TWO HARBORS
Investment Corp.
A Pine River Capital Managed Company

Second Quarter 2019 Letter to Stockholders

NYSE: TWO

August 23, 2019

Dear Fellow Stockholders,

We delivered a very strong quarter and first half of 2019. Our book value grew to $14.17 per common share, representing a total return of 5.4% for the second quarter and 14.7% for the first half of 2019. [1] Our book value performance was a result of both our portfolio positioning and active hedging. We are also pleased to have completed our first financing securitization for mortgage servicing rights (MSR), which has very competitive terms compared to our bilateral facilities and gives us more financing flexibility for MSR.

In the second quarter, our sector traded under stock price pressure, which we believe was driven by dividend cut concerns, lower interest rates and a flatter yield curve, and an emergence of faster-money buyers and sellers, creating more intra-day volume and volatility. As you know, our goal is to deliver book value stability through a variety of market environments. We construct our portfolio with this long-term focus in mind, while endeavoring to minimize the impact of short-term changes in rates and mortgage spreads. In particular, we believe our strategy of pairing MSR with Agency RMBS generates a more stable risk-adjusted return throughout market cycles, compared to hedging Agencies with swaps only. Additionally, our unique portfolio of legacy non-Agency securities is one that can't be replicated, and we believe that due to strong housing tailwinds, this strategy will continue to generate positive total returns. Since inception, we have grown our book value by 8.4%, compared to an average mortgage REIT book value decline of 28.7% over the same period of time.[2] Notably, we achieved these results with 35% lower book value volatility compared to the mortgage REIT average.[2]

The broader market in the quarter was impacted by global growth concerns, especially trade issues with China and Mexico. This fueled the rally in interest rates, which resulted in a flatter yield curve and 3-month LIBOR above most long-term rates. The flatter curve shape anticipated the Fed lowering rates, which ended up occurring in July, and the expectation is that there will be further rate cuts in the latter half of 2019.

Given this backdrop, we believe that we have positioned both our Rates[3] and Credit[4] strategies to deliver strong long-term, risk-adjusted returns. We expect current returns in our Rates strategy[3] to be in the low double digits, importantly, with mitigated interest rate and spread risk because of MSR. In our Credit strategy[4], we believe our portfolio of legacy non-Agencies will continue to benefit from the strengthening housing market. Additionally, the lower rate environment is beneficial to our discounted portfolio. Residential credit tailwinds have been strong and subprime non-Agency prepayments have increased, while severities and delinquencies have come down. Continued re-equification by borrowers has resulted in – and can continue to result in – increased prepayments, and lower delinquencies, defaults and severities. We believe these favorable dynamics will persist, driving bond prices higher and generating strong total returns going forward. Despite the fact that the legacy non-Agency sector is shrinking, we have a substantial and unique portfolio of deeply discounted bonds and we continue to find pockets of value and opportunities to add to our holdings.

We maintain a conservative risk profile, utilizing a variety of tools including MSR, swaptions, mortgage options and swaps. Our exposures to changes in rates remain very small. Consistent with our typical practice, in the second quarter we utilized an extensive amount of mortgage options and swaptions to protect our portfolio against significant rate moves. This hedging practice contributed to our strong performance. Our mortgage spread exposures to movements in rates, up or down, also remains close to zero. As we've discussed in the past, MSR has negative duration and hedges both interest rate and mortgage spread risk, helping to keep our overall risk exposures remain low.

Recently, we received some questions regarding our thoughts on possible GSE reform. We think it is unlikely that anything of substance happens prior to the 2020 election. Obviously, the outcome of that election could greatly influence the future path of the GSEs.

We believe that we have positioned our portfolio, through both security selection and active hedging to drive strong returns over the long-term. We are very excited about the opportunities in both our Rates[3] and Credit[4] strategies in the latter half of 2019 and beyond. Thank you for your interest in and support of Two Harbors.

Sincerely,

Thomas Siering
President and Chief Executive Officer

(1) Return on book value is defined as the increase (decrease) in book value per common share from the beginning to the end of the given period, plus dividends declared in the period, divided by the book value as of the beginning of the period.
(2) Book value growth and volatility since our inception is measured from December 31, 2009 or the peer company's inception, whichever is later, through June 30, 2019. Two Harbors quarterly book values have been adjusted for each quarter from Q1 2013 forward to include $1.88 of stock distributions associated with the special dividend of Silver Bay Realty Trust and, beginning in Q4 2017, $3.67 of stock distributions associated with the special dividend of Granite Point Mortgage Trust Inc. common stock. Peer mortgage REITs include AGNC, ANH, ARR, CIM, CMO, IVR, MFA and NLY. Peer book value figures are based on publicly reported data and have not been adjusted for the return of capital from dividends, if any, to peer stockholders during the same period. Book value volatility calculated by dividing the standard deviation of book values in the measured period by the average book value from the measured period. Source: Bloomberg.
(3) Assets in "Rates" include Agency RMBS, MSR and other interest rate sensitive assets.
(4) Assets in "Credit" include non-Agency securities and other credit sensitive assets.