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TWO - Q3 2012 Two Harbors Investment Corp Earnings Conference Call

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Ken Bruce *Bank of America/Merrill Lynch - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Two Harbors Third Quarter 2012 Financial Results Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will follow at that time.

(Operator Instructions)

I would now like to introduce your host of this conference call, Ms. July Hugen. You may begin.

July Hugen - *Two Harbors Investment Corp. - IR*

Thank you, Kevin, and good morning. Welcome to Two Harbors' third quarter 2012 financial results conference call. With me this morning are Tom Siering, President and Chief Executive Officer, Brad Farrell, Chief Financial Officer, and Bill Roth, Co-Chief Investment Officer.

After my introductory comments, Tom will provide some insights into the current macro environment and potential impact to our strategy. Then, Brad will highlight some key items from our financial results, 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. This call is also being broadcast live over the Internet and may be accessed on our website in the Investor Relations section under the Events and Presentations link. In addition, we'd like to encourage you to reference the accompanying presentation to this call, which can also be found on our website.

Before management begins its discussion of its third quarter results, we wish to remind you that remarks made by Two Harbors 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 would like to draw your attention to the second webinar in our ongoing series, which covers our views on Agency prepayments and is the first in a two-part series. The webinar can be found on our website.

We intend to post additional webinars in the future to provide investors and analysts with management insights regarding the market and our business. I'd also like to mention that an archived webcast of our Analyst and Investor Day, which took place in New York on October 10th, can also be found on our webpage.

I will now turn the call over to Tom, who will provide some highlights as summarized on Slide 3.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, July. Good morning, everyone, and thank you for joining our third quarter earnings call. Before I comment on the quarter, I wish to take a moment to note our sadness at the passing of Annaly's CEO, Mike Farrell. Mike was truly a pioneer in the mortgage REIT space. On behalf of everyone at Two Harbors, I would like to extend my deepest condolences to Mike's family, friends and colleagues.

We are also thinking about the victims of Sandy, which has been dubbed by many the weather event of a lifetime. Our hearts go out to the families who suffered the loss of loved ones, and we are hopeful for a speedy clean-up of the East Coast.

Now, moving to my prepared remarks, I'll begin with an overview of our performance this quarter. It was a truly an exceptional period from a return perspective. During the third quarter, we recorded \$524.4 million of comprehensive income. To put this metric into perspective, it represents over four times our book value when we commenced operations three years ago and represents an annualized return of over 70 %.

Our book value increased 15.1% to \$11.44 per share during the third quarter, representing a total return of 18.7 %, when combined with our dividend of \$0.36. We generated Core Earnings of \$0.31 per share, which Brad will discuss in a few moments.

Finally, we are pleased to report total stockholder return of approximately 90% since our launch in October 2009, including dividends and capital appreciation.

Next, I'd like to talk about the capital we have recently raised. Early in the quarter, we completed a public offering, raising approximately \$592 million in net proceeds. As previously discussed, we used these funds primarily to purchase Agency bonds, but also purchase non-Agency securities in single-family residential properties. Given the aforementioned investment results, the timing of this raise was fortuitous, as we have seen appreciation in the investments that we have acquired.

In September, some of our warrant holders exercised warrants for proceeds of roughly \$175 million. Approximately \$16 million warrants were exercised, leaving \$17 million of the original \$33 million warrants outstanding. As a reminder, the warrants are struck at \$11 per share, with an expiry date of November 7, 2013, so the warrants are currently in the money.

During the third quarter, Agency and non-Agency prices rallied, causing Two Harbors' book value to rise significantly. While this is great for book value, a result of this, as well, is a flatter yield curve and somewhat lower yields and net interest spreads on Agency and non-Agency RMBS that are currently available for investment.

I'll next provide insights on key macroeconomic events that could impact our business in the mortgage and housing sector. First, the situation in Europe, which we've discussed for several quarters, remains unsettled. While there have been positive developments, timing and political will seem -- will seem uncertain. We believe dissolution of the euro or EU represents a significant risk to global markets.

Secondly, I'd like to talk about is home price performance, which is important to our non-Agency portfolio. We are continuing to see signs of stabilization and some improvement in housing prices, which is certainly encouraging. According to Core Logic, home prices increased 6.1% as of October 1st on a rolling 12-month basis.



Thirdly, as it relates to interest rates, the so-called fiscal cliff has been a concern to investors and financial services institutions alike in recent months. With the presidential election behind us, we are certainly hopeful that this concern will abate, although we believe we are prudently hedging against a spike in interest rates.

The Fed announced "QE3" during the third quarter. While this wasn't a surprise to the market, and low funding costs are good for our business, we don't think this is a proper time to be taking interest rate risk. We try to hedge our portfolio in such a way that changes in interest rates will have a modest impact on our book value. In light of low rates, which tend to stimulate refinancing activity, we remain ever vigilant about selecting Agency securities with prepayment-protected characteristics, as Bill will discuss shortly.

And last, but certainly not least, current unemployment data is still concerning as next the loan-to-value ratio, employment is the most powerful determinant of a homeowner's ongoing likelihood to pay their mortgage. Obviously, we would all be pleased with a reduction in this metric going forward.

Despite what continues to be a murky macroeconomic backdrop, we believe there is an opportunity ahead for our business as we focus on security selection in our Agency and non-Agency portfolios. We believe additional opportunity exists through measured diversification into attractive sectors, which is a nice segue into our next slide, Slide 5.

I will next discuss our business diversification strategies. As you may recall, in September, we announced the proposed contribution of our portfolio of single-family homes to Silver Bay Realty Trust concurrent with its IPO. Since the announcement, we have continued to make progress purchasing single-family residential properties. As of September 30th, we had completed the acquisition of roughly \$190 million in properties.

Since quarter-end, we have continued to purchase homes. We currently have a total portfolio, including accepted offers, of approximately \$240 million and over 2,000 homes as of October 31st. We are purchasing homes where we believe current yields are attractive, discounts to replacement costs exist, and absorption metrics are favorable. We are currently invested in nine markets in Arizona, California, Florida, Nevada, Georgia, and North Carolina.

As some of you may know, in late 2011, we began acquiring Prime jumbo mortgage loans as another business diversification initiative. As of September 30, 2012, we had acquired mortgage loans held-for-sale with a carrying value of \$14.6 million and had commitments to acquire an additional \$319.9 million. Bill will comment more on this shortly.

Today, we announced the appointment of Bill as the sole CIO of Two Harbors effective January 1, 2013. Steve Kuhn, who has shared the role with Bill since 2009, intends to devote his full attention to his role as Partner and Head of Fixed-Income Trading at Pine River, the parent to our external advisors. This is a natural transition, and we believe it will best serve both Two Harbors shareholders and Pine River's private-side investors. Bill and Steve are Partners at Pine River and they will continue to collaborate with one another and the rest of the mortgage team. I would like to personally thank Steve for his considerable contributions to the success of Two Harbors.

As you may recall, in the past few months, we have expanded our senior management team with the hiring of Nick Smith and Dan Koch, both as Managing Directors. Nick was previously the CIO of Capital Markets at Green Tree and has extensive experience in investing in residential loans and mortgage servicing rights. Dan was previously at Redwood Trust, where he was responsible for sourcing loan acquisitions and the development of new business initiatives.

We have also announced the promotion of Matt Koeppen to Managing Director. Matt has been an important member of our investment team since he joined Two Harbors in 2010. Most recently, we have added Bill Greenberg also as a Managing Director. Bill was previously the Head of Investment Bank Risk at UBS -- investment bank risk control strategy at UBS.

We are excited about these new additions to the team, as these hires enhance our ability to diversify our business model and drive stockholder value over time. This was truly a remarkable quarter for our investment team, and we believe our performance speaks for the quality of our security selection and the advantage of our structure as a hybrid mortgage rate.

I will now turn the call over to Brad.

Brad Farrell - *Two Harbors Investment Corp. - CFO*

Thank you, Tom, and good morning. I'll begin my prepared comments with an overview of our financials, provide a quick update on repo financing, and finally, wrap up with comments about book value. Please turn to Slide 6.

Core Earnings at \$0.31 represented an 11.3% annualized return on average equity. As a reminder, Core Earnings is largely a function of our portfolio size, our investment spread, our cost of hedging, and our expense management. On July 18th, we completed an accretive public offering of 57.5 million shares for net proceeds of approximately \$592 million. Consistent with our expectations and historical experience, we completed the deployment of proceeds by the end of September. This deployment process during the quarter impacted Core Earnings.

As we have been discussing for some months, we saw lower projected yields on securities recently acquired driving a marginally lower net interest margin. Bill will comment further on this shortly, but importantly the CPR on our current portfolio has remained low and stable, despite low interest rates. That said, the somewhat lower net interest margin on newly invested capital does have an impact on Core Earnings.

Next, similar to last quarter, our hedging strategy and extension of repo maturities, especially for non-Agencies, contributed to lower Core Earnings. The hedging impact is primarily a result of the cost of credit default swaps, hedging our non-Agency RMBS portfolio, and amortization run-off in our interest-only securities, which hedge interest rate risk on our Agency RMBS portfolio. While these amortization costs pressure Core Earnings, they represent a hedge to protect book value over time.

Finally, our expense ratio as a percent of average equity ticked slightly higher to 0.9% from 0.8% in the second quarter, due largely to expenses related to real estate investments. Excluding the investment in real estate expenses, our expense ratio would have been 0.6%, which was historically low due to strong fair-market value appreciation and capital raised during the third quarter. As we mentioned during our Analyst Day, the size of our investment portfolio and new business diversification initiatives will likely impact this metric in future quarters.

Besides the impact of Core Earnings, GAAP Net Income of \$26.8 million for the quarter was negatively impacted by losses on swaps, which hedged our interest rate exposure and swaptions. As we have previously discussed, because the fair value changes in our hedging instruments are recorded in earnings, while the offsetting fair-value changes in our RMBS portfolio are in equity, GAAP Net Income will experience volatility quarter to quarter. This is illustrated in the Appendix on Slide 13.

In addition, Other-than-temporary impairments on our non-Agency RMBS were an adjustment of \$0.6 million this quarter. This adjustment continues to represent an immaterial amount relative to our overall holdings. As it relates to our financing profile, our total number of counterparties remained unchanged at 23. While we did not add any new counterparties, we continue to take steps to extend our maturity profile, including the addition of long-term repo.

As of September 30th, our days to maturity had extended significantly to an average of 123 days from an average of 86 days at the end of the second quarter. It is worth noting that this extends the majority of our repo past year end a period of time that we can see a pull-back in available lending capacity by counterparties. We also have \$100 million non-Agency repos with a 3-year term and another \$100 million with four years, which complements our overall financing profile.

Now please turn to Slide 7, which contains a quarterly book value roll-forward. As Tom noted, our book value per diluted share was \$11.44 this quarter, a significant increase relative to book value per share of \$9.94 at the end of the second quarter of this year. This increase was driven by significant fair-value strengthening in both our Agency and non-Agency strategies, net of hedges. As of quarter end, you will note that the remaining warrants have a slight negative impact on a fully diluted basis.

Now I'll turn the call over to Bill for a portfolio update.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thanks, Brad. And thank you, everyone, for joining us today. The search for yield dominated the investment landscape during the third quarter. This drove valuations higher across credit-sensitive asset classes, including both Agency and non-Agency mortgage-backed securities. Several key headlines served as a backdrop to this rally.

First, as Tom noted, the Fed committed to keeping fed funds rate low into 2015. In conjunction with this, the Fed also committed to open-ended purchases of an additional \$40 billion in MBS per month. The announcement had a tremendous impact on the Agency RMBS market, as spreads tightened by roughly 50 basis points, before recently retracing about half of this move.

The Fed also sold the remainder of its Maiden Lane 3 assets, primarily CDOs. These sales were well received by investors, and this was additionally encouraging in that it removed another source of supply of distressed assets from the market.

Mortgage-backed securities had an incredible quarter. As you will note on the bottom left of slide 8, a simple duration-hedged Agency strategy returned 3.6%, while the ABX 06-2 AAA Index appreciated by 12.1%. We estimate that a simple capital allocation strategy of 50% Agency and 50% non-Agency Sub-Prime would have generated a blended return of 7.9%.

We are extremely proud of our portfolio's performance this quarter. Our hybrid strategy outperformed these benchmarks and delivered a total return on book value of 18.7%. Both our Agency portfolio and non-Agency portfolios significantly contributed to this performance, delivering \$114 million and \$330 million in unrealized gains respectively net of hedges.

We believe that our opportunistic approach towards capital allocation and our security selection process drove this performance. During the quarter, prepayment protected pools outperformed generics, while our non-Agency bond-holdings experienced greater appreciation in comparison to many other non-Agency securities, as well as the ABX Index, as shown.

Please take a look at the chart in the lower right-hand quadrant of slide 8. The portfolio's asset yield was in line with our expectations at 4.2 %. Net interest spread for the quarter was also in line with expectations at 3.1%, down from the previous quarter's spread of 3.6 %.

As Tom previously mentioned, we continue to manage an RMBS portfolio in a lower-yield and tighter-spread environment. While this environment has been beneficial to our book value, it has led to lower spreads on reinvestment. As a result, the quarter-over-quarter change in net interest spread was impacted by lower yields on Agency securities acquired in recent months, including securities acquired during the deployment of our July capital rates.

The Agency portfolio inclusive of Inverse IOs yielded 3.1 %, representing a compelling return on equity when applying our target leverage of between six and seven times. Our non-Agency portfolio continues to generate an attractive yield for our stockholders at 9.6 %, which remains unchanged from the prior quarter. This consistency, as you can see in the top -- in the chart on the top right, has been quite beneficial to our overall portfolio yield. At quarter-end, Sub-Prime bonds represented 86% of our \$2.5 billion non-Agency portfolio.

We continue to benefit from historically low funding and hedging costs. These costs, as you can see in the chart on the bottom right, ticked up 10 basis points this quarter to 1.1 %. This marginal increase is primarily attributed to the cost associated with lengthening of our repo terms, including the 3- and 4-year non-Agency repos Brad mentioned, as well as maintaining our interest rate hedging strategy, as we increased the size of our Agency holdings by approximately \$3.8 billion.

Please turn to slide 9. Our RMBS portfolio increased approximately \$4.3 billion to \$15.3 billion this quarter. Our portfolio is comprised of approximately \$12.8 billion in Agency securities, including Inverse IOs, and \$2.5 billion in non-Agency securities at quarter end. This translates to an 84/16 asset mix, favoring Agencies.

This increase in our portfolio is primarily due to the deployment of proceeds from our July capital raise and strong appreciation experienced by both our Agency and non-Agency securities. In line with our expectations, we deployed the capital -- we deployed the proceeds from our July



capital raise primarily to the Agency sector, while remaining opportunistic in non-Agency and continuing to buy single-family properties. As Tom noted, we are pleased with the timing of our capital raise, as the assets we bought help drive our total return this quarter.

For our Agency portfolio, we continue to favor prepayment-protected stories. High LTV holdings, which are pools that consist predominantly of borrowers who have refinanced through HARP, also known as the Making Homeownership Affordable, or MHA program, increased by over \$2.1 billion during the quarter. These pools represented 31% of our Agency holdings, up from 21% in the prior quarter. We also allocated capital to Low Loan Balance, low FICO, and HECM pools.

As I previously mentioned, we were opportunistic in deploying capital in the non-Agency sector, and I am pleased to report that we were successful in purchasing Sub-Prime bonds that met our investment criteria.

As Tom noted, we had \$190 million in single-family properties at September 30th, up from \$72 million as of the end of June. As of quarter end, our capital allocation was 57% to Agencies, 36% to non-Agencies, and 7% to residential real properties. More details on our portfolio are as shown in the appendix.

As we turn to slide 10, I would like to highlight a few key metrics of the portfolio. The overall profile of our portfolio remains fairly consistent with prior quarters. Our Agency prepayment experience, including Inverse IOs, remains low and stable at 6%, which is in line with the prior quarter. We believe that this prepayment experience is a direct result of our dedication to stringent security selection approach when purchasing assets.

Owning a portfolio which consists of prepayment-protected securities has become increasingly more important in today's environment of low interest rates and tighter spreads. Slow prepayments in this low rate environment helped sustain our portfolio yield and reduce reinvestment risk. Furthermore, we anticipate that overall prepayment speeds will continue to be fast, due to today's low-rate environment, as well as the high volume of refinancings being conducted through the various government programs, particularly HARP.

As a result of this keen focus on managing prepayment risk, 98% of our Agency securities had either implicit or explicit prepayment protection as of quarter end. The debt-to-equity ratio for the third quarter was 3.8 times. Leverage for the quarter was impacted by the timing of proceeds received from the issuance of common stock in connection with warrants exercised in September. As a reminder, we continue to target a leverage ratio of six to seven times for the Agency portfolio and one to one-and-a-half times for the non-Agencies.

At Two Harbors, it is our intent to minimize interest rate exposure, especially given where rates are today. Although the Fed anticipates keeping the Fed Funds rate low for the foreseeable future, it did caveat its projections by adding that the forecast is subject to change as economic conditions improve. As I reviewed in our Analyst Day presentation, rates can move extremely quickly and violently as we experienced in the early '90s and again in the early 2000s.

With this in mind, we feel that it is beneficial to our stockholders to maintain low exposure to interest rate volatility in order to protect book value. The graph in the upper right-hand corner illustrates this. As you can see, our book is very close to duration-neutral as of quarter end.

Protecting our portfolio against higher interest rates makes a lot of sense to us, especially given that the cost of hedging with swaps, as well as long-dated protection in the form of swaptions, remain cheap. We have approximately \$12 billion in notional protection via swaps, with an average pay rate of 0.84%, an average maturity of three years. In addition, we increased the notional protection of our swaptions book to over \$5 billion. These swaptions have an average time to expiry of over four years.

We believe that incorporating long-dated swaptions as part of our hedging strategy will prove to be prudent when rates start moving higher. More details on our hedging positions are in the Appendix on slide 17.

Please turn to slide 11. We are very pleased with the composition of our portfolio. We have assembled an Agency portfolio that we believe has low and stable prepayment characteristics and that is fairly neutral to interest rate movements. On the non-Agency side, declines in severe delinquencies and better overall borrower performance have been continuing trends. Also, as Tom mentioned, home prices have been moving higher.



We believe that our strategy of purchasing deeply discounted bonds with improving collateral performance will benefit our investors, particularly as housing recovers, especially at the lower end of the market.

As a result of higher asset prices, lower yields, and tighter spreads, the current environment for investing today is more challenging than in recent quarters. While book value has appreciated -- and we are pleased about that -- it is also our goal to continue delivering attractive returns to stockholders. With this in mind, it is worth noting that the hybrid model provides us the flexibility to extract value from the market by taking an opportunistic approach to the residential sector, which does not just mean Agency and non-Agency securities.

As a hybrid mortgage REIT, our investment universe of potential opportunities is great, in that it encompasses all real estate asset classes, including unsecuritized assets. Our recent move into single-family properties is evident of this.

You will note on the bottom of slide 11 a variety of potential opportunities that dovetail with our core competencies of credit and prepayment risk management. While some of these may make sense to pursue and some will not, continuing to build our team with high-quality talent, we believe, gives us the ability to explore and expand into areas that will deliver value to shareholders.

One opportunity we have been working on and worth mentioning is securitization. You will note that we have commitments to acquire several hundred million in jumbo whole loans, with an eye on doing a securitization. The math around creating subordinate bonds and IOs via a securitization has become more attractive recently, and we believe that this initiative will be beneficial to our shareholders over the coming years, as the opportunity to create attractive mortgage credit investments expands.

With that said, I would caution that in today's world, the non-Agency securitization market is still in recovery mode. The government is still financing over 90% of housing and even as our initial efforts expand, it might in the near term represent a relatively small and immaterial portion of our portfolio. Some other potential opportunities are listed, as well, and we will certainly keep you informed when and if we progress further on any of them.

To conclude, we are optimistic about the investment opportunities we see going forward in the residential space. We look forward to leveraging our expertise in those sectors of the market that we believe utilizes our core competencies and that can be beneficial for our stockholders. At this time, I would like to turn it back to the operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from Bose George with KBW.

Bose George - Keefe, Bruyette & Woods - Analyst

(inaudible) and congratulations, Bill, on assuming the CIO -- sole CIO role. We have a couple of questions. Actually, first, in terms of incremental capital, you know, just curious where you see the value, Agencies versus non-Agencies, and, you know, if you can quantify kind of the returns in both those markets?

Bill Roth - Two Harbors Investment Corp. - Co-Chief Investment Officer

Yes, hey, Bose. Good morning. Thank you very much. Appreciate it. So as I mentioned, obviously, spreads and yields have come down, which has been great for book value. Right now, we see, you know, Agency yields, depending on what you're looking at, are anywhere in the ones to low to mid-tvos, which obviously is -- you know, those are low rates. But at the same time, hedging costs are extremely low.



So the investment ROE on an Agency strategy today, we think, looks very much like very low double-digits. On the -- on a non-Agency side, yields depending on whether you're looking at, you know, Prime or newly issued AAAs, all the way down to Sub-Prime range, anywhere from about 3% to 7 %, Sub-Prime bonds -- which is what we have typically been focusing on -- are somewhere in the five-and-a-half to six-and-a-half. And occasionally, you can get seven. So that also sort of leads you to sort of a low double-digits investment ROE, using the leverage that we apply.

Bose George - Keefe, Bruyette & Woods - Analyst

Okay, great. That's helpful. Thanks. And in terms of the -- you know, the leverage, I mean, does increase in book value, you know, make it look like your quarter-end leverage was lower? (inaudible) assets increase (inaudible) mark-to-market leverage goes up a little bit?

Bill Roth - Two Harbors Investment Corp. - Co-Chief Investment Officer

Yeah, I mean, that's a great question. There were, you know, obviously, some influences on the leverage, part of which was, you know, the increase in our book value. And the other part was the warrant exercise right at the end of the quarter.

The -- you know, the way we think about that is, is that we want to deploy capital where -- into opportunities that we think are attractive and deliver returns. So right now, we're being -- you know, obviously, we don't have a lot of monthly cash flow, which is good, because our prepayment rate is so low, but that capital will be deployed as we see opportunities that make sense, as I mentioned earlier, and to those different strategies.

At the same time, I would also note that, you know, we continue to buy single-family residential properties, and, you know, we still think that that's a terrific opportunity for our shareholders.

Bose George - Keefe, Bruyette & Woods - Analyst

Okay, great. And then just one last thing. As you're doing the first post-election call, you know, just curious on your thoughts on potential policy changes that could impact the markets, especially the Agency markets, in terms of prepayments.

Bill Roth - Two Harbors Investment Corp. - Co-Chief Investment Officer

Yeah, I don't know how many people are a little bleary-eyed from staying up watching. I know I am a little bit. The -- you know, there's probably less uncertainty, given that there's not a change in the regime. You know, we kind of know what the current regime, you know -- what their axes are. You know, the market rally in rates today is certainly evidence of a lower for longer mindset. At the same time, you know, it appears that there's going to be a continued emphasis on trying to help homeowners. Whether that results in any significant changes is really unclear, given the Republicans' control of the House.

So I think we'll just have to wait and see. But certainly, the trends that we've seen over the last, you know, 6 to 12 months I would expect to be maintained, if not increased.

Bose George - Keefe, Bruyette & Woods - Analyst

Okay, great. Thanks a lot, guys.

Tom Siering - Two Harbors Investment Corp. - President, CEO

Thanks, Bose.



Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thanks, Bose.

Operator

Your next question comes from Douglas Harter with Credit Suisse.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Hey, Doug.

Douglas Harter - *Credit Suisse - Analyst*

Hey, Bill. Hey, Tom. I was wondering if you could talk about, you know, how some of those other sort of new initiatives, how their returns have fared in those -- sort of in the search for yield. Have those compressed as much as we've seen in the sort of -- in the securities where you guys have invested?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yeah, hey, Doug. Thanks a lot for that. The -- you know, the one I noted particularly, securitization, the math on that, you know, as I've commented actually in recent months, has gotten better primarily because while the loans themselves, the value of those versus -- you know, is fairly unchanged. The credit enhancement levels have come down, and the AAA part of the capital structure is trading better, which means that the value created in the subs is better.

So while it -- you know, for a long period of time, we saw yields on those in the, you know, single digits, high single digits. At this point, it appears as if they're into the double-digits.

Now, that being said, you know, we haven't completed a securitization, so, you know, if and when we do, we'll certainly have better clarity on that and be happy to share that with you.

In terms of some of the other initiatives, I mean, these are all things that, you know, it's not -- we haven't partaken of any of those. Those are just on our radar screen. I think others have noted what yields on, say, MSR's are. It's unclear what yields on GSE credit bonds might be, because those haven't come out.

I guess the point was, is that, as a hybrid, you know, we're excited that, you know, we don't necessarily just have to stick to Agency securities or non-Agencies. There are just other things that dovetail with our competencies. And obviously, if we do get involved, we'll be happy to share the economics of what those look like.

Douglas Harter - *Credit Suisse - Analyst*

Great. Thanks for that color, Bill.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thanks, Doug.

Operator

(Operator Instructions). Our next question comes from Jason Weaver with Sterne Agee.

Jason Weaver - *Sterne, Agee & Leach - Analyst*

Just had question relating -- and you may have said this during your comments earlier, but I might have missed it -- could you just update us on the timing with regard to the Silver Bay spinout?

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Sure, thanks, Jason. It's Tom. Yeah, we really can't. You know, it's going through the SEC process, and, you know, so that process is ongoing, which is typical. And so, you know, the spinout will be subject to, you know, the timing around that. Other than that, we can't really comment.

Jason Weaver - *Sterne, Agee & Leach - Analyst*

Okay, fair enough. Thank you.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thank you.

Operator

Our next question comes from Ken Bruce with Bank of America.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Good morning. Thanks. My question really relates back to your discussion around the securitization business. Can you maybe get into some of the additional investments that would need to be made to basically develop either a conduit -- or how would you develop a flow of loans for securitization?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Sure. Good morning. Thanks for joining us, Ken.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Sure. Good morning.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yeah, the -- yeah, as you know, you know, we started down this path, you know, working with Barclays, and we have a number of originators that, you know, we've been working with. You may have seen that we recently hired Dan Koch, who's just a terrific addition to our team. You know, he's -- you know, he's got a tremendous capability in this regard, in terms of, you know, working with originators and, you know, helping us build that out.

I mean, I think that the -- you know, the key -- the key parts of this are obviously, you know, generating solid and, you know, working relationships with originators who we want to partner with. And then at the same time, you know, being able to -- you know, onboard loans, hedge them, et cetera, underwrite and oversee.

So there is a little bit of -- a little bit of a process to that. And, you know, we're very excited about it, because we think that, as we go forward, at some point the government share of the mortgage market will come down, whether it's, you know, through lowering loan limits or increasing [G fees] or whatever, and as the securitization math hopefully stays attractive, you know, and the non-Agency market reopens up, we just think it's a terrific opportunity.

So we're being very thoughtful about it. And, you know, we'll keep you posted as it unfolds.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Right. So I guess maybe the -- the way to just thumbnail it is that -- and I share your enthusiasm as to, you know, the government maybe reducing its role, and we've seen some encouraging signs in terms of the best execution across some of these asset classes, you know, kind of working in favor of securitization, so it's just a function of developing a pipeline and a distribution mechanism and then, you know, in essence, getting your first deal done to solidify where execution levels would be and kind of developing it from that standpoint?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yeah, exactly. You know, we started thinking about this, you know, quite a while ago, and, you know, as you know, there have not been that many deals done, and there's a bunch of reasons behind it, but, you know, as we look forward, you know, we're much more optimistic, even though it's taken longer than I think -- if you talk to any mortgage trader on the street, I think, you know, uniformly people would be surprised that it's taken time.

But, you know, there's a lot of issues. And it seems to be opening up, and we're excited about it, but I think that you -- you know, you laid it out correctly.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

All right. And maybe just one last one on that point. Is QRM and QM a necessary element to moving that forward in real size or can you move around that?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

That's -- that's a great question. You know, I think that the market is -- you know, the market's already sort of working on the jumbo side. I mean, banks are originating them. You know, underwriting is much more -- you know, people say underwriting is substantially more restrictive or stringent, but, you know, if you look back over decades as opposed to just in the last five or six years, underwriting is actually pretty reasonable, in terms of, you know, the kind of loans that are being made today.

So the market's sort of already voting on that. And, you know, it's not clear when any of that -- of those items will be resolved. But in the meantime, you know, if we can originate loans that we like at levels that we like, I think that would speak for itself.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Okay. And changing directions, but staying in the alternative investment opportunities, have -- in the -- and I apologize if I've missed this in an earlier comment, but have you been looking at mortgage servicing assets in any capacity as a potential investment?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yeah, on -- you know, as -- and you might have joined late -- on slide 11, we put together a little list of items, and it's not exhaustive, it's just meant to be representative of potential opportunities. And as we've built out our team, you know, Tom mentioned that we've added Nick Smith, who has expertise in MSRs. I mentioned Dan and, you know, Bill Greenberg joining us recently.

You know, we haven't done anything on that yet. Otherwise, you know, we would have told you guys. But it's certainly on our radar screen. You know, one of the reasons that they're very attractive is because the barriers of entry and the messiness of the product is quite high. But that being said, it's certainly within our wheelhouse, and that's why it's -- you know, it's on the radar screen.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Right. And do (inaudible)

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

If we get involved in it, you know, we'll be sure to, you know, have something to say about it.

Ken Bruce - *Bank of America/Merrill Lynch - Analyst*

Okay, all right. I'll just -- Okay, great. Thank you very much for your comments, and nice quarter. Thanks.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thanks, Ken.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Ken.

Operator

I'm not showing any further questions at this time. I'd like to turn the conference back to Tom Siering for closing remarks.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Kevin.

Thank you for joining our call. As we've outlined, we think there is incredible opportunity for our business, and we are optimistic as we look ahead. Thanks again for joining us today, and have a great week.

Operator

Ladies and gentlemen, that does conclude today's presentation. You may now disconnect and have a wonderful day.



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