out that the "Other" category increased by over \$350 million this quarter as we added prime jumbo holdings via the mortgage loan conduit. This category includes our net economic interest in securitizations. Over time, increased conduit activity will drive higher credit holdings from new issuance.

Turning to slide 10, you will see that our overall portfolio metrics are similar to last quarter. Leverage remains low with our implied debt-to-equity ratio for RMBS, Agency derivatives and mortgage loans held-for-sale, net of TBAs, at 3 times. This was up a bit with our use of FHLB financing and a smaller short TBA position. Agency prepays ticked up a bit as spring is the seasonally strong time for housing turnover and rates move lower during the quarter. Non-Agency prepays were also up slightly, which is great for our overall performance metrics given the deep discount on these bonds.

Moving to the right-hand side of the slide, in keeping with our typical positioning we are carrying low interest rate exposure. In addition, due to our holdings in shorter duration Agency assets and MSR, our basis risk exposure is also still relatively low. As to our increased swap position, as noted earlier, this relates to the dramatic increase in prime jumbo loans and locks which increased our overall duration risk.

As we have discussed before, MSR is a good hedge for fixed rate mortgage assets but the timing of MSR purchases does not always match up with asset purchases. As we continue to acquire more MSR, it will help to drive overall swap hedges down relative to our total hedging needs. For more on our rates and credit holdings, please refer to the appendix slide 18 through 22 and see slides 24 and 25 for more information on our hedging.

Turning to slide 11, let's talk about our mortgage loan conduit which was certainly a highlight of our second quarter. We saw an increase in our prime jumbo loan holdings and our pipeline to approximately \$377 million and \$650 million, respectively, bringing the combined total to north of \$1 billion at quarter end. This is up substantially from the first quarter due to having more originators on board as well as being able to provide consistently attractive rates to our originators.

Our ability to provide consistently strong pricing is the benefit we get from having longer term FHLB financing available to fund loans in the event that pricing a securitization -- pricing in the securitization market is not attractive when we might be looking to issue a deal. This allows us to more effectively help homeowners finance their purchase of a home. We highly value our relationship with the FHLB and believe it enables both parties to effectively and efficiently meet our respective goals of providing permanent capital to the US mortgage market.

To date our conduit efforts have been focused on sourcing prime jumbo loans from our originator partners, which allow us to create mortgage credit investments for our portfolio. As we mentioned last quarter, we are considering the possibility of offering a non-QM product or potentially other products if it makes economic sense for borrowers as well as our stockholders.

Subsequent to quarter end we closed Agate Bay Mortgage Trust 2014-1, a \$268 million securitization. It was backed by 334 prime jumbo mortgage loans and allowed us to create attractive assets for our portfolio.

I'm also pleased to report that after completing this deal, our positive momentum has continued with prime jumbo loan holdings in pipeline totaling approximately \$1 billion as of August 6. With this type of volume, we anticipate completing additional securitizations later this year should market conditions permit. We are very excited about the growth of the conduit and becoming a more frequent issuer, as this bodes well for our credit strategy going forward.

Please turn to slide 12. We added \$5.3 billion UPB of bulk and flow MSR during the quarter, investing about \$53 million. We closed on a bulk portfolio of approximately \$4.8 billion UPB of MSR from Flagstar early in the quarter and added \$545 million UPB from our flow arrangement with PHH. The market value of our MSR at quarter end was approximately \$500 million, or about 13% of capital.



Looking forward, we continue to see opportunities in the MSR sector for both bulk transactions and flow-sale arrangements through our originator relationships. As we have said before, we are focused primarily on new production MSR given its attractive yield and hedging benefits to our portfolio.

In closing, this was a great quarter with strong return on book value and excellent progress on developing our originator-facing platform. We believe this will serve as a growing source of product for our rates and credit strategies over time and look forward to keeping you apprised of our progress on the next call. Thank you for joining us this morning. I will now turn the call back to our Operator, Vincent.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Mr. Douglas Harter of Credit Suisse.

Douglas Harter - Credit Suisse - Analyst

I was wondering Bill if you could talk about how -- what the securitization markets look like right now for funding and the attractiveness of the deal that you just completed?

Bill Roth - Two Harbors Investment Corporation - CIO

Yes, sure, absolutely. Well the markets for mortgage assets there's still good demand. The way that we looked at this transaction is we originate loans and securitize and sell the AAAs. The credit bonds run ROEs in the low to mid teens. We've actually retained some AAAs on past deals as well as some on this deal and those ROEs are in the 10% plus or minus area. So both of those are more dominant than other alternatives that we're seeing to invest.

Over time as that market opens up and there is better liquidity and more investors because currently as you know that market is still seeing small volumes, we think that pricing will be even better and that returns will be attractive for us. Historically, the securitization market offers returns in the 10% to 15% range over time and so we're confident that we'll see that. We're sort of in that range already, but I think that'll sustain. The other thing that we're excited about is our pipeline is obviously quite healthy, so we, as I said on the call, we anticipate a number more of securitizations in the near future.

Douglas Harter - Credit Suisse - Analyst

And on those returns, are those returns that are available too because of the attractive FHLB or would that be available through market level funding?

Bill Roth - Two Harbors Investment Corporation - CIO

Well on the subordinates and obviously the IOs, those are securities that we either don't use leverage on or if we do we can get attractive terms from the street. On the AAAs, the returns are certainly better if we put those on the FHLB which we're happy to do but there is street funding available there as well. The primary benefit as we've mentioned before to the FHLB is that we can provide consistent rates to our originators so that if the AAA market cheapens up at some point and we don't want to sell bonds, we can hold those until it's time to sell them.



Douglas Harter - *Credit Suisse - Analyst*

And is that the biggest factor as to why you became much more active in that market this quarter versus prior quarters?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Well the biggest thing is frankly we've been adding originators as we move through the year. We've said before that we were targeting 35 to 40 originators and we're making very good -- by the end of the year, and we're making very good progress. So the biggest thing has been if you look back at the beginning of the year housing activity was really low primarily because of weather.

We added a bunch of originators, housing activity in the spring and summer is better. And our rates have been more consistent. You don't necessarily have to pay up. It's just that you have to be there day in and day out with a rate that's competitive. So it's actually a combination of factors.

Douglas Harter - *Credit Suisse - Analyst*

Great, thank you.

Operator

And our next question comes from Mark DeVries of Barclays.

Mark DeVries - *Barclays Capital - Analyst*

Bill, curious about your comment about seeing additional upside on your legacy non-Agencies particularly given how much credit assets have already rallied. Could you give a sense of how much more upside you think there could be if you see a conversions between what the market is pricing in and where you may think default frequencies and severities are headed?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Yes, sure. It's hard -- I certainly can't necessarily put a number on it but our average mark is on the bonds that we retain for the -- not including the newer issue stuff is right around \$70. So it's still a big 30% discount to par. So if prepays increase and credit performance improves, obviously we have a big credit reserve against that position. You could see us eat into that and gain more than we might expect.

So I can't necessarily predict an amount but I can tell you that if things go awful in the housing market it's not going to happen. If things go the way they've been going, we would expect to see more upside. Note, as you probably saw we did release a little bit more reserves this quarter and that's consistent with what we've seen in the performance of our holdings.

Mark DeVries - *Barclays Capital - Analyst*

Okay, that's helpful. And Brad, I'm sorry if you covered this but is there much expense leverage that we should expect as you ramp up your securitization function or are most of the expenses related to that variable and will go up if volumes increase?



Brad Farrell - *Two Harbors Investment Corporation - CFO*

Yes we've absorbed most of our, quote, platform expense so i.e. to get to a point where we have a platform that can support the MSR and conduit. But then what I note in -- I noted this last couple quarters, any time we have large transactional volumes whether that be due diligence or other types of costs associated with a large purchase or a large transaction, that's where the variable is going to float and potentially cause either a little bit of volatility in that expense ratio.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Is there an opportunity as you get bigger to bring some of that -- more of that variable expense in-house?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Yes, definitely. There's always an opportunity to right size that. When you deal with legal and certain professional services, there is economies of scale to use outside vendors. There's a specialty skill set that you might not be able to bring in-house. But yes we always are looking to balance between the external expertise that we need as well as building our own capabilities in-house.

Mark DeVries - *Barclays Capital - Analyst*

Okay great, thanks.

Operator

And our next question comes from Bose George of KBW.

Chas Tyson - *Keefe, Bruyette & Woods - Analyst*

This is actually Chas Tyson on for Bose. Another quick one on the securitization. Did you guys mention how much of that you retained on balance sheet? And then I know you talked about the ROEs for the AAAs and the credit bonds, but do you guys have the blended ROE on that as well?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Yes we -- no we actually -- we just closed this deal. When it comes down to the accounting and like that we'll probably have more to talk about that next quarter. We obviously sold AAAs. We did retain some and we had as we said there's been times going back as I said on the call that AAA spreads got attractive to us in terms of adding positions to the portfolio. So we're happy to buy other bonds that we see in the market as well. We didn't actually put out updated numbers on this particular deal yet.

In terms of the ROEs, I think the best way to think of that is from the longer term perspective, if the ROEs to the activity are consistent with what we're seeing and consistent with what they've been over a longer period of time i.e. in that low to mid teens, about 5% of a given transaction is what you would expect roughly to be put to work at that kind of number. So for every \$100 figure \$5 of that would be looking at that kind of ROE.

Chas Tyson - *Keefe, Bruyette & Woods - Analyst*

Okay, that's really helpful, thanks. And then a question for you on your positioning versus rates. Looking at slide 10, I know you guys are still fairly neutral to rates but it did flip around from last quarter. Wanted to get your thoughts on that, if there's anything behind that or if that's not intentional.



Bill Roth - *Two Harbors Investment Corporation - CIO*

Well yes, that's a good question. I don't want to say a little bit of it is noise, but given that we have the conduit and you have loans coming in every day and then we know that we're going to sell out a number of that, we obviously hedge that on a daily basis but we don't necessarily hedge this scenario which is up [100] immediately. So I think you can expect over time the numbers to hover around zero unless we obviously take a view like we have in the past at certain times. But I wouldn't put too much reading into the fact that it went from 1% one way to 2% the other.

Chas Tyson - *Keefe, Bruyette & Woods - Analyst*

Got it, that makes sense. And then on the MSR I know you guys had another Flagstar deal come through and some flow from PHH as well. You guys obviously think the opportunity is still attractive there. What's a good sizing for you guys in terms of UPB on that. Where -- is there a target you're looking to get to?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Yes what we said in the past and we haven't really said anything differently to counter this, is that given the size of our balance sheet and our duration need that we could easily see the holdings of MSR be around \$1 billion before we really give too much thought to having -- allocating capital from either the credit strategy or more from rates et cetera. So we have plenty of liquidity and that's a big number especially in that space because the challenge isn't to go from [\$500 million] to [\$1 billion], the challenge is to get the right product at the right price. And these deals as you know take a decent amount of time to pull together. But we're still -- we still have in our minds that's that a number that would be worth us shooting for.

Chas Tyson - *Keefe, Bruyette & Woods - Analyst*

Got it. Thanks, guys, appreciate the time.

Operator

And our next question comes from Trevor Cranston of JMP Securities.

Trevor Cranston - *JMP Securities - Analyst*

Hi, thanks. One more on the increased conduit activity this quarter. Obviously you guys did a good job growing that it and seems like there's been increased issuance overall and some other new issuers have come to market. I was curious you guys have talked before about some factors that have constrained the market in terms of bank demand for balance sheet jumbo loans. Have you guys seen any change in those factors or do you think the increased issuance recently is mostly related to AAA levels?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Hi, Trevor, good morning, this is Bill. I think the banks are obviously still looking for high-quality assets that have yield. I don't think that has -- we don't track that weekly or monthly but certainly they're competitive with their rates. There's also been stability in the AAA space which has helped. When spreads and prices are flopping around people are less certain to invest. So we have seen much better stability and as you said, we've seen a little bit of pick up in activity.

It's also worth noting that as I said before, during the winter production overall I mean everybody saw the GDP was awful. So I think coming out of winter into spring and summer we saw a pick up in originations and general overall activity which has also been a factor.



Trevor Cranston - *JMP Securities - Analyst*

Okay, that's helpful. And on the rates portfolio, a detailed question. Would you guys get the CPR for the overall portfolio, is there anything notable to pay attention to in terms of divergence between the prepay speeds on the Agency MBS versus the MSR portfolio?

Bill Roth - *Two Harbors Investment Corporation - CIO*

I'm not sure I totally understand your question. I think that -- yes maybe you could elaborate a little bit.

Trevor Cranston - *JMP Securities - Analyst*

Basically you guys are giving an overall number for the entire portfolio which went up about two CPR this quarter. I was wondering if the number for the Agency MBS is meaningfully different from what the MSR portfolio is prepaying at?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Yes, this is Brad. Maybe to clarify, so on slide 18 and in other places, we reference CPR speeds of 8.5%. It's important to understand that that is just the RMBS portfolio, that does not include MSR. So that is a metric that's consistent with prior periods. And I think maybe that answers your question. We have not disclosed the speed of our MSR in the form of CPR.

Trevor Cranston - *JMP Securities - Analyst*

Okay, fair enough. Thank you.

Operator

Our next question comes from Joel Houck of Wells Fargo.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

A question on the FHLB, obviously it's a -- as you pointed out, mostly Agency pledged. As you move into rated securities the non-Agency, can you help us strictly for modeling purpose understand what the borrowing cost would look like obviously I think they'd probably go up but give us some sense of the pricing on those facilities?

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Yes, this is Brad. Looking at it from a big picture perspective, one of the positives of FHLB advances is it's really a term debt for a period of say three to five years if you look at our average maturity. And really it's a replacement of collateral benefit. So really the costs are fixed as we've already taken those positions. And so really that's not going to change as we shift the collateral. Now obviously different haircuts are applied depending on the collateral type, but the actual cost of borrowing remains constant based on the term we've taken on that debt.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

So you have to put more collateral against it as you shift into the non-Agency.



Brad Farrell - *Two Harbors Investment Corporation - CFO*

Exactly. But the cost of the debt itself remains as we've disclosed it's around 40 basis points floating off LIBOR.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Okay, so that's not going to -- at this point that's locked in for three to five years.

Brad Farrell - *Two Harbors Investment Corporation - CFO*

Yes, exactly.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Okay, thank you very much.

Operator

And our next question comes from David Walrod of Ladenburg.

David Walrod - *Ladenburg Thalmann & Company Inc. - Analyst*

I had a question on the FHLB. Given the moratorium that was imposed, do you see that impacting your ability to borrow from them or expand your line and I want to get your thoughts in general on the moratorium.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Sure David, this is Tom. In respect to that, we really obviously don't want to speak for the Federal Home Loan Bank or for FHFA. And so we don't know what the result of the moratorium will be. We consider ourselves to be in very good standing with the Home Loan Bank of Des Moines. We have a very good relationship with them, they're tremendous people.

And we feel importantly that what we're doing is very faithful to the mission of the home loan which is to provide liquidity and a funding source for prime jumbo loans which we think is helpful to the mortgage and the housing market. So what the ultimate outcome of the moratorium is going to be we really couldn't say that I do want to say that we consider our relationship with home loan to be very healthy at this point.

David Walrod - *Ladenburg Thalmann & Company Inc. - Analyst*

Would you look to expand above the [\$1.5 billion] if you were able to down the road?

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

Well perhaps, we're very happy with the facility as it stands today. Perhaps we might expand it but obviously I really couldn't comment further on it. But we're very happy with the relationship and the funding amount as it stands today.



David Walrod - *Ladenburg Thalmann & Company Inc. - Analyst*

Okay, appreciate it. Thanks a lot.

Operator

(Operator Instructions)

And our next question comes from Merrill Ross of Wunderlich Securities.

Merrill Ross - *Wunderlich Securities, Inc. - Analyst*

On slide 10 you indicate that you increased your notional swap position by \$2 billion to hedge primarily the jumbo pipeline which I think you sized at about \$1 billion right now in the conduit. So maybe can you give us some insight as to the gearing and the tenor of the swapping that you'll do to hedge your pipeline risk?

Bill Roth - *Two Harbors Investment Corporation - CIO*

Hi, Merrill, this is Bill. That's a great question. So one of the things that we have to do is hedge all points -- we try to hedge all points across the curve or at least manage our exposures there. And so our overall need was obviously if you look at \$1 billion and you figure out the duration of those loans, you could say well you could do more swaps or shorter tenor or fewer swaps of much longer or a blend. So we also move our TBA positions around to hedge. So I don't think it's -- I don't think you should necessarily read into the fact we had \$2 billion versus \$1 billion. That also could have been a factor of -- for hedging overall.

Merrill Ross - *Wunderlich Securities, Inc. - Analyst*

I'm sorry, I seemed to have missed what you're TBA position was at quarter end.

Bill Roth - *Two Harbors Investment Corporation - CIO*

Yes, well Brad is going to look that up for you in a second. But like I said, our TBAs longs and shorts move around (technical difficulty) but for some reason we're getting feedback (technical difficulty). Merrill, I'm sorry just one second.

Merrill Ross - *Wunderlich Securities, Inc. - Analyst*

I'm getting a lot of interference. I think I'll have to disconnect and speak with you later. I apologize.

Operator

And at this time I see no further questions in queue. Like to turn the call back over to you Mr. Siering.

Tom Siering - *Two Harbors Investment Corporation - President & CEO*

I'd like to apologize for our technical difficulties today, but thank you Vincent. And thanks to everyone for joining our call today. On September 8 we will be participating in the Barclays Global Financial Conference in New York and we would welcome the opportunity to speak with you at this event, or as you wish. As always we appreciate greatly your interest in Two Harbors. Have a terrific day, thank you.



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