TWO HARBORS Investment Corp.
A Pine River Capital Managed Company

Fourth Quarter 2016 Letter to Stockholders

NYSE: TWO

February 17, 2017

Dear Fellow Stockholders,

Superior asset selection across our three strategies and a prudent approach to risk management drove solid results in the fourth quarter and strong stockholder returns for 2016. Despite the historic increase in interest rates in the quarter, we generated a positive return on book value of 0.1%[1] and Comprehensive Income of $2.2 million, highlighting our ability to deliver stable results in just about any rate environment. For the year, we reported a 5.9%[1] return on book value, $193.4 million in Comprehensive Income, and a 20%[2] total stockholder return. While we are proud of these results, we are even more excited about the opportunity to increase our earnings potential in 2017.

In our Rates[3] strategy, we continue to thoughtfully manage our Agency portfolio and build out our MSR position. Consistent with our philosophy of sustaining an overall conservative risk profile, we continued to maintain very low exposure to interest rates, which allows us to better protect our book value and our income-generating ability. MSR is a key component to our ability to protect against an increase in interest rates and wider mortgage spreads, as evidenced in the fourth quarter when servicing valuations increased substantially. We expect that the trend for slowing prepayment speeds could continue throughout 2017 given the relatively higher rate environment, which would benefit our MSR holdings. If you are interested in learning more about how MSR hedges our Agency residential mortgage-backed securities (RMBS), we released a webinar in November titled, *Mortgage Servicing Rights Primer*. It can be found on our website under the Investors tab, by clicking on Webinars. In terms of portfolio activity in our Rates strategy in the fourth quarter, we repositioned our Agency RMBS to better align with the current interest rate environment. We also added approximately $10.6 billion in unpaid principal balance (UPB) of high quality, new issue MSR, largely from flow-sale arrangements, to pair with our Agency holdings. It is our expectation that near-term flow-sale MSR volume will be between $2.0-3.0 billion UPB per month.

Our Credit[4] strategy and legacy non-Agency RMBS continued to benefit from the strong tailwinds for residential credit. Housing price appreciation and the age of our portfolio with respect to principal payments provides upside to prepayment speeds, and in 2016 we continued to experience favorable trends relative to our modeled expectations. Given this strong performance, we again released credit reserves during the fourth quarter. As a result of this, we anticipate maintaining attractive yields for our legacy non-Agencies and, with an average market price of about $74.53 as of December 31, 2016, we believe that there remains future upside owing to better underlying loan performance.

Prior to the end of 2016, we completed the closure of our mortgage loan conduit business consistent with our previously stated timeline and expense expectations. We have redeployed the capital from that business to other strategies that we believe will generate higher returns, namely MSR and commercial real estate lending, which we expect to be additive to earnings in 2017.

With respect to our Commercial[(5)] strategy, our portfolio value grew to $1.4 billion as of December 31, 2016, with an average stabilized LTV of 62.4%[(6)] and an average spread over LIBOR of 474 basis points. As a reminder, this is a strategy whereby we originate, source, underwrite, document, close and monitor primarily first mortgage LIBOR floating rate loans. We believe the opportunity today for nonbank commercial real estate lenders is even stronger than it was a few years ago. We expect this to continue due to the regulatory environment for banks and the implementation of commercial mortgage-backed securities risk retention rules. We remain focused on growing this portfolio of high-quality loans.

We further diversified our financing profile in the quarter, adding multiple cost effective sources of funding aimed at MSR and commercial real estate lending in 2016. In addition to these efforts, subsequent to quarter-end, we successfully completed an underwritten offering of convertible debt, providing us additional flexibility in our financing to help us pursue opportunities in the areas of our business generating the highest returns. Demand was strong for this security as demonstrated by the exercise of the overallotment option by the underwriters.

Throughout 2016, we made significant progress on simplifying our business, redeploying capital and improving efficiencies with the goal of maximizing returns for stockholders. As we head into 2017, we remain committed to deploying capital to areas of our business with the highest anticipated returns and driving our earnings power, while also maintaining a disciplined approach to risk management and protecting book value.

Thank you for your interest in and support of Two Harbors.

Sincerely,

Thomas Siering
President and Chief Executive Officer

(1) Return on book value for the quarter ended December 31, 2016 is defined as the decrease in book value from September 30, 2016 to December 31, 2016 of $0.23, plus the dividend declared of $0.24 per share, divided by September 30, 2016 book value of $10.01 per share. Return on book value for the year ended December 31, 2016 is defined as the decrease in book value from December 31, 2015 to December 31, 2016 of $0.33, plus dividends declared of $0.93 per share, divided by December 31, 2015 book value of $10.11 per share.
(2) Two Harbors' total stockholder return is calculated for the period December 31, 2015 through December 31, 2016. Total stockholder return is defined as stock price appreciation including dividends. Source: Bloomberg
(3) Assets in "Rates" include Agency RMBS, Agency Derivatives, MSR and Ginnie Mae buyout residential mortgage loans.
(4) Assets in "Credit" include non-Agency RMBS, prime jumbo residential mortgage loans, net economic interest in securitization trusts and credit sensitive residential mortgage loans.
(5) "Commercial" consists of senior and mezzanine commercial real estate debt and related instruments.
(6) Stabilized LTV considers the prospective market value "as stabilized" which reflects the property's market value as of the time the property is projected to achieve stabilized occupancy. Stabilized occupancy is the occupancy level that a property is expected to achieve after the property is exposed to the market for lease over a reasonable period of time and at comparable terms and conditions to other similar properties.