

THOMSON REUTERS STREETEVENETS

# EDITED TRANSCRIPT

TWO - Q2 2013 Two Harbors Investment Corp Earnings Conference Call

EVENT DATE/TIME: AUGUST 07, 2013 / 1:00PM GMT



## CORPORATE PARTICIPANTS

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

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

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

**Bill Roth** *Two Harbors Investment Corp. - CIO*

## CONFERENCE CALL PARTICIPANTS

**Mark DeVries** *Barclays Capital - Analyst*

**Douglas Harter** *Credit Suisse - Analyst*

**Trevor Cranston** *JMP Securities - Analyst*

**Jackie Earle** *Compass Point - Analyst*

**Dan Altscher** *FBR Capital Markets - Analyst*

**Joel Houck** *Wells Fargo - Analyst*

**Bose George** *Keefe, Bruyette & Woods - Analyst*

**Stephen Laws** *Deutsche Bank - Analyst*

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

## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the Two Harbors second-quarter 2013 financial results conference call. At this time, all lines are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will be given at that time. (Operator Instructions). As a reminder, today's conference call is being recorded. I would now like to turn the conference over to your host, July Hugen, Director, Investor Relations. Please proceed.

---

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

Thank you, Sean, and good morning everyone. Welcome to Two Harbors' second-quarter 2013 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 brief recap of our second-quarter 2013 results and the macro backdrop, Brad will highlight some key items from our financials and Bill will review our portfolio performance and our new investment opportunities.

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 webpage 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 a discussion of quarterly 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 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](http://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 who will provide some highlights as summarized on slide 3.

---

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

Thank you, July. Good morning everyone and thank you for joining our second-quarter earnings call. It was a challenging quarter, but we are happy with measures we took to mitigate our risk profile and protect book value. This morning, after I comment on the quarterly results and provide some insights related to the current macroeconomic environment, I would like to discuss some developments regarding our new investment opportunities.

As some of you may recall from the updated metrics we provided as-of May 31st, early in the second quarter we positioned the portfolio defensively and put hedges in place to guard against higher interest rates, mortgage base widening and a shifting environment. We believed this was prudent given what we felt was an asymmetric profile in rates and concerns in the market regarding the Fed tapering its participation in the Treasury and mortgage markets or, if you will, "QE Adieu". This repositioning was a significant positive contributor to our outperformance this quarter.

During the quarter, Agencies were pressured as interest rates were volatile and ultimately moved substantially higher. Our non-Agency strategy also experienced a mercurial quarter and we ultimately reported a small loss on our non-Agency portfolio. That said, it is worth noting that the non-Agency allocation has performed well in 2013 and is up \$259 million year-to-date, net of hedges. We believe our performance this quarter and our positive return for the first half of 2013 speaks to the benefit of our sophisticated approach to hedging and our hybrid model.

Now, let me briefly recap our financial results. Our book value was \$10.47 per share at June 30, representing a quarterly total return of -3.7% when combined with our second-quarter dividend of \$0.31. In the quarter, we recorded a comprehensive loss of \$146 million, or \$0.40 per weighted average diluted share. Year-to-date, we have generated \$102 million in comprehensive income, representing a return on average equity of positive 5.2%. We reported GAAP earnings of \$1.06 and core earnings of \$0.21, which Brad will discuss further. We believe this is remarkable in the context of the sector's performance during the same timeframe.

During the quarter we also repurchased stock under our share repurchase program. One million shares of the 25 million shares authorized under this program were acquired during the second quarter as the sector came under pressure. We believe this was a good investment for stockholders as the stock was trading below book value at the time, so the repurchase was accretive.

In the second quarter, approximately 3.5 million of our warrants were exercised. Today, that leaves just 4.2 million of the original 33 million warrants outstanding. The warrants expire on November 7, 2013 and are currently out of the money as they are struck at \$10.25 per share.

Please turn to slide 4. Next, I will provide some commentary on the macroeconomic environment that could impact our business and the mortgage and housing sectors. Rising interest rates were a challenge as were concerns about the Fed's announcement that they may begin to taper RMBS purchases. Unemployment metrics have been showing signs of strength recently, with monthly job reports demonstrating improvements in employment this spring. Improving employment metrics are good for our non-Agency portfolio as it should result in a decline in delinquencies and defaults, although we believe improvements in employment may result in higher interest rates over time.

Another metric that has shown improvement is home price performance. On a national level, home prices increased 12% as of May 31st on a rolling 12-month basis according to CoreLogic. Most forecasts call for a continuation of home price appreciation in the next several years. This creates a nice tail-wind for the performance of our non-Agency portfolio, including Credit Sensitive Loans, or CSLs.

Now, let's turn to the policy front. First, I'd like to touch on the potential for GSE reform. Several bills have been circulated to address the eventual wind-down or the diminution of the GSEs. We believe the private sector is necessary to support the U.S. housing market going forward and find it



sensible from a policy standpoint to have a private sector, rather than the US taxpayer, backing the mortgage market. Progress is being made in this regard as witnessed by Freddie's recent sale of credit risk into the market. A few other issues that we are monitoring from a policy and regulatory perspective are on this slide.

Next, I'd like to discuss some of our new investment opportunities as outlined on slide 5.

Let's start with Mortgage Servicing Rights, or MSRs. We have been working hard on the infrastructure required to support this initiative and continue to make progress on that front. As we reported previously, during the second quarter we closed on the purchase of Matrix Financial Services, a small servicing company with Fannie Mae, Freddie Mac and Ginnie Mae servicer licenses. This came with a small servicing portfolio and servicing oversight professionals. Additionally, we closed on two small bulk purchases of Fannie Mae MSRs in July and are in negotiations around other bulk and flow arrangements. We also anticipate that we will have the opportunity to make significant additional investments in MSR later this year.

Next, let's turn to the conduit business and securitization. As you may recall, in the first quarter we participated in a \$400 million securitization with Credit Suisse. In the second quarter, we have continued to aggregate loans, and it is our goal to complete a securitization in the future as market conditions allow. We continue to build relationships with originators and grow our middle and back office to support growing our mortgage loan acquisitions. While we view the economics and risk return profile associated with securitization as attractive today, over the longer-term, this business line could be quite fruitful as the government reduces its footprint in financing residential real estate.

Last, let me provide an update on our Credit Sensitive Loan investment initiative. We closed on some CSLs during the quarter, bringing our holdings to approximately \$440 million in market value. As a reminder, we view the sector as an alternative to investing in legacy non-Agency securities and allocate accordingly based on both absolute and relative value. Bill will discuss all of these topics more fully in a bit.

A compelling aspect of these new investment opportunities is that they dovetail nicely with our existing strategies and core competencies of credit, interest rate and prepayment analysis. The events of the second quarter are not only emphasize the importance of an effective hedging approach, but also underline the benefit of having a more diversified business model. We believe that as we expand into these new areas, we can drive higher returns over time, create franchise value and provide improved book value stability in times of market turbulence.

I will now turn the call over to Brad for more a fulsome discussion of our financial results during the quarter.

---

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

Thank you, Tom, and good morning everyone. I'll begin my prepared comments with an overview of our second-quarter financial results and discuss certain accounting matters. I will then conclude with an expanded discussion around financing and liquidity. Please turn to slide 6.

Core earnings of \$0.21 per weighted share represented a 7.6% annualized return on average equity. The \$0.21 per share earnings roughly aligned with our core earnings expectations for the quarter and what we considered when establishing our second-quarter dividend. While we acknowledge this non-GAAP measure underperformed relative to our historical measures of core earnings, it is a direct result of the successful defensive measures our investment team took to protect book value and our overall economic return. Bill will expand upon these measures shortly.

The most direct impacts to core earnings were the lower leverage applied to our capital base and costs of increased levels of interest rate and mortgage spread protection we utilized through derivatives, namely TBAs, mortgage options, swaps, and swaptions.

As noted on slide 6, our debt-to-equity ratio to fund cash RMBS through the use of repurchase agreements was 3.6 times and 3.1 times as of June 30 and March 31, respectively. While this would imply our leverage marginally increased, it is important to keep in mind that TBA positions are not part of the debt-to-equity calculation, although they do impact overall exposure. As such, implied leverage can be higher or lower, depending on whether we are net long or net short TBAs.

As of March 31, we held a net \$2.2 billion long TBA position and at June 30, we held a net \$2.7 billion short TBA position. This shift during the quarter resulted in a reduction to imply debt-to-equity from 3.6 times as of March 31 to 2.9 times as of June 30.



Similar to other quarters, albeit on an exacerbated basis this quarter, core earnings were also pressured as we added considerable hedges to protect our portfolio against rising rates. As we had pointed out before, we focus on total comprehensive income, which includes the health of our book value per share more than core earnings so the near-term cost of insurance is outweighed by the overall protection of returns.

Our operating expense ratio, as a percentage of average equity, moved modestly higher on a quarter-over-quarter basis to 0.9%. The rise in operating expense was largely driven by costs incurred in connection with the acquisition of credit-sensitive loan packages and the build-out of the prime jumbo conduit and MSR programs. As we have discussed previously, the capital re-allocation and timing of new business diversification initiatives may impact this metric in future quarters.

As noted in historical earnings discussions, GAAP earnings are not as meaningful as the core earnings in comprehensive income measures when assessing the performance of the quarter. This quarter was a good illustration of that, as GAAP earnings were \$1.06 per weighted share. The size of GAAP EPS was due to significant gains in our derivative positions utilized to hedge our portfolio.

I would now like to briefly touch upon a few accounting matters. First, other-than-temporary impairments on our non-Agency RMBS, were an immaterial adjustment of \$1.4 million this quarter, with only three bonds impacted. This fact combined with our release of [\$29] million of our credit reserves to accretable discount demonstrates the continued fundamental soundness in our non-Agency holdings.

Second, as Tom mentioned earlier, during the quarter, one of our wholly-owned subsidiaries acquired a company, Matrix Financial Services Corporation. This acquisition added approximately \$1.5 million in MSRs to our portfolio, which is captured in the "Other Assets" line item this quarter due to its small size. At the time of acquisition, the net equity of the subsidiary was only \$0.2 million, de minimis from an overall balance sheet perspective.

Third, I want to highlight that we recognize a tax expense for GAAP purposes of \$49 million this quarter associated with the various hedging instruments we hold in our taxable REIT subsidiaries. This tax expense lowered our comprehensive income to that same effect. However, I want to make clear that the majority of these tax expenses will be offset by deferred tax benefits recognized in prior periods from derivative losses or in other words, the TRS corporations do not have a significant tax liability to the IRS as a result of these hedging gains.

Now, please turn to slide 7, which contains a quarterly book value roll forward. As Tom noted, our book value per diluted share was \$10.47 this quarter. I'd like to take a moment to highlight a few key items from the book value roll forward. First, the book value decline this quarter was driven by the comprehensive loss of \$146 million. As Tom noted earlier, we are pleased with our performance, given the turbulence in the market. To us, this is an important note, as comprehensive income is the key way we judge our performance over the long-term.

Second, we announced dividends of \$0.31 per share, representing a 12.1% dividend yield for the quarter. When thinking about our dividend, it is important to understand not only core earnings but the components of our realized gains, most specifically this quarter, the realized gains from TBAs. In the quarter, we realized \$41 million of realized gains from TBAs and TBA options, or \$0.11 per weighted share.

Year-to-date, core earnings and realized gains, including gains from sales of RMBS, have generated approximately \$0.61 of weighted EPS, which mirrors our cash dividend paid year-to-date of \$0.63 per share.

Please turn to slide 8. I would next like to spend some time discussing the repo markets, our counterparty exposure and financing profile, both in the second quarter and how we are positioning ourselves for the long-term given our new business initiatives.

The first thing I will note is that we didn't experience any disruption in the repo market during the second quarter or thus far in the current quarter. The repo markets are functioning in a normal manner and we have not experienced any sizable shifts in financing haircuts.

Second, there were no unexpected or surprising margin calls during the same period. Third, to the extent that we do have margin calls, we typically maintain a high level of unencumbered cash-on-hand, which was the case during the past quarter and at quarter-end. Lastly, regarding funding rates, we haven't seen any dramatic changes in terms of the cost of repo funding for Agency securities. For non-Agencies, on the other hand,



funding levels have come in nicely in the first half of this year, and liquidity providers are plentiful. Repo rates that were LIBOR +175 to LIBOR +225 for subprime bonds six to 12 months ago typically are now in the LIBOR +135 to +175 range, a 40 to 50 basis point improvement.

As it relates to our repo financing profile, we continue to maintain a lengthy maturity profile with an average of 86 days to maturity at June 30, in line with our profile at the end of the first quarter. Consistent with prior quarters, we continue to manage our repo across a variety of counterparties, which during the quarter comprised 24 firms. We believe diversity of our counterparty exposure is important should the market undergo a period of stress.

On this slide we have highlighted our diverse Agency counterparty relationships -as you can see, no single counterparty represents a systemic level of risk to our business. We monitor our repo counterparties on a daily basis and track a host of metrics that are indicative of the health and solvency of our counterparties. Slide 8 indicates the high-quality of our non-Agency counterparties based on CDS spread, which we have found to be an important representation of how the market used the health of our counterparties. Another metric we monitor is the geographic exposure profile of our counterparties.

At quarter-end, the majority of our repo was with counterparties based in North America.

Separately from our day-to-day management of financing profile for our RMBS portfolio, we have been working on a variety of financing arrangements to support our new business initiatives. During the second quarter, we entered into two new financing facilities, totaling over \$600 million, to finance our mortgage loans. The facilities include a 364-day facility to finance both credit-sensitive and prime jumbo mortgage loans and a 90-day facility to finance prime jumbo mortgages. As we increase the size of our credit sensitive loan portfolio and prime jumbo conduit program, we will continue to establish strategic partnerships to finance this asset class prior to our end objective of selling the loans into securitization or holding them in an alternative financing structure.

Now, I'd like to turn the call over to Bill for a portfolio update.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Thank you, Brad, and good morning everyone. Today I'd like to discuss our second quarter performance and portfolio positioning, our current portfolio positioning and give you an update on our new investment initiatives. Before discussing quarterly results, there have been some recent developments that are good for our business, including pending GSE reform and some exciting progress we've made in advancing our MSR and conduit businesses.

Two competing GSE reform bills have recently been introduced. While neither bill seems likely to be passed anytime soon, both imply the desire to move toward less government involvement in the mortgage market, creating opportunities for the private sector and companies like Two Harbors to provide capital to the U.S. mortgage market. We believe this provides good support for our conduit business.

Continued developments around mortgage servicing bodes well for our MSR initiative. Working on the infrastructure to support MSRs has been a key focus this year, and we are pleased to report that we have made significant progress on this front. I'll go into more detail later, but we are involved in some very interesting opportunities, which is exciting as we like the available ROEs of this asset and MSRs are a natural hedge to our existing portfolio.

Given our lower leverage profile today, we have 'dry powder' to put to work as we continue building out this business in the back half of the year.

In short, both the potential for GSE reform and the tailwinds that support our MSR initiative are good developments for Two Harbors over the long-term.

Moving into comments about the quarter, please turn to slide 9. The second quarter of 2013 was certainly busy from a portfolio management perspective, as we positioned ourselves more defensively early in the quarter, given concerns we had around the potential for increased volatility, rising interest rates, and wider mortgage spreads. Clearly, that panned out well, given market events and sector results for the quarter. Despite a

modest total comprehensive loss, we were largely able to protect our portfolio from the dramatic move in interest rates and Agency spreads, as well as the widening in credit spreads which affected non-agencies.

Let's talk about the Agency market. Agency mortgage securities underperformed in the second quarter. With increasing concerns around Fed tapering, rising interest rates, and improving economic sentiment, spreads widened dramatically. Further, pay-ups on specified pools were under significant pressure as a result of the higher interest rate environment also underperforming their hedges. As a result, our Agency strategy, despite our defensive positioning suffered on a total return basis.

The non-Agency portfolio fared better, down nominally in the second quarter net of hedges. For the first half of the year, our non-Agency and CSLs have performed well with strengthening fundamentals. The improving housing market has led to lower delinquencies and improved prepayment speeds. Continued improvement in housing metrics and job growth are good for the future performance of these portfolios.

On the bottom-left of this slide, you can see our book value performance relative to a weighted average 50/50 Agency/non-Agency portfolio. Despite a total return of -3.7%, we are pleased to have outperformed by almost 300 basis points. On the bottom-right, you will see the yields and spreads for the quarter were slightly lower than the first quarter. Our annualized portfolio yield fell to 3.7 from 4%. As we have been discussing for some time, we saw lower projected yields on securities acquired in the latter half of 2012 in early 2013, driving a marginally lower net interest margin.

Some of this came from the Agency side, but some also came from non-Agencies. The non-Agencies we have bought recently are attractive, with loss-adjusted yields in the 6% to 7% range. But those yields are still less than what we were able to achieve in early 2012 when the sector offered 10% and higher yields. This serves to slowly drag down the overall non-Agency yield over time. Keep in mind that the cost of financing non-Agencies has also declined somewhat, as Brad noted. The overall cost of financing moved slightly higher in the quarter, as we increased the size of our swap and swaption hedge by over \$2 billion. As Brad mentioned, the cost of repo was static quarter over quarter. Our total net interest spread was 2.5% versus 2.9% in the first quarter of 2013.

Turning to slide 10, let's take a look at our portfolio. Our portfolio as of June 30 was \$16.1 billion in size, including \$12.2 billion in Agency securities and \$2.9 billion in non-Agencies as well as other investments. On the top-right, you will see that our capital allocation is 54% to Agency and 46% to non-Agency and CSLs. We no longer have an allocation to single-family residential properties, as the distribution of silver-based stock has been completed, and the bulk of that capital is now allocated to the non-Agency CSL space.

As we turn to slide 11, let's discuss a few metrics from our portfolio. Our Agency prepayment rates for the quarter, including inverse IOs, ticked higher to 8.7% from 7% previously. This is in line with our comments the past few quarters about expecting slightly faster speeds as a result of the low rate environment and the continued seasoning of our pools.

More interestingly, our non-Agency fees increased again, to 4%. Faster prepays on deeply discounted bonds is a clear win for us, especially as we typically model 1 to 2 CPR on our holdings. More details about our Agency and non-Agency positions can be found in the appendix on slides 19 through 21.

Next, let's talk about leverage. As Brad mentioned, we reduced our implied leverage during the quarter. While our overall debt-to-equity ratio is 3.6 times, once we take into account our net short TBA position of \$2.7 billion at June 30, the metric is actually 2.9 times. As you can see on this slide, we continue to prefer carrying higher leverage for agencies but intend to wait for better ROE opportunities to increase this metric.

Let's turn to hedging, which is a very important part of my commentary on today's call. Hedging is critical to protecting book value, especially during times of market volatility. As you may recall from last quarter, at the end of March, we had positioned the portfolio with a net short position, and by the end of May and June, we had a more significant short exposure to rates, including a sizable net short position of \$2.7 billion in TBAs. This has the effect of greatly reducing our exposure to wider mortgage spreads in a rate sell-off. Given our concerns about increased volatility and the potential for mortgage basis widening, which turned out to be justified, we felt it was appropriate to use a variety of hedges to protect book value. More details on our hedging positions as of June 30 are in the appendix on slide 18 and in our forthcoming 10-Q.





Now let's take a moment to talk about our current portfolio positioning. While overall volatility today is somewhat muted relative to the month of June, it is still elevated. Economic data continues to reflect growth and employment continues to improve. With the likelihood of the Fed tapering this fall, and the potential for higher rates and wider agents spreads, we continue to maintain a defensive stance with low leverage in a short interest rate position.

However, since quarter end, we have made a number of adjustments. First, although we are still net short interest rates, in July, we reduced our short position to reflect the dramatic rate increase that has already occurred and align our risk position with the current environment. We have also reduced our total Agency pool position. We sold several billion specified pools against buying back the associated short TBA position. This had a neutral effect on both our duration and mortgage credit risk but reduced our balance sheet assets and repo borrowings. The reduction in our pool position will lower our net interest income, but it will be more than offset by the reduction in hedging costs from carrying the short TBA positions. In addition, we continue to employ low overall leverage today, much less than our long-term targets. In general, we don't think ROEs in the Agency market currently provide adequate compensation to investors for the increased rate and spread risk in today's environment. To the extent that Agency ROEs become attractive to us again, we intend to be opportunistic buyers. The good news is that our lower-leverage profiles freeze up capital for future deployments into new investment opportunities, including MSRs and mortgage credit.

Please turn to slide 12, where we have highlighted these initiatives.

First, let's talk about mortgage servicing rights, or MSRs. MSRs are a natural hedge to our Agency MBS, hedging both interest rate as well as mortgage spreads. As Tom mentioned, our purchase of Matrix Financial Services Corporation allows us to be involved with Fannie, Freddie, and Ginnie MSRs. And, as Brad mentioned, this acquisition added a nominal amount of MSR to our balance sheet. Putting together the internal infrastructure to support this endeavor has been our primary focus over the first half of this year. And we are pleased to report that we've made significant progress. We have added expertise in servicing oversight, transaction and documentation management, as well as underwriting, which benefits not only our MSR effort but also the CSL and conduit businesses.

We also closed on two MSR transactions in July, both Fannie Mae deals, with midsize originators that could have flow arrangements to follow. These had an initial investment of \$13 million. Looking ahead, we are seeing significant deal flow on a weekly basis for mortgage servicing brokers, primarily on mini, bulk-plus-flow arrangements. We are also pleased to report that we are involved in advanced discussions with potential sellers that are likely to result in significant investments later this year. Given that MSR transactions are subject to closing conditions and GSE approvals, there is no assurance that these investments will close. We are quite excited about the developments in this business. And while we don't expect MSRs to contribute significantly to our 2013 financial results, we believe the long-term opportunity set is attractive. Certainly, we will keep you posted as we continue to make progress here.

Second, let's talk about the prime jumbo conduit and securitization business. As Tom mentioned, we participated in a \$400 million securitization in the first quarter. Separately, we currently hold about \$520 million in prime jumbo mortgage loans, which we could securitize if market conditions allow. An important development for us this quarter was the creation of our own depositor; so when the timing is right, we will be able to complete the securitization on our own. As we discussed last quarter, our top priority is developing an originator network to source loans, which will enable us to be an ongoing issuer over time. Today, we have a number of originators that are live and several in some stage of our evaluation process. We are constructive about the long-term opportunity in this market and hope to play a meaningful role as the government reduces its involvement in the mortgage market over time.

Third, let's discuss credit sensitive loans, or CSLs. As you may recall, we view CSLs as a multi-year but not long-term opportunity, similar to distressed non-Agencies. CSLs are a nice complement to our non-Agency holdings, as they are essentially like the performing loans in non-Agency deals. At the end of the second quarter, we had accumulated CSLs with a carrying value of \$438 million, as compared to \$123 million at March 31. Recently, supply has been muted, and available yields in the CSL space have contracted relative to non-Agencies. So we intend to take an opportunistic approach going forward in terms of adding to our current holdings.

Finally, as we have discussed before, credit investments from the GSEs are something we have been monitoring, given our strength in understanding mortgage credit. As mandated in the FHFA scorecard, the GSEs have been charged with disseminating credit risk in 2013 on at least \$60 billion notional of Agency RMBS. As you may know, in July, Freddie Mac brought to market a \$500 million deal covering about \$22 billion in notional MBS.





This deal offered securities that we viewed as having attractive risk-reward characteristics. This was a great first step in the government's effort to determine private capital, credit risk appetite and pricing. We are excited about the potential for similar deals in the latter half of this year and on a longer-term basis, as this is exactly the type of opportunity that dovetails well with our existing core competency in understanding and managing mortgage credit risk.

Before I turn the call over to the operator to begin the Q&A session, I would like to note that this is a very exciting time for Two Harbors. Our current positioning gives us the ability to be opportunistic going forward, as we continue building out our new investment initiatives or when ROEs become more attractive in the secondary market. For all of the reasons we have highlighted today, we believe we can continue to drive value for stockholders over the long term. We are most excited about the MSR and conduit opportunities we have been highlighting but also expect that in the second half of this year, we will likely see renewed market volatility provide opportunities for us in either or both the Agency and non-Agency markets.

Again, thank you for joining us today. I will now turn the call back over to our operator, Sean.

---

## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Mark DeVries, Barclays.

---

### Mark DeVries - Barclays Capital - Analyst

Yes, thanks. So Bill, it sounds like, at least at these levels, you don't find Agency MBS that attractive. How much OES widening would you have to see here before you'd be a bigger investor in the space?

---

### Bill Roth - Two Harbors Investment Corp. - CIO

Yes, so Agency ROEs will, depending on what sector of the market, range anywhere from mid-single digits on lower coupon to the most attractive, when you can find them. And it's, you know, sort of bond by bond gets you around 10%. So, in general, I think if you wanted to categorize Agency ROEs to put any real money to work is probably high single digits on a gross basis.

So if you think about kind of OAS widening that we need to occur, it's probably somewhere in the neighborhood of 20 basis points or so. I mean, if you look at mortgages on a 10-year time horizon, even though they've widened since the tights of the -- earlier this year, they are still barely average. You know, over a long-term basis.

---

### Mark DeVries - Barclays Capital - Analyst

Okay, great. Next, I just wanted to explore some of the implications of any MSR acquisitions. And also your comment that you wouldn't expect it to contribute that materially in the back half of the year to earnings.

So if I think about this, let's say you go out and you buy -- MSR was about \$1 billion worth of UPB. Am right to think that you could then -- let's say assuming it's got like a five-year average life, if you could go out and then terminate roughly \$1 billion worth of swaps and kind of illuminate that negative carry?

---

### Tom Siering - Two Harbors Investment Corp. - CEO, President, and Director

Hey Mark, it's Tom. How are you?



**Mark DeVries** - *Barclays Capital - Analyst*

Good.

---

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

Let me just say a couple of words, then I'm going to hand it over to Bill. In respect to what we mean by not contributing significantly to 2013, you know, it takes a while for these things to close right? You need GSE approval, and, you know, there's a bit of tail to closing these things. So any activity would be found within Q4 if it is to -- if it were to close. And that's why we mean it's not -- from an overall perspective not going to contribute significantly to 2013.

So, Bill, do you want to take rest of that, then?

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, sure. Yes, so if you want to think about \$1 billion of notional, is really probably about a \$10 million investment. Okay? So it depends on what the duration of that is. You know, if you look at the duration probably -- it depends on the coupon, because anywhere from negative [five], [six], [seven], to as much as negative [20]. So you wouldn't be talking about \$1 billion notional of pools, right? Because you'd be talking about something that's more like \$50 million or \$100 million. You'd be talking about a much smaller number. It depends on the duration of the MSR. But importantly, the point is that MSR has a significant positive yield and negative duration, which basically means that we could reduce our swap hedges, for example, which cost us money, which would generally increase the ROE on the overall portfolio.

But in terms of volume, it's hard to predict. It depends on what the MSR duration is.

---

**Mark DeVries** - *Barclays Capital - Analyst*

Okay, got it. So clearly, you know, I guess the swaps that you can close out, you benefit from that negative carry going away. And then on the MSR itself, I assume the incremental carry from that is not huge, right? Because you're going to be -- one, you'll be subservicing. And then you'll have amortization expense that will be modest, very modest positive carry on the asset itself.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes. You know, I think we've said in the past that we thought yields were in the low double digits on the excess MSR. So that's after extracting all costs. So I think, you know, we haven't -- we have two small deals we've closed on. Some of the things we're looking at. We can't really talk about what the yields are, certainly until they close. But I think it's not unreasonable to assume that the yield is not dissimilar to those metrics.

---

**Mark DeVries** - *Barclays Capital - Analyst*

Okay, got it. And then, just finally, I think, Bill, you said your non-Agencies have performed well so fourth quarter to date. Can you give us an update broadly on how you think book value is doing mark-to-market relative to quarter end?

---

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

Yes, Mark, it's Tom. There hasn't been a heck of a lot of movement in either agencies or non-Agencies since quarter end. So there haven't been dramatic changes in either market.

**Mark DeVries** - *Barclays Capital - Analyst*

Okay, got it.

---

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

Non-Agencies are modestly better since quarter end. Agency spreads haven't moved very much at all.

---

**Mark DeVries** - *Barclays Capital - Analyst*

Got it. All right, thanks for your comments.

---

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

Thanks, Mark.

---

**Operator**

Douglas Harter, Credit Suisse.

---

**Douglas Harter** - *Credit Suisse - Analyst*

Thanks. Bill, I was hoping you could update us on where you stand of securitizing some of those credit-sensitive loans. Whether you think you have enough size to be able to execute that.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Hey, good morning, Doug. Yes, so the credit-sensitive loans, we closed some of those in the first quarter and some in the second quarter.

The endeavor that it takes to securitize those actually involves substantially more effort than, say, a brand-new prime jumbo. There's a lot of documentation and data work to get together to pull to produce what is required to do a securitization. So it's something that we are working on. And there are deals that are getting done in the market, but it's not something that I would say is imminent.

---

**Douglas Harter** - *Credit Suisse - Analyst*

And then on that, can you talk -- would that accomplish better leverage, cheaper financing? Or would it just give you the comfort of having term financing?

---

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

Hey, Doug, it's Tom. How are you, good morning. You know I would say this, given our overall leverage in the portfolio, we have a lot of financing flexibility right now. So we can really pick our spot. And so that would apply to CSLs, and certainly it would apply to MSR to the extent that that comes on the books. So right now, we have all the financing flexibility in the world, so we can really pick our spots.



And, obviously, our goal is always to optimize financing metrics. And, as I said, we just have quite a bit of flexibility today and a lot of financing options, given our low -- very low leverage in the Agency portfolio.

Bill, was there anything you wanted add to that?

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

No.

---

**Douglas Harter** - *Credit Suisse - Analyst*

All right, that's helpful. Thank you.

---

**Operator**

Trevor Cranston, JMP Securities.

---

**Trevor Cranston** - *JMP Securities - Analyst*

I guess first, I just wanted to make sure I heard correctly, the portfolio changes at the end of the quarter. Do I understand correctly that -- so you sold several billion of specified pools; bought back the short TBA positions, which was net kind of neutral to duration and implied leverage. But then, on top of that, you also reduced the net short exposure to interest rates?

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, that's exactly right. You know, if you look at -- slide 11 that showed that up 100 parallel shift would benefit. We would expect that to benefit by 9.9%. And by reducing our net short since quarter end, you can expect that number to be lower. So everything you said is correct.

---

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

Yes, so what we said is we're still net short, but we're just less net short than we were at quarter end.

---

**Trevor Cranston** - *JMP Securities - Analyst*

Okay. Can you give any color on kind of how you reduced the net short? Was that in the swap book or the swaptions?

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, so it was a -- basically, it was a combination of things. You know, in addition to selling pools and buying back similar amount of TBAs, we did cover some more of our TBA shorts. And we did a combination, actually. Without getting into too great detail, we covered some of our TBA shorts. And we had some mortgage options positions that we unwound. Specifically, put options.

**Trevor Cranston** - *JMP Securities - Analyst*

Okay. Thanks. And then switching to the prime jumbo securitization slide, can you give any color on what you've seen with spreads, kind of on the new-issuance AAAs this quarter and how far you think that market is away from being kind of functional again for new deals coming out?

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, sure. So, well, first let me answer the first question, which is spreads.

So we went to a time where AAAs were quoted at some spread over swaps to some speed. Typically, 15 CPR. And the challenge with that is that the market moves, either rallies or sells off. 15 CPRs, not necessarily appropriate. So the market has switched to a convention. I'll put these in quotes -- points back. So, in other words, how many points back of the applicable TBA? So let's say 3.5% Fannies are at par and a half. The market today is somewhere around 3.5 points back of that. So that would be \$97 for a 3.5 pass-through.

And that, you know, is a lot easier for market participants to digest. Because then you can make your own speed assumptions.

Now, in terms of what does that imply for, you know, the economics of this? There's -- obviously, there's several inputs. The input -- the first input is where are the loans being produced? So AAAs are wider today than they were at the beginning of the year, but so are jumbo mortgage rates. Wider. So it's a combination of where the loans are made, what the credit enhancement is, and where the AAAs are sold.

I guess the best way -- the way we think about it is if you look at those metrics, you know and you retain the subordinate bonds, you are looking at yields on 0% to 7%. In other words, the bottom 7%, as somewhere in the 6% to 7% range unlevered. And if you retain the bottom pieces of that, you're going to get ROEs using a little bit of leverage, somewhere in the low to mid teens. And, as you can tell because there so much leverage, that number can be very volatile. It's ranged -- that ROE number has been below 10% and above 20% in the last six months. So I think the market is, you know, cheaper on AAAs; it's cheaper on the underlying loans. And the subordinates are coming out at what today seem to be reasonable levels. More importantly for us, I would say, is that, as I mentioned, the government is going to figure out a way to reduce their involvement. Whether it's reducing Fannie and Freddie footprint, lowering the loan limits, etcetera. Which we think ultimately bodes very well for securitization platforms. So I'm not super concerned about today's metrics per se as much as the overall long-term prospect.

---

**Trevor Cranston** - *JMP Securities - Analyst*

Got it, good. Thanks very much for the color. It's very helpful.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Thanks, Trevor, appreciate it.

---

**Operator**

Jackie Earle, Compass Point.

---

**Jackie Earle** - *Compass Point - Analyst*

Thanks for taking the question. Just two quick ones. What was the discount to book value when you repurchased shares? And how do you look at repurchasing stock versus other capital investments?



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

Sure, it's Tom, Jackie. Good morning. We haven't disclosed what our calculation of book value was at the time. We merely said that it was accretive. And how we think about repurchasing shares is this. We view it on an absolute and relative basis, given other alternatives within the market. Now, given our, I would say, general lack of love for the Agency space right now, you might expect that, in times like this, repurchasing shares might be relatively more attractive than they were if Agency spreads were at very wide levels. So we view it simply through the lens of what's best for the shareholders. If we think that repurchasing shares is better than other investment alternatives, that's what we'll do.

---

**Jackie Earle** - *Compass Point - Analyst*

Okay, thanks. And then, secondly, on slide 10 when you guys referenced your targeted capital allocation, can we expect similar numbers going forward or--?

---

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

Yes, I'm going to let Bill tackle that one, Jackie.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, hey, so basically our capital allocation is driven, as you might expect, by what we think the ROE -- the expected ROE is at a given sector. You know, one thing you'll notice is that as the Silver Bay holdings went out of the portfolio, we pretty much dedicated most of the capital to the credit side of the equation, non-Agencies and CSLs, because I think the ROEs there on bonds that we are buying is in the low double digits. And I mentioned agencies are tighter.

If agencies get much more attractive, that would go up. But if the market stays the way it is today, you can expect that the Agency will probably go down relative to the others. The other thing I would say is that we mentioned the possibility of significant investment in MSR to the extent that that comes about, you know -- you can expect that that will obviously go up, given it's close to zero, and that the others will come down.

---

**Jackie Earle** - *Compass Point - Analyst*

Okay. Thanks. I appreciate the color.

---

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

Thanks, Jackie.

---

**Operator**

Dan Altscher, FBR.

---

**Dan Altscher** - *FBR Capital Markets - Analyst*

A question on book value moves. I guess two-part. One on the non-Agency. Bill, I think you referenced -- maybe it was Tom who referenced that I guess the move was pretty nominal. I guess, one, do you think that's a function of the underlying bonds that you owned that held up pretty well? Or was there, I guess, significant protection in things like CBS that meshed pretty well with the basis? And then I just have a follow-up question on the book value after that.



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

Sure, I'll let Bill tackle that. My comment was that non-Agencies since quarter end were a tad higher, just to be clear on the comment that I made. Bill, do you want to tackle the second-quarter commentary?

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, hey Dan, good morning. Yes, so just to give you an idea of the price path in the second quarter. So, April was a good month for non-Agencies, generally. They went higher. May, they were generally unchanged. And then June was sort of a general widening in credit spreads. Agencies got marked -- or are non-Agencies got marked down again. And so, you know, net of credit hedges, which sort of went in the opposite direction, it was pretty close to a wash for the second quarter. To be good in April, flat in May, down in June. And in July, we've seen a little bit of a bounce-back both on the non-Agency bonds, as Tom mentioned; and then applicable hedges have also done well, as you probably know, since quarter end.

---

**Dan Altscher** - *FBR Capital Markets - Analyst*

Okay. Thanks. And then one other on the book value change. For the mortgage loans that are all market fair value; those, I guess, that are in the securitization trust and those, I guess, that are being warehoused for potential securitization. How did those fare in the quarter from a fair-value perspective?

---

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

I'll just comment more on the technical accounting side, and Bill can kind of get the color. So all of those loans, including the loans held in the securitization that are on balance sheet, are fair valued. So the marks on those loans do move through the P&L. And Bill, I'll let you give a bit of color on the shifts.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, so basically, the loans that we owned -- the prime jumbo loans that we owned during the quarter moved as you would've expected them to move; basically, with TBA prices. As I mentioned, the AAAs, which are 93% of the capital structure, trade off of TBA. So as TBAs went down, so do the loans.

Now, that being said, we had hedges in place, both short TBAs as well as swaps, against that. Now, you know, that sort of goes into the overall portfolio management. But just in terms of direction, they went down like you -- similar to Fannie (inaudible) has. Go ahead, Tom.

---

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

Yes, just to be clear, net of hedges, this was not a significant factor in respect to book value, to be abundantly clear on this. So, obviously, we hedged the interest rate exposure attendant to these, and -- but it's not a big factor in respect to book value for the quarter.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, just to be clear, when loans come on -- come in onto our balance sheet, or when we are locking loans, we're hedging those just like we are everything else. So the net is a de minimis impact, as Tom pointed out.

---





**Dan Altscher** - *FBR Capital Markets - Analyst*

Got you. Okay. Thank you.

---

**Operator**

Joel Houck, Wells Fargo.

---

**Joel Houck** - *Wells Fargo - Analyst*

Thanks for taking my question. Somewhat confused, I guess, more for the July moves. I mean, you reduced spec pools and then closed the short TBAs, which seems to imply you don't think rates are going down a whole lot. On the other hand, you reduced your overall net short position, which means you're a little less worried about rising rates. Although from Bill's comments about the Agency, it sounds like you are concerned about possibly continued MBS spread widening or basis risk. Can you kind of handicap those three -- or how kind of organizationally you guys feel about those three scenarios? Lower rates, say, down 50; higher rates, up 50; and then continued basis widening. Just where do you think the real risk lies here between now and year-end as we kind of get through this? Seems like tapering on one week, off the next, and then you got a new Fed Chairman coming in here probably at the end of the year.

---

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

I'll let Bill comment, Joel. But, from an overall perspective, you're exactly right, right? There's a fair amount of uncertainty. And the Fed is a very big factor within the mortgage market. And so, you know you put all that in the blender, and the output is that we are pretty defensive. Because, you know, if you look at it from a risk-reward perspective, Agency spreads are simply are not that attractive on an absolute or historic basis. And so we want to play defensively. That allows us to reserve a lot of capital for the new business initiatives. It allows us a lot of capital if Agency spreads were to widen to more attractive levels. But, you know, the past quarter certainly has proven that sometimes the best offense is a little bit of defense. So Bill, do you want to add to that, please?

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, sure. So the three things. First, I just want to be clear on something. Selling pools against a short TBA is virtually indifferent economic position. In fact, it's actually a net small positive because the carry on the pools was less than the short -- the role, buying the role. So it was actually economically beneficial to our shareholders. It had no impact at all on duration mortgage spread risk, because a long pool short TBA position -- assuming that these pools have no pay-up, you know, basically is not really any position at all. It's just one is on balance sheet and one is not. So, you know, just in terms of making that commentary. That had nothing to do with rates, mortgage spreads, or anything. That was just as I referred.

In terms of cutting our short duration position. As you saw, we were short -- you look at that slide. That's a pretty substantial short position. And given that ten-year had gone up almost 100 basis points by sometime in July, you know, we hit 274, the odds of going up another 100 in the very short run, we thought, were greatly reduced. And so, you know, that is why we cut that position back. Now, that doesn't mean we don't think that rates could go to 3% or 3.25%. But the odds that ten-year notes hit 4% or something like that in the next six months is pretty low. The Fed has pledged to keep the funds rate where it is, which would imply a steepness of the curve that I don't think we've ever seen before.

So, you know what rates do going up or down, frankly, is going to depend on the data that comes out. It's just that simple. The data, we believe, continues to be supportive of the Fed tapering and modestly higher rates. And so, that's why we're maintaining low overall exposure and a short rate position. You know, if you look at what has happened and what's likely to happen, higher rates are likely to be accompanied by a wider mortgage spreads, and lower rates are likely to be accompanied by tighter mortgage spreads. So by having low leverage and a somewhat short position, if rates go up, we might lose on our basis position somewhat, which is greatly reduced. And then we'll win on the rate short.



So it's a very defensive position. If it goes the other way, we'll lose on our duration and we'll win on our basis. So the idea is to keep in this time of high uncertainty, where we have a lot of new exciting things that are going to basically potentially make a big difference in our profile, we just think that preserving book value is by far and above the most important thing to do.

---

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

And to be clear, Joel, how we got there is if you look at our swaptions, you know the position there, they started to pick up deltas as the market sold off. So actually we're getting somewhat shorter as the market sold off, which speaks to the efficacy of our hedging program.

---

**Joel Houck** - *Wells Fargo - Analyst*

You know, I think most would agree you guys have done the best of any on hedging.

The -- how would you -- I don't want to handicap, is the right word, but what are your thoughts regarding how much is priced in the mortgage base, with respect to tapering, by the end of the year? This is obviously the big topic and you get lots of different answers. But I'm just curious as to what you guys think.

---

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

Yes, the market is a little schizophrenic around that, right? Because the news changes from day to day. So, you know, it's -- we try very hard not to trade the headlines, I would say, and really just position the book as we think best. I mean, it's very simple, right? There's a few metrics that Bernanke, et al., are all are fixed on, as they should be. And, obviously, kind of the super metric is employment. And to the extent that waxes and wanes, the Fed's desire to taper or not will be affected. And, obviously, a change in the leadership of the Fed will have an impact on that. And obviously, that's still uncertain, too. So, you know, I think the market -- how much of it is priced in. We would say this, that not enough is priced in, in respect to tapering. Because ROEs simply are not that attractive, and we're going to let that be our guide in how we position the book.

---

**Joel Houck** - *Wells Fargo - Analyst*

Okay that's helpful. And then, you know if you had to run this defensive position for a while, just given the uncertain volatility, what type of kind of ROE does it generate? Obviously, if it's lower than, say, a year ago. But if you're going to protect book value -- and I think that's the right strategy, most people would agree -- the trade-off is lower current returns. But how should we think about that? Not that you guys necessarily are going to hold you to running this thing into infinity. But if we had to think about this for a while, what would the ROEs look like?

---

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

I can promise you that we will not run the book like this into infinity. (laughter) It will be different in some respects. That much I can promise you.

You know, we said this a lot, and perhaps at the point of ad nausea. But, you know, Bill and I think about the portfolio in respect to total return. And it's a heck of a lot easier to generate the dividend when you preserve book value and you have the ability to put money to work in times when it's prudent. And one thing that we're simply not going to give get trapped in is trying to work backwards to generate dividends. In other words, unduly increase leverage. So, it's very difficult to say. You know, the mortgage market is very ephemeral in nature. And conditions that exist today almost certainly won't exist tomorrow. So we really think about it from the standpoint of prudence and respect to total return.

---

**Joel Houck** - *Wells Fargo - Analyst*

All right. Again, thanks for your comments, guys.



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

Thanks a lot, Joel.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Thanks, Joel.

---

**Operator**

Bose George, KBW.

---

**Bose George** - *Keefe, Bruyette & Woods - Analyst*

Just wanted to follow up on the last question, just on the potential returns. Just when we think about this quarter versus last quarter, what should we think about terms of the changes that you made that impact core earnings? The changes to your hedges presumably have some upside to core earnings as a result? Just any comments on that?

---

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

Sorry, Bill, I'll start, and then Bill you can kind of deep dive into maybe the strategy and more color. I tried to expand my comments around that point. I mean, it is a large component of leverage and defensive measures to protect book value. So those are the key drivers. Now with this quarter coming off the back of those actions, you know, we did not focus on core earnings. And, as I noted, realized gains, specifically TBAs, which by definition are not part of core earnings, those are generating cash flow gains that we look at when we are declaring our dividend. The other component is, we made -- we have the intention of treating the value of this Silver Bay stock as a return of capital. And so, to do that for 2013, we will largely target distributing 100% of our taxable income. And so that's another factor in how we think about core earnings, the dividend, and really, again, focusing on Tom's comments, preserving book value. Bill, do you want to expand upon that?

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

I think I'll be the third person to say that we really don't think that much about core earnings. If there's anybody else on the team that wants to say the same thing. You know, the bottom line is we could generate a lot of core earnings, which would require us taking a lot more leverage and probably a lot of interest rate risk. And we already know how that movie ends. And so when spreads are narrow, you don't want to jack up leverage or take extra risks. Because when things go the other way, you know, I don't care how much core earnings you produce, it's going to be a bad total return. And so, frankly, we're just not focused on it. We're focused on what we think will generate the highest total returns and -- you know, I'll give you a real simple example. If we had one dollar and that's all we had, and we didn't invest it for 89 days of the quarter, and then we bought a bond really cheap on the last day and it went up in price 10%, we would have no core earnings, but yet, we would have had a terrific total return. And I would argue that that is a very good result. And so that's kind of the way we think about it.

So the only thing I could tell you is that you can expect us to have a very high focus on our total return or total comprehensive income, but I can't tell you what core earnings are going to be.

---

**Bose George** - *Keefe, Bruyette & Woods - Analyst*

Okay, then I definitely agree with you guys. Unfortunately, we've got to, like, try and throw out core earnings, so we're trying to see if we can fine tune that. But, yeah, I definitely agree with your approach to this.

---



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

And Bose, to answer your question, I think what you asked at the front end was the changes we've made since quarter-end. So if the changes that we made that Bill discussed -- for instance, you know, reducing the overall balance sheet and taking down the interest rate hedge would have a modest positive impact on core earnings. But, again, that's not the real driver behind that.

But I think that was your question.

---

**Bose George** - *Keefe, Bruyette & Woods - Analyst*

Absolutely, thanks, that makes sense. And, actually, just on the non-Agency, though, I was just curious where current returns are.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Actually, yes, I mentioned during my comments that bonds we bought recently are in the 6% to 7% range on a loss-adjusted basis. You know, and if you sort of apply our typical 1.25 times leverage, given that financing has come into sort of midmarket LIBOR +150, you get to low double digits ROE. And these are on bonds we think we have upside optionality.

Now, I will tell you that the bulk of the non-Agency market does not trade in that 6% to 7% range. It trades lower than that. So it's not like we can put substantial amounts of capital to work on a daily basis or monthly basis. But when we are finding bonds that are in that zone, that works for us.

---

**Bose George** - *Keefe, Bruyette & Woods - Analyst*

Okay, great. And then actually just a question on that Freddie Mac securitization. Did you guys participate? And also, is there leverage available for that in terms of getting to a double-digit return?

---

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

Yes, Bose, it is our understanding that there were some confidentiality provisions around that offering. But you might infer that this is something -- and area that we would be attracted to. And with respect to financing, obviously the most efficient way for us to finance today is through the Agency market, and we're very under levered in that respect.

---

**Bose George** - *Keefe, Bruyette & Woods - Analyst*

Okay, perfect. Thanks.

---

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

Thanks a lot, Bose.

---

**Operator**

Stephen Laws, Deutsche Bank.

---



**Stephen Laws** - *Deutsche Bank - Analyst*

Thanks for taking my questions. Actually, most of those have been addressed. I missed a little bit of revolver around the tax recorded during the quarter. Could you maybe (inaudible) as far as what the accounting treatment was that the cost impacts liability would be reported?

---

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

I'm going to let Brad tackle that one.

---

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

Yes, and just I'm going to -- the connection didn't come across terribly clear, so I just want to repeat what I think I heard. So you're asking is, you missed the tax comment I made, and then you're just trying to understand what drove the taxable income?

---

**Stephen Laws** - *Deutsche Bank - Analyst*

(technical difficulty) the \$49 million (technical difficulty) of --.

---

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

Got it, the tax expense. I'm sorry. So the tax expense -- so as a REIT, your mortgage bond exposures are allowable, and good asset and good income for a REIT. Certain derivative activities that we participate in, specifically swaptions and other more complex synthetic instruments, credit default swaps, things like that, TBA mortgage options, are not good assets or good income items for the REIT. And so, we create a taxable REIT subsidiary to conduct that activity. So when certain gains are generated in our taxable REIT subsidiary, it is a corporation that does have tax exposure. My comment, specifically, was addressing that, over time, we've actually taken losses in that entity as we made money on our cash bonds. So this is largely just a flip of that position over our history.

So it's a tax expense associated with our derivatives, but it doesn't a surly correlate to tax payments with the IRS.

---

**Stephen Laws** - *Deutsche Bank - Analyst*

Great, that's very helpful. And you guys have addressed my other questions. So thank you very much.

---

**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Thank you.

---

**Operator**

Ken Bruce, BofA Merrill Lynch.

---

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

Thank you. Good morning, gentlemen. My questions really relates to the new initiatives. And, firstly, thank you for your comments around the capital preservation risk aversion. I think I kind of understand that, certainly in this market backdrop. But on the new initiatives, and some of these



questions may seem a bit skeptical, but I just want to kind of understand your commitment to these businesses. How does Two Harbors want to define itself as it looks at the mortgage market, either from the servicing perspective or within the conduit activities?

---

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

Sure. Well, I hope I can allay some of your skepticism. You know, how we think about it is that our history is steeped in certain competencies, which are prepayment risk; interest rate risk; credit risk within the housing and mortgage markets. So if you look at securitization, it requires credit analysis, just as we go through in our legacy non-Agency book. If you look at MSRs, we view those through the lens of prepayment and interest rate risk. And historically we've participated in the IO market when that is attractive. Today, MSRs are much more attractive than IOs. And so they write a natural hedge to our Agency book. But important -- very importantly, they need to stand on their own in respect of their attractiveness. And so, today they are attractive, and the reason is because of the capital and regulatory environment that we've been in.

And, secondly, given the frenetic amount of refinancing that has gone on, there are certainly a lot of people who have a lot of MSRs on the books. And in some cases it's fairly large relative to their overall capital. And so we provide balance sheet, and we are a good partner for certain counterparties because we're not going to be in the underwriting business and we're not going to be directly servicing the MSR. And, therefore, we're quite a good partner. And so today, you know, both of those sectors are attractive.

Now, fully, the key is being able to execute on those. Today, we are quite enthusiastic that we will be able to within the MSR space. But, as we've cautioned, it's subject to diligence, closings, GSE approval, etcetera. On the securitization front, it's fully going to be tethered to the ultimate profile of the GSEs to the extent that they either, you know -- to the extent they reduce their footprint within the mortgage space, which is immense today, as you know. That allows private capital, such as that provided by Two Harbors, to participate in the jumbo market and to participate in securitization.

---

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

I guess really what I'm trying to understand is do you define yourself as an investment Company that's looking for relative value and it just so happens that these areas are interesting today, and ultimately, you know, you want to allocate capital into them? But as you look forward, that obviously can change? So that interest in whether it be MSRs or, frankly, even in the conduit activities may not be there. And how do you think about it in the context of maybe a longer-term view?

---

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

Sure. You know, yes, great question. You know, how we think about it is simply this, right? We are going to participate in the mortgage market as a mortgage REIT, and we want to have all the options that are available to us to enhance shareholder returns. So how Bill and I think about it, the portfolio is in the context of short ratios or information ratios. In other words, return as measured through volatility metric. And so we want to have all the options available to us. And, you know, our commitment to certain spaces is going to be driven simply by what we think the risk reward is within those areas. And so, we built out a very lean infrastructure that allows us to efficiently, economically, but prudently manage all of the issues associated with these initiatives. And we will move capital around, dependent upon the relative attractiveness of all of these things. And so we don't want to be narrowly defined. Because, at times, the Agency market is attractive. And we have gone through a long period of that in the last few years. Now, today, it's less so. And so on an absolute and relative basis, these new initiatives are much more attractive, relative to the legacy of the Agency book.

And that really is what drives us. I mean, it's a cliché, but shareholder value is what drives us. And, today, these new initiatives are really attractive in that respect.

I think Bill is going to add something too.



**Bill Roth** - *Two Harbors Investment Corp. - CIO*

Yes, hey, Ken. Yeah, let me just add something that I think is important to keep in mind. You know, in keeping with what Tom said, you can be very opportunistic. And if you want to buy agencies when they're cheap; or if they're not so cheap, reduce it.

You know, one thing about these new initiatives that we are very serious about, because these obviously have a higher operational component, is these are things that you have to commit to be in for a long period of time. So, given the fact that we're a mortgage REIT, we're going to be invested in mortgages. MSR, almost without exception, due to the nature of the asset being a positive yield/negative duration, has a place in the portfolio for a long period of time. So you don't just go in that and say, hey it's cheap today and then in a year, oh it's not cheap. You can't do that because of the nature of owning mortgage servicing. It's our intent to be in this business for, I guess, somebody threw out infinity. So maybe a little less than infinity. You make a commitment to that, and it's important for the people that we partner with also. Because they need to know that we're going to be here. And our balance sheet can absorb that asset regardless -- as those prices fluctuate and it still makes sense.

And then, furthermore on the conduit side, you know, look, you can't sign up dozens and dozens of originators and say you're in that space, and then a year later just say I'm out, okay? I'm really not worried about the longevity of either of these businesses. The mortgage market has and will continue to go through dramatic changes with regards to the players and the capital. And these are two businesses that we are very confident they can be value added for our shareholders over many years to come.

So understand that we've added staff, with added expertise. We are very well positioned, and we're committed to both of them. And I think that's important to understand.

---

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

Yes, and that's exactly what I was getting after, was that these are businesses that have much more operational investment and require consistency over time in terms of being able to aggregate a group of sellers. And so it's -- I'm trying to understand your interest in this area and how that will evolve, is really what I'm getting after. You've seen a number of other companies that have gotten involved in, and I'm trying to understand -- as the return profile in the business changes around, mortgage business is cyclical by its very nature. That's going to lead to some ups and downs, and understanding how you're thinking about that is really what I'm trying to achieve. So thank you for your comments.

---

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

We do understand. We spent a lot of time; we've been very measured and how we've approached this. And we've built out the infrastructure to support these initiatives. And, as I've said, we're quite confident that not only are we a good partner in respect to capital, but we have the competencies at every level to handle these new initiatives. So we've taken our time, we've built slowly, and we are quite enthusiastic about the future for these new initiatives.

---

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

Great. Thank you. That's all I had.

---

**Operator**

I'm not showing any other questions in the queue at this time. I'd like to turn it back over to management for closing comments.

---





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

Thank you, Sean. And thank you to all of our participants for joining our second-quarter earnings conference call today. We appreciate your interest in Two Harbors and look forward to speaking again to you soon. Have a great day.

---

**Operator**

Thank you. Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the conference. You may now disconnect. Good day.

---

**DISCLAIMER**

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2013, Thomson Reuters. All Rights Reserved.