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TWO - Q1 2014 Two Harbors Investment Corp Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Two Harbors first quarter 2014 financial results. (Operator Instructions).

As a reminder, today's conference is being recorded.

And, now, I'll turn the conference over to your host for today's conference, July Hugen, Director of Investor Relations. Please begin.

July Hugen - *Two Harbors Investment Corp - Director, IR*

Thank you, Tyrone, and good morning. Welcome to our first quarter 2014 financial results conference call.

With me this morning are Tom Siering, President and Chief Executive Officer; Brad Farrell, Chief Financial Officer; and Bill Roth, Chief Investment Officer. 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 our website and the SEC's website.

This call is being broadcast live over the Internet and may be accessed on our website in the Investor Relations section under the Events and Presentations link. We encourage you to reference the accompanying presentation to this call, which can also be found on our website. Reconciliation of non-GAAP financial measures to GAAP can also be found in the presentation.

We wish to remind you that remarks by Management during this conference call and the supporting side 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 on 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.

Before we move into first quarter results, we would draw your attention to our Introduction to Non-Agency Securities webinar, the latest in our on-going series. You can find this and other webinars on the Investor's tab of our website under the Events and Presentation link.

I will now turn the call over to Tom.

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

Thanks, July. Good morning, everyone and thank you for joining our first quarter Earnings Call. Let me start with a summary of our financial results.

Please turn to slide 3. We had a solid start to the year. Generating a total return on book value of 3.9%. In the quarter, Two Harbors delivered comprehensive income of $152.6 million, or $0.42 per weighted average diluted share, representing a return on average equity of 15.7%.

For the quarter, we also reported core earnings of $0.24 per share, and a GAAP loss of $0.08 per share. While GAAP earnings are an important and necessary accounting standard, this metric is not instructed as to our financial performance.

The interest rate curve flattened during the quarter as longer term rates fell, while shorter term rates rose modestly, due to perceived Fed intentions. Mortgage rates remain elevated from early 2013 levels, but fell slightly in the quarter. Over the last two quarters, we have delivered a total return on book value of 8.5%, which we are proud of, considering the volatility in the interest rate environment. Interest rates rose in Q4 2013 and fell in this quarter.

To frame this result, the 10-year treasury has returned only 1.5% over the last two quarters. This is a testament to our ability to generate alpha in a variety of interest rate environments.

I would like to provide a brief update on the MSR and mortgage loan conduit initiatives. We continue to work with a variety of partners to further develop our investments in MSR. We have been adding MSR to our portfolio from the previously-announced flow arrangement with PHH, and subsequent to quarter end, we closed an additional bulk portfolio sale from Flagstar. MSR continues to be an excellent asset for our portfolio.

We have made considerable progress on our mortgage loan conduit initiative, as well. We have been adding loans to the portfolio and continue to advance relationship with originators. From a financing perspective, we expect to utilize the FHLB to support our conduit activities in the future, which is an important way for us to optimize our overall funding mix. Bill will cover more details on the MSR and conduit initiatives later in this presentation.

Let's discuss the macro environment, as outlined on slide 4. Unemployment figures were stable throughout the first quarter with unemployment at 6.7% at the end of March. Subsequent to quarter end, unemployment fell to 6.3% in April. This, coupled with home price appreciation, which according to CoreLogic was up 12.2% on a rolling 12-month basis as of February 28th, creates a good environment for the performance of our credit strategy.

Late last year, the Fed announced its intention to begin tapering its purchases of US Treasuries and Agency MBS. The Fed has cut its monthly purchases of US Treasuries and Agency MBS to $25 billion and $20 billion, respectively, down from $45 billion, $40 billion, respectively, at the peak. The Fed remains focused on what they view is the economic super metrics of unemployment and inflation.

We believe the winding down of asset purchases will continue through 2014, although questions regarding the end date to the Feds accommodative a policy will most likely continue to impact the MBS market this year. Chairman Yellen has made it clear that until the target figures of 2% inflation and 5.5% unemployment are achieved, the Fed will continue to tweak, as they say, their accommodation to the markets.

There are a number of legislative proposals that could significantly impact our sector. So, let's spend a moment discussing what we're monitoring in Washington.

With the introduction of the Johnson-Crapo Bill and HOME Forward Act in March, GSE reform remains a hot topic on Capitol Hill. Other legislation we are monitoring include The PATH Act and Corker-Warner, both of which would also phase out the GSEs.

While it is uncertain if any of the proposals will ultimately become legislation, it does appear that significant change to the US mortgage market is likely in the coming years. That being said, we have doubt as to how much will be accomplished in 2014, as it is a contentious election year. Over the longer term, however, mortgage REITs like Two Harbors will be part of the solution to the quandary of how to reduce the government footprint in the mortgage markets.

Another topic of interest is the implementation of the QM guidelines that went into effect in January. These essentially delineate very high quality loans from those with weaker credit scores, thus, creating a bifurcated market for residential credit.

Bill will touch on the potential opportunity created by this legislation, by this regulation.

Now, I'll turn the call over to Brad for discussion of our financial results.

Brad Farrell - *Two Harbors Investment Corp - CFO, Treasurer*

Thank you, Tom. Good morning, everyone.

Now, let's turn to slide 5. Book value increased to $10.71 after adjusting for the quarterly dividend of $0.26 per share, and our comprehensive income was $152.6 million, or $0.42 per weighted share. Our comprehensive income was driven by solid performance across both our Rates and Credit strategies.

Please turn to slide 6 for an overview of our financial results. Core Earnings of $0.24 per weighted share represented a 9.1% annualized return on average equity.

This is in line with our expectations when we set the dividends. Although we remained defensively positioned and are managing liquidity prudently, Core Earnings increased by $11.8 million, quarter-over-quarter, primarily due to the full quarter investment in MSR of approximately $500 million and generally higher yield across our portfolio.

In the first quarter, our implied debt-to-equity ratio, including our TBA position, was 2.7 times. This was a decrease from 3.1 times, as of December 31, as we eliminated some of our long TBA positions in the quarter and at March 31st are net short about $1 billion in TBAs.

Our other expense ratio increased to 1.5% this quarter, up from 1.3% in the previous quarter. As are reminder, our operating expenses will vary depending on the need of our MSR and conduit businesses.

On the bottom right-hand side of this slide, we have noted a variety of accounting topics. We have released, approximately, $23 million of credit reserves on our non-Agency mortgage-backed securities. This quarter, some of our holdings outperformed our original recovery assumptions. This caused us to release reserves. However, our general view of fundamentals remains unchanged.

As our prime jumbo pipeline gains momentum, I would like to highlight one accounting topic believe it is important. In accordance with ASC-815, we recognize interest rate lock commitments on mortgage loans held-for-sale as derivatives and account for them at fair value on the balance sheet.

At March 31, the loss on the derivative was immaterial, but the financial impact may become more relevant as our pipeline grows. Our MSR assets decreased from, approximately, $514 million, as of December 31, to $477 million at March 31st. As a reminder, we have chosen to account for this asset at fair value.

During the quarter, we recognize $30 million of servicing income, $5 million of subservicing expense, and a $33 million decrease in the fair value of our MSR, which includes implied amortization of $12.5 million. Unlike the mortgage loan interest rate lock commitments I previously discussed, in accordance with GAAP standards, any MSR pipeline we might have as of March 31, that is MSR we have committed to purchase, but not yet funded is not recognized on our balance sheet as a derivative.

Please turn to slide 7. I would, next, like to spend some time discussing our financing profile, including the Federal Home Loan Bank of Des Moines, as well as an update on the repo markets. As we discussed in our fourth quarter call, our subsidiary TH Insurance Holdings, was granted membership on the Federal Home Loan Bank of Des Moines in December.

As of March 31st, we have secured advances of, approximately, $465 a million, with a weighted average maturity of approximately 2.8 years. While today our advances are primarily collateralized by Agency securities, we continue to believe over time the most efficient and constructive use of our FHLB financing availability is with our prime jumbo conduit initiative.

As a reminder, our total capacity is $1 billion so our available funding capacity with the FHLB is, approximately, $535 million, as of March 31st. We're pleased with this continued diversification of our financing profile as it allows us to optimize our funding mix.

Moving to repo, the repo markets are functioning in a normal manner and we have not experienced any meaningful shifts in financing haircuts or repo rates. We have a lengthy maturity profile with an average of 84 days to maturity at March 31, a slight extension from the 72 days as of December 31st.

With that, let me turn the call over to Bill who will provide an update on the portfolio.

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

Thanks, Brad. Good morning. We're pleased with our total return on book value of 3.9%, given our conservative positioning.

Let's turn to slide 8 for an overview and take a look at the performance drivers in our Rates and Credit strategies. Our rates strategy did well. With yields increasing 50 basis points quarter-over-quarter to 3.7%. The rates performance was driven by higher realized yields on our Agency assets, primarily due to slower prepays on IO, inverse IO, MSR and HECMs.

For example, our MSR yield this quarter was 10.6%. Yields in the future for MSR and other IO type products will be determined by the amount of prepayments. Tighter spreads on higher coupon Agency MBS and ARMs, also contributed to overall performance.

Our credit strategy had another good quarter and non-Agency yields increased 20 basis points to 9%. Non-Agency bond prices also appreciated during the quarter, as the market's viewpoint regarding macroeconomic conditions improved. We're pleased that our higher aggregate portfolio yields generated an annualized net interest spread of 3.5%, up 30 basis points from the fourth quarter.

Please turn to slide 9. Our portfolio as of March 31 was $13.6 billion, including $10.5 billion in rates, and $3.1 billion in credit.

Our portfolio composition reflects a 58% capital allocation to rates, which is comprised of 45% Agencies and 13% MSR in line with last quarter. With regards to opportunities on the rates side, yields and spreads on most Agency RMBS still aren't very appealing. As such, we continue to maintain low leverage in the rates strategy, as well as a low-risk profile.

We still prefer assets higher in coupon, as well as other short duration products, such as ARMs and HECMs. This positioning keeps our basis risk exposure fairly low and aims to minimize any book value impact from wider spreads that could be a consequence of the Fed ending is asset purchases later this year.

With respect to MSR, we expect to increase allocation over time, which I will cover later. Within our credit portfolio, we continue to emphasize discounted non Agencies, particularly subprime, and have been adding to our holdings as they become available at levels we like. We typically prefer bonds that are priced between $0.40 and $0.65 on the dollar, offering an attractive expected yield and with upside to better prepay and credit performance.

Also, during the quarter, we closed on the sale of substantially all of our CSL portfolio. As we have previously discussed, we viewed our investment in CSLs as more of a trade than a long-term strategy.

Turning to slide 10, you will see that our overall portfolio metrics are very similar to last quarter. Leverage remains low with our implied debt to equity ratio for RMBS, Agency derivatives, and mortgage loans held-for-sale, net of TBAs, at 2.7 times. Prepays on our Agency and non-Agency portfolios fell in the quarter, due to the traditional, seasonal slowdown and an especially harsh winter across much of the US.

As discussed in prior quarters, we have modeled our non-Agencies with a fairly draconian prepayment assumptions of 1 to2 CPR for life. On these deeply discounted bonds, higher prepay, such as we have been experiencing in recent quarters, greatly enhance our performance metrics.

Moving to the top right of the slide, we continue to carry very little exposure to interest rate risk. Also, as you can see on the bottom right, we added significantly to our swaption position this quarter. Given that the price of volatility has been near historic lows, we added out-of-the-money swaptions to help immunize our portfolio from a dramatic move in rates.

So, to summarize, we continue to be positioned conservatively with low leverage and risk. For more on our rates and credit holdings, please look at the appendix slides 18-22, and see slides 24 and 25 for more information on our hedging.

Please turn to slide 11. We continue to make progress adding MSR. During the first quarter, we added $121 million unpaid principal balance, or UPB, from our flow arrangement with PHH. This was, largely, from production late in 2013, just after this program started. Subsequent to the end of the quarter, we closed on a bulk portfolio of approximately $5 billion UPB of MSR from Flagstar, with economics having transferred on April 1.

Consistent with our prior transaction in December, Flagstar will continue as servicer under our subservicing arrangement with them. The underlying pool of mortgages is compromised primarily of recent production Fannie Mae loans and the purchase price is approximately $50 million. We continue to make great enhancements to our MSR platform, adding to our oversight, investor reporting, underwriting and technology capabilities.

There is still a robust pipeline for MSR sales, particularly of new originations. The combination of tight origination spreads, reduced volumes, and more onerous capital requirements have led many originators to look to MSR sales to rationalize their business economics. To provide some insight about the MSR pipeline, in the last 12 months we have evaluated over $400 billion UPB of servicing that was for sale, bid on a subset of that amount and won and closed on $42 billion UPB. This enabled us to invest about $500 million of capital in MSR.

Going forward, we expect to see opportunities to add MSR via bulk purchases, flow-sale arrangements, and through our originator relationships. As we said before, we're focused primarily on new production MSR, given its attractive yields and benefits to our portfolio.

Turning to slide 12, let's talk about our mortgage loan conduit. We have seen an increase in loan production this quarter and our pipeline for prime jumbo loans at March 31 has increased to $154 million, which are subject to customary closing conditions. Combined with our holds of $141 million, we expect to have $300 million or more sometime this quarter, which we would intend to securitize should market conditions warrant.

During the quarter, we added multiple new originators and we continued to identify additional candidates for inclusion to our already robust new originator pipeline. One benefit of our conduit initiative is our ability to use our originator relationships to generate attractive assets for our portfolio. While so far this has been restricted to prime jumbo loans and MSR, we are currently evaluating the benefits of offering a non-QM loan product.

For those not familiar with, it the term non-QM, or non-Qualifying Mortgage refers to loans that do not meet the CFPBs Qualified Mortgage rules. We believe this segment of the market to be very large, as it generally encompasses borrowers that do not have pristine credit and fall outside of the stringent lending standards outlined by the CFPB.

In broad strokes, this could present an opportunity to acquire prime and non-prime loans that do not meet the definition of a qualified mortgage, while still representing an attractive yield and good credit risk for our business. Similar to other initiatives, we will allocate resources and capital, if we think this will drive increased shareholder value over the long term.

In closing, we are pleased with our strong return on book value in the quarter. We remain conservatively positioned with low leverage and interest rate risk, while we continue to evaluate opportunities we believe are beneficial to our stockholders.

In terms of the second quarter, we are off to a decent start with respect to portfolio performance, although we caution that we are only a month into the second quarter. The areas we're most excited about remain MSR and our conduit activities, which we view as a way to drive increased franchise value while serving our goal of being a permanent capital provider to the US mortgage market.

I will, now, turn the call back to our operator, Tyrone.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). First question is from Mark DeVries of Barclays. Your line is open.

Mark DeVries - *Barclays Capital - Analyst*

Thanks. Bill, could you just walk us through where you see the levered ROE opportunities in each of your different investment categories?

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

Yes, sure, good morning, Mark. Thanks for joining us. So, generally, on an ROE basis, on the Agency side, most buckets we see fully-hedged as below 10%.

On the non-Agency side, in terms of securities, there are also generally below 10%. As I mentioned, we're adding some from time to time that we find attractive. And so, those we hope would drive returns that are higher than that.

In terms of the MSR, MSR today, just on the asset alone, we see as the high single-digits, expected yield. But, keep in mind that when you add the benefits of reducing hedges, or getting long duration to offset that, it adds several hundred basis points. That would take that into the low double-digits.

Then, securitization, securitization today is, generally, north of 10%, not by a whole lot. But I will tell you that we expect to see AAA spreads normalize over time and that would drive those numbers higher. So, today, I would call it low double-digits, but we think there's upside to those over time.

Mark DeVries - *Barclays Capital - Analyst*

Okay, that's helpful. I think you mentioned some of you guys in the Agency side still focused assets with less spread duration out of concern that OAS could widen. Was that -- are you guys getting a less -- little less certain about an eventual widening when you say could? Or is that just going to (cautious) the way you've cashed it in the past?

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

I think that's consistent with what we've said before. I mean, the Fed has continued to taper, yet, mortgage spreads have hung in very nicely. So, as we go through the remainder of the year, if they continue on that path, and they stop their buying new investments every month, it, certainly, is possible that spreads could widen. I mean, I think you've seen the data. They're very narrow.

So, we're just being cautious from that standpoint. I mean, we're not suggesting they will or they won't. We're just aware of where spreads are and think that they're not attractive enough to be very aggressive adding in Agency space.

Mark DeVries - *Barclays Capital - Analyst*

Okay, got it.

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

Mark, it's Tom. Good morning.

Bill and I still feel there is asymmetry to that market today. So, we really haven't changed -- to answer your question directly, we really haven't changed our point of view very much at all with regard to Agency spreads.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Got it. And, then, along the same lines, I guess, you increased interest rate exposure a little bit on a Q-over-Q basis, is that a reflection of the fact that we just saw rates rally a little bit here, or that you're a little bit less convinced that rates could be headed higher?

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

Well, on slide ten, we show that, you know, fourth quarter -- keep in mind, this is only one measurement. This is a parallel shift of 100 basis points, which, as we said many times before, it's extremely unlikely to happen. But in the fourth quarter, we would have actually expected to lose a little money. And as of the end of the first quarter, we actually would have expected to make a little money.

So, you can determine from that, that, as of the end of the quarter, we were slightly net short. But I think the bigger point is that if you look at that chart, with the exception of second quarter last year, we're pretty much keeping very little exposure to rates on a general basis. Rates are very low. Funding rate is low.

I mean, as Tom mentioned, there is asymmetry. We think it is prudent to keep a very low, overall position with respect to rates.

Mark DeVries - *Barclays Capital - Analyst*

Got it. Got it. Sorry. And, then, just one last question. What needs to happen before you guys jump into the non-QM market?

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

Well, "jump in" is an interesting way to phrase it. As I mentioned during my remarks, we're certainly evaluating it. And there is a number of factors that go into that; right? The first is, is there demand for loan product at a certain rate and level of underwriting that is non-QM? And what do those terms look like and who are the borrowers?

Then, additionally, the other thing is, as you can imagine, there is a substantial amount of stringency we need to have on the underwriting side, on the legal side, on the compliance side, because if you're in the non-QM bucket, you're not exempt from what the CFPB has set as the standard. It is not just setting a rate and a LTV and a FICO, there are a lot of things, which we are investigating.

It we decide to offer a product, it will be because we feel like the return opportunities are attractive and that we've covered all of the basis. So, we'll keep you posted on that.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Is that something you think, realistically, could happen in 2014?

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

Well, I can just tell you that we're certainly evaluating it. I can't give you a dead set timeframe. As I said, there is a lot to consider. I can't give you an exact timeframe.

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

I would say stay tuned, Mark.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Appreciate your comment.

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

Thank you.

Operator

Thank you. Our next question is from Trevor Cranston of JMP Securities. Your line is open.

Trevor Cranston - *JMP Securities - Analyst*

All right, thanks. I guess on the conduit -- hey, Bill. I guess on the conduit side, you know when you went through the ROEs, it sounded like the returns on the jumbo loans were reasonably attractive versus the other alternatives you guys look at. Can you give some more details about how the build-out of the conduit's progressing? It looks like the pipeline of loans is starting to increase a little bit. Give us a little bit of color on how to think about the run rate size of the pipeline going forward.

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

Yes, sure. As I mentioned, we've added a number of originators in the second quarter. We have more that we're evaluating. We've come out of this deep freeze we had in the winter. So, we've continued to see on into the second quarter, an increase in volume that we're pleased with. And as I would say, without getting into hard numbers, because there's fallout and rates could change, et cetera, that could change what our holdings look like, the bottom line is that we're still adding originators and our volumes are picking up. I would say, if market conditions warrant, we would intend to conclude some securitizations as we move through the year.

Trevor Cranston - *JMP Securities - Analyst*

Got it. That's helpful. And one follow-up -- quick follow-up on the non-QM opportunity, as far as you're aware, would those be financeable with the FHLB borrowing lines, or something done more in the private repo market?

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

I think Brad's going to take that one, Trevor.

Brad Farrell - *Two Harbors Investment Corp - CFO, Treasurer*

Hey, Trevor.

Trevor Cranston - *JMP Securities - Analyst*

Hey.

Brad Farrell - *Two Harbors Investment Corp - CFO, Treasurer*

Yes, so FHLB, they do publish a lot of their guides. Obviously, this would be one thing we would be look at, as well, as part of our assessment. They don't, necessarily, look at non-QM-QM. They're looking at the underlying collateral and the structure of the loan. Assuming those loans meet the standards of LTV, and FICO, and underwriting protocols, they would be accepted. So, that is an option of financing, depending on the product we issue.

Trevor Cranston - *JMP Securities - Analyst*

Got it. Okay. One last thing, you know, the size of the swaption portfolio increased quite a bit this quarter. I was just curious if you guys have any general thoughts on -- it seems to make sense to add, given how low volatility is, do you guys have any thoughts on why volatility remains so low, given the shape of the curve; and kind of how you expect that to play out over the next few quarters?

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

Hey, Trevor. That's a great question.

I'm not sure we're the best at explaining why certain things exist. With the Fed having anchored the front end, that, obviously, you know plays into a part. I think the forward guidance, et cetera explains it. But the bottom line is if you look at we are in the bottom decile in terms of costs for short-dated ball, meaning three-month tenure, six-month tenure, et cetera. If you look back, we haven't seen levels like this persist since 2007, and before that, 1998.

So, we're not predicting the kind of volatility that occurred in [2007] and [1998], but we do think it is prudent to add volatility when it is very cheap. And, then, we're protected against violent moves.

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Trevor Cranston - *JMP Securities - Analyst*

Makes sense.

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

Trevor, it's Tom. Chairman Yellen has been forthcoming about how she views the world; right? Unemployment and inflation. Or as I said earlier, her super metrics. I think that the market has taken comfort that she's going to continue to provide QE support for the market, as needed, until those things are met.

With respect to inflation, we're somewhat distant from that, from unemployment. We're also distant from that. I think the market has taken solace in what she's said publicly, which is fine. But the risk is that the world changes and the market is caught offside. Given how cheap volatility is right now, it seems prudent to us to take advantage of that to immunize from shock risk or immunize shock risk within the portfolio.

Trevor Cranston - *JMP Securities - Analyst*

Okay. Great. Appreciate the comments, and thanks, everybody.

Operator

Thank you. Our next question is from Bose George of KBW.

Unidentified Participant

This is (Chaz Tiseman) in for Bose today.

Going back to slide ten there. The debt-to-equity -- implied debt-to-equity ticked down a little bit. How are you thinking about that going forward? Any opportunity to take that out and lever it up a little bit?

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

Yes, hey, this is Bill. Thanks for joining us.

Brad mentioned in his section that a lot of that was driven by changes in our TBA position. And so that TBA position, actually, can move around somewhat given opportunities we see there. If you look back the last several quarters, though, our overall implied debt-to-equity has been in this same general area.

I would say, if we see opportunities to put capital to work at expected ROEs we think are attractive, then, absolutely, you should see that go up. That would be what would drive that.

Unidentified Participant

Okay. Thanks. And, then, on the credit sensitive loans, you know, I know you talked about seeing that more as a trade as opposed to a long-term opportunity. But are you guys kind of out of that market now, or is there opportunity to jump back in at some point, or where do you see that going?

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

We're never out of any market, but Bill --

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

Basically, the situation was, you know, when we bought them, we thought they were really very attractive. And, then, they got to the point where, frankly, the market had repriced quite a bit. We didn't think that they were attractive to hold. We sold them.

So, obviously, we still pay attention to that market. But for us to build that position back up, we need to think that they were, once again, very attractive. So, I would leave it -- it is like any other asset. They would have to cheapen up quite a bit for us to get interested again.

Unidentified Participant

Okay. And, then, on the $5 billion bulk MSR transaction, what are you guys seeing, transaction activity, like in the bulk market? I know you guys are evaluating different partners and kind of making progress there.

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

Yeah. So, as I mentioned on the call, in the last 12 months, we've looked at over $400 billion of UPB that was in for bid -- or available for sale. So, that's -- whatever. [$30 billion], $40 billion a month, if you want to break it down that way. So, without getting into details about particular sellers or sizes, it is our view that the market, going forward, will still be very robust.

I mean, if you look at it, new production, just monthly loans, when you add them up for the year, is about a trillion dollars. And it is our belief that there will be a reasonable amount of that new production servicing that gets sold because, as I mentioned on the call, the dynamics that are taking place in that market. We continue to work with both, bulk flow in our originators, to look at opportunities there.

Unidentified Participant

Okay, thanks, guys. Thanks for the time. I appreciate it.

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

Thank you.

Operator

Our next question is from Stephen Laws of Deutsch Bank.

Stephen Laws - *Deutsche Bank - Analyst*

Good morning. A couple of questions. Two on the financing side.

It looks like there's about -- there is $3 billion of swaps maturing over the balance of 2014. I guess about $900 million matured in the first quarter, and it looks like you rolled that into, mainly, three-year swaps, a little bit of longer-dated swaps, as well. Can you talk about how you're going to roll the swap book, as it matures this year, you know, so we can think about the blended financing cost impact there?

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

Yes, hey, good morning, Stephen. Thanks for joining us. You know, unfortunately, I'm not going to have a great answer for you in terms of from a modeling standpoint. The way we think about our swap and swaption position is from a total duration standpoint. We would look at any amount in any given bucket and that would contribute to our overall hedge profile. And we look at that on a daily basis.

So, I mean it is entirely possible that those -- obviously, they're very short, so they don't contribute that much to our overall duration profile. So, I can't tell you what we might do or not do with regards to that particular bucket. Just that, you know, if you look at our overall duration profile, we tend to keep it fairly closely-huddled around no exposure.

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

This is Tom. As you know, hedging is a living, breathing thing. The portfolio changes on a daily basis. Interest rates change on a daily basis. And so, hedging needs to be fluid and dynamic. While no hedging strategy is perfect, one thing that we've tried to use, as I said earlier, chief volatility to try to mitigate shock risk; and today, to us, that seems like a smart thing to be doing. But we really can't give forward guidance on that because we don't know what the portfolio will look like a month from now. But our hedging strategy will accommodate whatever the portfolio does look like at that time.

Stephen Laws - *Deutsche Bank - Analyst*

Great. I appreciate the color. I guess what's the average maturity for the bucket of about seven months, it will be later in the second half before we really get a great idea of that.

I guess, to follow up a little bit, whole loan questions earlier, and just the commentary in your prepared remarks regarding, potentially, financing those through the FHLB, you know, I appreciate the color -- availability financing is really more due to the underlying characteristics of the loan. Do you have any guidance on what the financing cost is and how FHLB financing for whole loans compares and contrasts with Wall Street's financing that's available?

Brad Farrell - *Two Harbors Investment Corp - CFO, Treasurer*

I can take part of that. And to a certain degree point you to -- we had an analyst day presentation in late February and we had a pretty robust discussion about the benefits, the comparatives of the repo market, why the FHLB is appealing to us. I point you there. But, obviously, I can answer some of the question right now.

You know, the appeal to FHLB is twofold. One it gives us some optionallity on Agency securities. Especially if we want to take out more lengthy maturity profiles. So, on a short-term rate, it is relatively comparable to finance, say, three to six month.

If we were looking to extend out, as you can see, our average extension is 2.8 years,the rates really don't increase that much, relative to the street financing. So, it is very appealing in that regards.

For loans, the advance rates and the cost of financing really don't change, whether it's whole loans, or whether it's Agency securities. So, again, our average funding cost is say 40 basis points, that's relatively what we would be financing with whole loans.

So, obviously, that's a pretty big advantage versus kind of street financing, which is typically a LIBOR plus 200. Now, having said that, the advanced rates aren't quite as strong but you can see that there is an appeal to finance our conduit activities with FHLB.

Stephen Laws - *Deutsche Bank - Analyst*

Great. I appreciate the color there. Thank you for taking my questions.

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

Thank you.

Operator

Thank you. Our next question is from Eric Beardsley from Goldman Sachs. Your line is open.

Eric Beardsley - *Goldman Sachs - Analyst*

Hi, thank you. Back to the MSR acquisition opportunity, wondering if you could comment how the competitive environments for those assets has developed, and if you've seen any shift in what types of institutions are selling MSRs?

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

Yes, hey, Eric, good morning. Like any market, you know, the market in MSRs is competitive. There are, obviously, banks and servicers that compete. There's some new entrance, as you know, that have come in, but, I mean, bottom line is, in a given transaction, you'll see anywhere from a handful to a dozen people -- companies show up. And the bottom line is, right, you have to have a market bid to be competitive.

We feel like we're competitive. We, obviously, have been successful so far. But it is a competitive market and if you're on the market, you have a chance to win.

Eric Beardsley - *Goldman Sachs - Analyst*

Have there been any changes in terms of what your expected yields are, based upon the competition, or it is pretty similar to when you guys last spoke at the investor day?

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

Yes. I mean, I think the market is a little bit tighter. We have been talking about high single- to low-double digits. That's probably in a little bit. I mentioned high single-digits. Now granted, the MSR that we have was in excess of 10% yield in the first quarter. That, obviously, is a low-double digits number, but I would say it is probably a little bit firmer today than it was when it was a quarter ago.

Eric Beardsley - *Goldman Sachs - Analyst*

Got it. Then, just on the prime jumbo conduit, what's your ideal deal size in terms of waiting to do securitization; and is it really just waiting to gather enough assets or would you like to see spreads come in before you do another deal, as well?

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

You know, from a deal size standpoint, it doesn't become really cost-effective until you're at least [$250 million] or $300 million, just because of the costs you pay for legal and rating Agency, et cetera. So, I think if you look at the deals that have been done, that's sort of the low end. In terms of timing, for us to do a deal and sell AAAs, we would be monitoring that market continuously.

I mean, that market has bounced around quite a bit. Certainly, last year was fairly volatile. So, kind of hard to predict timing because you get a little movement there and it really makes -- can make a big impact.

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

And the benefit -- this is Tom -- the benefit of the home loan facility, obviously, affords us patience to let AAA spread get to where we think they should be. And so, AAA spreads aren't where we like them, there's no reason to sell into a market that we don't like and respect a AAA spread.

Stephen Laws - *Deutsche Bank - Analyst*

Okay, great. Thank you.

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

Thank you.

Operator

Thank you. Our next question is from Joel Houck of Wells Fargo. Your line is open.

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

Good morning. Thanks for taking my question.

Just wondering if you can talk about, you know, given kind of the concern over basis, or spread widening as the year plays out,you do have $6 billion and 30-year fixed, of which five being the [4%] and [4.5%] coupon. Can you remind us, again, what, specifically, those securities represent in terms of mitigating basis risk? Obviously, you can't completely eliminate it, but if you could kind of go over that, it would be helpful.

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

Yes, sure. Look, it is fairly simple. If the basis widening is driven by excess supply that the Fed isn't buying, that will be reflected, primarily, in current coupon; right? And current coupon has longer spread duration. They're longer assets. Presumably, that would filter through to the higher coupons, which the Fed, you know is not in their targets today. But because those are shorter assets, we would expect those to perform better than current coupons. It may not filter through, but if it does, you would lose less money owning those than current coupons.

One of the reasons you see -- I think on analyst day, we showed what our overall exposure was. It is extremely low. HECMs are sort of unrelated to Fed activities. Those are very short assets as are ARMs, as you know. The higher coupons could get impacted if current coupons widen. They would be impacted less.

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

Okay. That's helpful. The other, I guess, thing you kind of alluded to is, what is your assessment, Bill, of the risk of, kind of, not just spreading into other higher coupons, but, also, spilling over into the non-Agency market, if we start to see people get really nervous in the second half of the year as the taper plays out?

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

Well, yes, presumably, right. The tapering -- the Fed combination ends because the economy is better. Unemployment is lower. Inflation is at the target rate and so forth. Which means economy is purring along. That's pretty good for the non-Agency market.

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

Yeah, no, I agree. I agree with the comment. I guess my concern is that it seems like the Fed and Yellen are going down a path of eliminating this QE because they don't think it's effective and the underlying economy really isn't that strong. Now, clearly, the housing market has been. But, as we've all seen, those numbers are starting to weaken here in through the first four months. I'm kind of wondering how you view -- do you play more defense in the non-Agency side, if the date doesn't pick up soon, or is it, hey, we've got confidence the Fed is not going to taper all the way if it is not supported by the data?

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

Well, obviously you know, we're looking at what we actually own. Right? What are the performance of the underlying pools? What does that look like? Obviously, that's impact by general economic activity. But we want to look at the actual holdings within the pools that, you know, that fill our portfolio, and to the extent we're comfortable with the outlook for those, we'll continue to hold them; to the extent that we're not, we would start to trim.

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

The other thing is, Joel, you know, implicit in your remarks there is that rates, presumably, would go up. And spreads would widen. So, any drivers of returns are going to be driven by how much interest rate exposure you have and how much leverage you have; right?

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

Yeah.

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

So, obviously, you can see where ever so slightly short the market, which we think would help us, and we have very low leverage. So, look, it is very possible that we, or anybody else, could lose money as a result of widening spreads and changing rates; right? It is just a question of managing your overall exposure and that's why we're very conservatively-positioned right now.

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

Okay. Fair enough.

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

It continues to be right. Rosetta Stone of non-Agency is prepayments are so low at current levels and we've modeled them to low levels. To the extent the economy picks up and people are able to move, or refinance off of those very muted levels, then, that's good for our non-Agency portfolio. But like anything else, if we think conditions are shifting on us, we're going to shift the portfolio to reflect that new point of view.

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

Okay. Great. Thank you for the color.

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

You bet.

Operator

Next question is from Daniel Altscher of FBR. Your line is open.

Dan Altscher - *FBR Capital Markets & Co. - Analyst*

Thanks. Good morning. I appreciate you taking my call.

It is good to see some of the PHH flow come on this quarter. Can you just help us give a little walk-through from $7.5 billion of UPB they did this quarter to the $121 million that you actually took on?

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

Hey, good morning. There are a couple of comments I make there. First, what we took on is what we closed during the quarter, which was, primarily, fourth quarter activity. And you know, only a very small portion of the fourth quarter. Because we put that in place. By the time we put it in place, we were pretty much at the end of the year. So, it doesn't reflect any activity from the first quarter. That's the first thing I would say.

The other thing I would say is, under the agreement, the agreement is for at least 50% of their production. Of eligible production. If you wanted to project forward, you would have to determine what you thought eligible production was that would come through to us. But the bigger answer is that this is really from a tail end of fourth quarter.

Dan Altscher - *FBR Capital Markets & Co. - Analyst*

Okay, that makes sense. We'll see next quarter, maybe a full quarter looks like. That's fine. We'll pay attention and watch there.

Question on the FHLB advances. Rates are similar to repo. The term makes sense. I think, probably, what I would have thought is the more clear advantage would have been trying to finance on the non-Agency side, obviously, for term and costs, even though maybe the haircuts may have been larger there. Why only focus on Agency for this go around and not non-Agency, with more attractive borrowing rates?

Brad Farrell - *Two Harbors Investment Corp - CFO, Treasurer*

Yes, this is Brad. You'll see that we do have some non-Agencies, but the key thing is absolutely key is, and it is absolutely key, that the FHLB only finances single A rated and above, and if you think about the majority of our non-Agency holdings, they would not meet that standard. So, really, the target for FHLB financing, for us, is, again, kind of threefold, again, agencies that fit our maturity profile that's appealing to us. Most importantly, the conduit and being able to aggregate whole loans, prior to securitization. And, then, if we do retain any bonds on deals, obviously, related above A. But, if you think of our legacy portfolio, it doesn't really apply.

Dan Altscher - *FBR Capital Markets & Co. - Analyst*

Okay. That's really helpful, thanks, Brad. Then, Bill, hopefully, a quick one.

It seems like there's, definitely, been a market trend to move in more toward the swaptions, and I understand your point that that involves the yearly lows and attractives on the pricing, but do you think, fundamentally, or anything, that's, maybe, an advantage that a swaption has, over using a traditional swap? Because, obviously, the swaption needs to be rolled, maybe, a little bit sooner than the actual swap does, so beyond the price, what's the incentive for using a swaption?

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

Well, a swap and a swaption are very different instruments; right? A swap is just, basically, a flat-out, either short- or long-position, if you're paying it, the short position in the market; right? So, rates go up, you win; rates go down, you lose. And that's fine, because on your assets, it's going the other way.

A swaption, like any other option, is optional protection. So, if you are a longer payer swaption and the market rallies, you win, and you just lose your little premium that you pay. You can keep winning as long as the market rallies, and vice-versa, you're covered in a sell-off. They're just very different profiles.

The reason that it is important to use swaptions with mortgages is because the mortgage is short convexity, i.e., the mortgage is shortened and extend in different environments, and so you need that optional protection. So, the reason that we like swaptions more today is just a function of price.

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

Okay. Thanks so much for the comments.

Thanks for joining us.

Operator

Our next question is from Ken Bruce of Bank of America Merrill Lynch. Your line is open.

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

Thank you. Good morning, gentlemen. Your comments have been very helpful this morning. As usual, I'm going to pull back a bit and go a little bit more strategic on you. One of the aspects and characteristics of Two Harbors, which I find quite interesting, in addition to the unique portfolio construction and very close risk management, is the blend of investment businesses and what is, effectively, operating businesses. I really want to get your thoughts around, strategically, what do you see Two Harbors being when it grows up?

Effectively, you've been a little bit of a chameleon, in terms of an investment portfolio, getting into areas that have strong relative value; some are trades, and you get out of those businesses. You are, obviously, investing in platform businesses, so I really would like to understand how you think

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about this business over time? If it is shifting more into operation companies; or do you think it will be this unique blend that we see in the market today?

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

Thanks for the question, and thanks for the kind remarks, as well. This is Tom.

As far as where we are in the future, I don't have a great answer for you because it is going to depend upon a lot of different things. I mean, for instance, the ultimate fate of the GSEs is going to be very impactful to our business. And what we are here to do is to drive shareholder value. We want to do the things with the best reward, with the least risk, and with dampened volatility. One of the benefits, we think, of the existing model is, it really does reduce volatility within our portfolio. Importantly, the market ascribes value to operating businesses. So, with respect to the MSR, and the conduit, not only are they the most attractive use of an investment dollar today, clearly, the market covets the long-term benefits of the operating businesses that those initiatives represent.

So, it's really difficult to say what the future will hold for us. Bill and I, and the Team, and Brad, we spend a lot of time thinking about these things. Our only thought is, what's the best outcome for our shareholders? No doubt, there's going to be the need for private capital within the mortgage and the housing markets going forward.

You know, the banks are very present within the market today, but, traditionally, they've had an ephemeral love affair within the mortgage market. If you look at mortgage REITs, like Two Harbors, we're really the ultimate [permanent] capital vehicles to provide that liquidity. And so, it is going to depend where is capital needed? Where are our investors paid most handsomely to provide capital? That is where we will dedicate our time and resources.

Brad Farrell - *Two Harbors Investment Corp - CFO, Treasurer*

Maybe I can add just one comment. Having a very robust middle office around people, so, strong underwriting; IT surround systems that can analyze different types of assets; you can onboard different types of assets; then, obviously, the licenses, themselves. Being able to acquire loans; being able to acquire MSR, not only is it operational in nature, it gives it a lot of optionality. So, as the future unfolds, it affords us the ability to -- if we were to look at CSLs in the future, we have a function that can underwrite those loans and we can be nimble.

So, non-QM or any other optionality that comes up, not only do we have the front end that can assess the risk around those assets, we have the middle office and back office that can, actually, support those decisions in a manner that is going to reduce the risk of the Company to execute.

So, I'll just add that.

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

Yeah, I guess, maybe as a part comment and trying to tease out a little bit more, how you're thinking about this, I share your views around the opportunities that are unfolding in the mortgage market. I do think that mortgage REITs are very uniquely position to capitalize on those changes.

I guess, in addition to building the core competencies that are necessary to be in these aggregation business, whether it be on the loan side or on the servicing side, it also, over a superior amount of time, requires investment, in terms of brand recognition in the market, in terms of being able to develop these businesses more wholly. I would be interested if you have been thinking about it in that context as you look at your early involvement in these businesses? They're, clearly, very deep markets and you can grow into something quite a bit different, or quite a bit larger than you are today, and how you're thinking about that?

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

This is Tom, again. So, in respect to that, I mean, one of the benefits of our business and also, frankly, having the imprimatur of Pine River Capital Management, which is the parent company to the manager of Two Harbors, we see a lot of things coming over the [transium]. I don't think that would shock anyone. We've built out a very robust infrastructure in respect to being able to due diligence opportunities, to investigate opportunities, to think about the future.

So, I really don't have anything to say, with respect to today, of where we may be in the future, but just be confident that we think about all things within the housing and mortgage market, and we think about them with one thought, that's for our shareholders. So, can the business transform from where it is today? Sure. Will it? I do not know. I don't know because if the existing business model, we think, is best for our shareholders, then, we'll conduct business as it is today. But, there will be a lot of opportunities. There is going to be some alteration, ultimately, to the GSEs. There is going to be the need for more private capital. And we are well-positioned to provide that capital. We think our shareholders will be paid well to participate in the market going forward. So, please stay tuned. You know, we, obviously, will have more to say about emerging opportunities in the future.

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

Thank you very much for your comments and color this morning.

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

Okay. Thank you for your questions and comments.

Operator

This does conclude the Q&A portion of today's conference. I'll turn the call over to Mr. Siering for any closing remarks.

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

Thanks, Tyrone. Again, thank you all for joining us today.

On May 20, we'll be hosting our annual stockholders meeting at the Pierre Hotel in New York. On June 3, we will be attending the KBW Mortgage Finance Conference in New York. We would be pleased to have the opportunity to speak to you at either or both of these events.

As always, we greatly appreciate your interest in Two Harbors. Have a great day.

Operator

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