

Two Harbors
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Operator: Ladies and gentlemen, apologies for the technical difficulties. Good morning. My name is Garode (ph) and I will be your conference facilitator. At this time, I would like to welcome everyone to Two Harbors Second Quarter 2019 Financial Results Conference Call. All participants will be in a listen-only mode. After the speakers' remarks, there will be a question-and-answer period.

I would now like to turn the conference over to Maggie Field with Investor Relations for Two Harbors. Please go ahead.

Maggie Field: Thank you, and good morning, everyone. Thank you for joining our call to discuss Two Harbors' second quarter 2019 financial results.

With me on the call this morning are Tom Siering, our President and CEO; Mary Risky, our CFO; and Bill Roth, our CIO. After my introductory comments, Tom will provide an overview of our quarterly results and long-term strategy, Mary will highlight key items from our financials, and Bill will review our portfolio and investment opportunities.

The press release and financial tables associated with today's call were filed yesterday with the SEC. If you do not have a copy, you may find them on our website or on the SEC's website at sec.gov.

In our earnings release and slides, which are posted in the Investor Relations section of our website, we have provided a reconciliation of GAAP to non-GAAP financial measures. We urge you to review this information in conjunction with today's call. I would also like to mention that this call is being webcast and may be accessed on our website in the same location.

Before I turn the call over to Tom, I would like to remind you that remarks made by management during this conference call and the supporting slides may include forward-looking statements. Forward-looking statements are based on the current beliefs and expectations of management and actual results may be materially different because of a variety of risks and other factors. Such statements are typically associated with the words such as anticipate, expect, estimate and believe, or other such words. We caution investors not to rely unduly on forward-looking statements. Two Harbors describes these risks and uncertainties in its annual report on Form 10-K for the fiscal year ended

December 31, 2018, and in other filings it makes or may make with the SEC from time to time which are available in the Investor Relations section of Two Harbors' website and on the SEC's website at sec.gov. Except as may be required by law, Two Harbors does not update forward looking statements and expressly disclaims any obligation to do so.

I will now turn the call over to Tom.

Tom Siering:

Thank you, Maggie, and good morning, everyone. We hope that you had a chance to review our earnings press release and presentation that we issued last night.

Please turn to Slide 3 to review our results. This quarter was highlighted by our strong book value growth. We delivered a 5.4% quarterly return on book value and a 14.7% return on book value for the first half of 2019. Our book value performance was a result of both portfolio positioning and active hedging. We are also pleased to have completed our first MSR securitization in the quarter which has competitive terms compared to our bilateral facilities and gives us more financing flexibility for MSR. Please turn to Slide 4.

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, as well as an emergence of faster money buyers and sellers which created 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. 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 easily replicated, and we believe this strategy will continue to generate attractive returns given the strong tailwinds in housing. On this slide you can see how these differentiating factors have resulted in total stockholder return outperformance of 45% since our inception.

Recently, we have received some questions on possible GSE reform. We think it is unlikely that anything of substance happens prior to the 2020 election. Obviously, that outcome could greatly influence any reform efforts.

Finally, I would like to congratulate Bill on behalf of Two Harbors on his retirement at the end of this year. Under his leadership we have built a strong team of investment professionals. We would also like to congratulate Bill Greenberg and Matt Koeppen on their appointment as Co-Chief Investment Officers beginning in 2020. We have a great team at Two Harbors, and we are very excited about the opportunities ahead.

I will now turn the call over to Mary to review our financial results.

Mary Risky:

Thank you, Tom.

Turning to Slide 5, let's review our financial results for the second quarter. We generated Comprehensive Income of \$201 million, or \$0.74 per share, and our book value was \$14.17 per share compared to \$13.83 at March 31st. The increase in book value was

primarily driven by the outperformance of higher coupon Agencies and specified pools, with MSR performing as expected and offsetting current coupon spread widening. Credit spreads also improved and contributed positively to book value. Finally, I'd note that through the end of July our third quarter book value is up between 2% to 3% after accruing for dividends.

Moving to Slide 6, let's review our Core Earnings results. Core earnings, including dollar roll income, was \$0.39 per share in the second quarter representing a return on average common equity of 11.1%. Core earnings was impacted primarily by the higher prepayment environment, however, we also realized a minor impact from the compression of the LIBOR repo spread. We avoided much of the effects from spread widening that occurred in the first half of this year by maintaining longer repo maturities. We do expect to see a small impact from this in the third quarter; however, we are actively managing our repo laddering to minimize both costs and exposures.

I'd like to take a brief moment to discuss a change we made this quarter to Core Earnings. The change involves a modification of the approach we use to calculate MSR amortization; specifically, an adjustment for any gain or loss on the capital used to purchase the MSR.

We recognize that Core Earnings is an important metric to the investment community. We believe that our new approach allows Core Earnings to better reflect how the carry earned on MSR varies as a function of prepayment rates. As such, we believe it is a much improved and more accurate reflection of the economic returns our portfolio can generate. Further details are provided in Appendix Slide 19.

Finally, I'd note that our other operating expense ratio, excluding non-cash LTIP amortization, was 1%, down slightly from 1.2% in the first quarter. As a reminder, we anticipate that our expenses will remain stable in the low 1s in 2019.

Turning to Slide 7, our portfolio yield declined in the quarter to 3.93%. This was primarily driven by lower Agency yields reflective of the lower rate and higher prepayment environment. We also purchased discounted legacy non-Agencies at lower base yields. However, as we've discussed in the past, we anticipate that over time these discounted bonds will generate double-digit total returns through a combination of both strong yields and price appreciation.

Now let's review our financing profile as shown on Slide 8. Our economic debt to equity ratio, which includes the implied debt on our TBA positions, was 7.8x at June 30. Our average economic debt to equity was up slightly quarter over quarter at 7.2x from 7.0x. Our diverse financing profile includes a mix of traditional repo, convertible debt, revolving credit facilities, and MSR secured term notes. We have 25 active Agency repo counterparties, and the market continues to function efficiently for us.

As I mentioned earlier, we are focused on managing the laddering of our repo maturities to minimize costs and exposure to repo LIBOR spread changes. The improvement in financing for both MSR and non-Agencies presents an ongoing opportunity for our business. On the MSR front we closed our first financing securitization this quarter. This \$400 million securitization of five-year secured term notes has 12-month prepayment protection and a spread of LIBOR plus 2.80. The benefits of this structure include scalability, competitive advance rates and pricing, and the length of the term is greater than bilateral facilities.

Across all of our bilateral MSR facilities we had \$300 million outstanding with a total capacity of \$790 million as of June 30. With respect to non-Agencies, haircuts and spreads have continued to be favorable and were consistent quarter over quarter.

With that, I will now turn the call over to Bill for a portfolio update.

Bill Roth:

Thank you, Mary, and good morning, everyone. Please turn to Slide 9.

In the second quarter global growth concerns, especially trade issues with China and Mexico, fueled the rally in interest rates and impacted economic growth expectation. This resulted in a flatter yield curve and three-month LIBOR above most longer-term rates. This curve shape reflects the market's expectation that the Fed will lower rates, which ended up occurring in July, and the anticipation is that there will be further rate cuts in the latter half of 2019.

In the mortgage market the Agency basis widened with current coupons widening by about a point, while higher coupon mortgages outperformed, widening only by about 3/8 of a point. Specified pools performed quite well in the rally, offsetting much of the basis widening. MSR performed as expected, declining in value in line with its duration and current coupon spread.

Residential credit assets continued to perform well. Discounted legacy non-Agencies benefited from lower expected forward LIBOR, which would have the effect of increasing the excess spread available to cover future losses. As a result, prices were modestly higher by about 1 point.

Let's move to Slide 10 to review our portfolio, which at June 30th was comprised of \$32 billion of assets and about \$9 billion of net long TBAs. From a capital allocation perspective, 76% of capital was allocated to our Rates strategy and 24% to Credit.

In terms of portfolio activity, as the market rallied in the quarter, we added Agency RMBS, in part to manage our duration exposure, but also to take advantage of the wider spreads available in the market; specifically, we added approximately \$5.7 billion of 3.5% and 4% coupon lower pay-up specified pools. We think that these bonds have excellent prepayment protection and convexity characteristics at reasonable prices.

We also reduced our 4.5% and 5% coupon higher pay-up specified pool position by approximately \$950 million as we felt these pools were priced at levels that had more risk than reward. Despite the higher Agency balances, however, our exposure to mortgage spread was slightly lower since our mortgage spread risk declines as interest rates fall.

One question we've been getting recently is our outlook for leverage as it has been drifting higher the past few quarters. We think about leverage in our portfolio from a risk exposure standpoint, similar to the way we think about interest rate exposure. In short, our focus is more on the sensitivity of book value relative to movements in mortgage spreads than it is on just the nominal leverage number. Although this quarter we added Agencies, which increased our leverage, our mortgage spread risk actually declined. As we've discussed in the past and as you will see on the next slide, we continue to believe that pairing Agencies with MSR allows us to have higher Agency leverage, but with lower overall risk. We are comfortable with our current level of leverage and do not expect it to change materially from here.

On the MSR front we did not purchase any bulk servicing in the quarter as we didn't see any packages that met our criteria, either collateral-wise or pricewise. We do expect to see a pickup in transaction volume in the second half of 2019 as there will likely be an increase in supply driven by higher refinance volumes.

Finally, in our credit strategy we added approximately \$370 million in market value of discounted legacy non-Agency which, at an average price of \$58, we believe have the potential for upside price appreciation.

Turning to Slide 11, let's discuss our risk positioning. As seen on the top of this slide, our exposures to changes in rates remain small. Consistent with our typical practice, in the second quarter we utilized an extensive amount of swaptions and mortgage options to protect our portfolio against big rate moves, either higher or lower. This hedging practice contributed to our strong performance.

The bottom table of this slide shows our spread exposures to rates up and down 25 and 50 basis points. As we've discussed in the past, MSR has negative duration and hedges both interest rate and mortgage spread risk, which you can see in this table.

Please turn to Slide 12.

The second quarter presented an interesting rate environment with a flat yield curve, LIBOR elevated relative to longer-term rates, and the potential for increased refinance activity. Nonetheless, we delivered strong returns because of our portfolio positioning, principally holding higher coupons, specified pools and MSR, and also because of our dynamic use of options in hedging. Given the current market backdrop, we believe that we've positioned both our Rates and Credit strategies to deliver strong long-term risk-adjusted returns.

In our Rates strategy we view levered returns on Agencies as currently in the low double-digit range. We continue to believe our holdings of specified pools and higher coupons will generate attractive long-term returns. Returns on Agency paired with MSR are also in the low double-digits but, as we discussed on the last slide, this comes with a lower risk profile.

I'd like to spend a moment highlighting the total return opportunity that exists in our Credit strategy. We believe that 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, as you can see in the charts on this slide, subprime non-Agency prepayments have increased while loss metrics have come down.

Continued reequification over time 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.

In conclusion, 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 and Credit strategies in the latter half of 2019 and beyond.

I will now turn the call back to the operator for Q&A.

Operator: Thank you. If you would like to ask a question at this time, please signal by pressing star and then one on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow your signal to reach our equipment. Again, please press star and then one to ask a question.

We will take our first question from Doug Harter. Please go ahead. Your line is open.

Doug Harter: Thanks. Obviously, kind of the start to August has been quite volatile. If you could just talk about kind of how your rate positioning is for kind of this kind of magnitude of rate declines we've seen, and kind of how you see the prepay outlook changing with this move.

Tom Siering: Sure. Good morning, Doug. How are you?

Doug Harter: I'm well, thank you.

Tom Siering: First of all, I'd like to apologize for the technical glitch we had this morning. With that, I'll turn your question to Bill.

Bill Roth: Hey, Doug. Thanks for joining us. So there were a couple of questions in there. I think Slide 11 is sort of a relatively good depiction of where we were at the end of June. We continue to maintain a slightly long bias in duration, but we have a substantial amount—I talked on the call and one of the things that benefited us in the second quarter is the extensive use of options. Certainly as the market's become more volatile and with around protecting the mortgage—the portfolio by the use of options is very important and effective.

In terms of what we've seen in August, it's a little hard to make sense of what's going on, but we continue to stay close to home. If the primary rate comes down—and it's been pretty sticky so far, but I guess it depends on what rate level we settle at—if the primary rate comes down, then I think you'll see a reasonable pickup in generic prepays or prepays on generic collateral. One of the reasons that we've been active—continue to be active in adding specified pools, especially off of lower coupons as I discussed on the call, is because that creates more stability in the portfolio, it's easier to hedge, and there's less prepay volatility there. So we continue to move in that direction.

Tom Siering: Yeah, the team has done a really good job managing those, Doug, and that continues into August as well.

Doug Harter: Great. Just I guess on that, the relative—where do you see relative attractiveness of kind of specified pools today? Obviously given the commentary that generic speed's going to likely continue to increase, but obviously pay-ups have increased substantially.

Bill Roth: Yeah, great question. I think the positioning that we talked about on the call is representative of where we think value is. We've been trying to buy lower pay-up off of say 3.5s. We haven't seen as much off of 3s yet, but we sold pools that had performed very well, and pay-ups went up quite a bit off the higher coupons. And so by recycling

into lower pay-ups off of lower coupons we come up with better convexity with less premium at risk, and we think those represent good value and we continue to pursue those.

Doug Harter: Great. Thank you, Bill and Tom.

Operator: Thank you. We will now take our next question from Mark DeVries.

Mark DeVries: Yeah, thanks. Let me be the first to congratulate you, Bill, on your retirement. I know we may have you for another quarter, but it's been a pleasure working with you over the years.

First question. As you noted in the prepared remarks, leverage went up almost—more than a half turn in the quarter, although it sounds like part of that was efforts to manage both spread and duration risk. Are there any implications we should think about, though, from the higher leveraged in terms of higher earnings power at the end of the quarter versus the average for the quarter?

Bill Roth: Hey, Mark. Well, thanks for the good wishes. I appreciate it and enjoyed working with you as well.

The average economic leverage for the quarter went from 7 to 7.2. And keep in mind that we think of leverage in terms of including net TBAs because that is economic leverage. And I think as we discussed on the call, we frankly think about really more our risk metrics, which we talked about on Slide 11, which is, because we have MSR, MSR helps dramatically hedge the mortgage spread risk. So even though we have more Agencies, we actually have less risk to spread moves. That being said, we do not expect to see leverage change materially from the levels that we've been running recently.

Tom Siering: Yeah. Leverage in isolation is sort of a hollow metric, Mark. Really, we think in terms of risk over counting on headline leverage metrics. Obviously, that's an important number, but in isolation it doesn't mean all that much.

Mark DeVries: Okay. Fair enough. So I think you also noted that through some of the leveraging—or I'm sorry, laddering of your maturities on repo, you've at least mitigated some of the impact of the bit of a dislocation we've seen in that kind of repo LIBOR spread. But how much of a drag is that on earnings? And if that normalizes, how much of a lift might we see from kind of Core Earnings?

Tom Siering: Yeah, that's a great question. Mary's going to answer that one.

Mary Risky: Good morning, Mark. So yes, we realize it's a small impact in Q2, about \$0.01 per share due to our maintaining the longer repo maturities. I think repo costs obviously haven't come down like the rest of short-term rates. And it's not really the availability, but really the pricing. We are keeping our eyes on it and expect it to normalize as time passes.

Mark DeVries: Okay, got it. Thank you.

Tom Siering: Thank you.

Operator: Thank you. We'll now take our next question from Bose George. Please go ahead. Your line is open.

- Bose George: Hey, good morning. Just in terms of incremental returns, you gave us some numbers on that, but I'm just curious how the incremental kind of spreads that you're getting compares to the level you were in the quarter.
- Bill Roth: Could you rephrase that, Bose? I wasn't sure I got your idea.
- Bose George: Sure. Just spreads on new investments and how that compares to the—I guess the 138-basis-point spread you guys had at quarter end.
- Bill Roth: Yeah. Well, I'd say a couple things. The first thing, as we talked on the call about our expected total return that we think we can realize generally being in the low double digits. And then on the non-Agency, clearly the—we've talked about this in the past, sort of the baseline is lower than what we think the total return will be.
- If you think about it, right, we talked about the NIM, the prepays, the repo spreads, and then obviously some purchases at lower yields of assets. But as you know, we don't really manage our portfolio based on a NIM. We really are thinking about it in terms of where we can generate the best total return while keeping book value stable. So I think it's kind of hard to talk about the spread vis-à-vis today versus the historical accounting spread; rather, we think about the returns that we discussed on the call, low double digits and then potentially strong total returns on non-Agency being better than that.
- Bose George: So then maybe just in terms of the low double—the returns from an ROE standpoint, I mean that's a bit of a range. Is that similar to what you have in the portfolio? Is it a little lower? Or just how would you characterize it versus the ROE you generated this quarter?
- Bill Roth: Well, I think it's probably pretty similar to what you saw this quarter. I mean, obviously, one of the things we've been positioned in has been higher coupons in the specfieds which did well last quarter. They've continued to do well this quarter, as Mary talked about our performance through July and into—so far this quarter, so I think that's relatively consistent with what we saw.
- Tom Siering: Yeah. You know, Bose, we're the kind of people that, when we stink, we have our hat firmly in our hand. For instance, in the fourth quarter we were very honest about our disappointment in our performance. But this was a great quarter for us. We generated a lot of alpha and the opportunities for us going forward are abundant, so we're excited.
- Bose George: Okay, great. Thanks. And then actually, just on the MSR securitization that you guys did, should we think of that more as just a better structure because of the term funding, or is there any funding benefit as well from that?
- Mary Risky: Good morning, Bose. So we think of it—a number of benefits from it. The term is definitely beneficial, the scalability, the ability to add additional term notes in the future (inaudible).
- Bose George: Okay, great. Thanks. And then actually, one just on the regulatory side. You noted that GSE reform is unlikely, but just curious what your take is on how the QM patch issue gets resolved.
- Bill Roth: Oh, yeah. That's a good one. I think what we saw was sort of an initial shot across the bow, if you will. I think the—it sounds like the FHFA, they would like to get a number of

things accomplished and yet, at the same time, it seems like Mr. Calabria has—also aware that there's a lot of this that might need legislation. And so I think by putting something out there on the QM patch expiring, the idea's not necessarily to have it expire, but maybe have a discussion and a dialogue as to what should it look like and how can the GSEs continue to support housing but with the modified footprint. So I think this is just the beginning of the discussion of how that patch and how the QM—how it's going to play out, and I think it'll probably take a decent amount of time.

Bose George: Okay. That helps, thanks. And let me add my congratulations to you, Bill, on your retirement, and to Bill Greenberg and Matt on their promotions as well.

Bill Roth: Thanks, Bose.

Tom Siering: Thank you.

Operator: Thank you. We will now take our next question from Trevor Cranston.

Trevor Cranston: Hey, thanks. Good morning. And I'll add my congratulations on your retirement, Bill.

A question on the updated methodology you're using for your Core Earnings calculation on the MSR amortization. I guess I wanted to make sure I understand the change better. Is the new method that you're using I guess similar to what we would think of in the Agency MBS market is using, like a lifetime assumed yield on the MSR that you're multiplying by the amortized cost? Or maybe you can just expand a little bit on exactly what the change was there and how we should think about modeling that going forward.

Mary Risky: Sure, Trevor. This is Mary. So as I discussed in my remarks, we did modify the amortization to include an adjustment for the gain or loss on the capital used to purchase the MSR. So this is consistent with the rest of our portfolio where the hedging or the gains and losses on our RMBS portfolio are not included in Core Earnings. Appendix Slide 19 provides some more details, but I think you can think about MSR for income as the amortized cost at the beginning of the period times the original pricing yield. And we really believe this is a more accurate reflection of the economic return and the carryon MSR.

Trevor Cranston: Okay. So I guess—so when we think about, for example, this like third quarter to date where rates have dropped significantly, does the new methodology imply that there wouldn't be a significant uptick in amortization because the original pricing yield hasn't changed, or am I not thinking about that correctly?

Mary Risky: Yes, that's correct.

Trevor Cranston: Okay, great. Thank you. And then a second question, I guess more on the macro side. With the volatility we've seen this quarter and expectations for the Fed to likely continue dropping rates pretty significantly, just curious if you guys had any thoughts on the likelihood—if we do continue to see things move lower in the rates market, if you think the Fed would be likely to potentially reinstitute balance sheet growth or the QE programs and whether or not you think that might be focused on the MBS market.

Tom Siering: Yeah, a great question. Matt Koeppen's here. He's going to answer that one for you.

Matt Koeppen: Hi, there. That's an interesting question. Maybe some other people in the room want to weigh in. It's—we're definitely in the midst of a transitioning market here back to the world where we're in a low rate environment and the Fed is cutting. We definitely—here I think you would expect to see in a higher volatility environment mortgages continuing to be under pressure.

I think in terms of looking forward to QE again, I don't think anybody is really talking about that or discussing that. That seems—that's probably a ways down the road. But we are continuing to—like we said earlier, we are continuing to manage the portfolio consistent with how we have in the past. We're certainly glad in an environment like this to be maintaining low-risk exposures, low duration and low spread risk. This is the environment that we talk about and prepare for lots of times. So, we feel like we're holding in fairly well.

Trevor Cranston: Okay, great. Appreciate the comments. Thank you.

Operator: Thank you. We will now take our next question from Rick Shane. Please go ahead. Your line is open.

Rick Shane: Hey, guys. Thanks for taking my question. And Bill, those looks that everybody's giving you at the table are jealousy. Congratulations.

Multiple Speakers: (Laughter)

Bill Roth: Thank you, Rick. I appreciate it.

Tom Siering: That's a good one, Rick.

Rick Shane: I have my moments. Hey, Tom, you talked about the alpha that you guys created in the quarter and it's—given the challenging quarter, it really stands out. And I think we understand a lot of it. I think the call protected or the prepayment protected Agency MBS did very well. Obviously, some challenges on the MSR side. But when we look through the details, there are some significant gains—and these are realized gains on swaps. That really makes sense to us. There's \$97 million of realized gains on other derivatives. What is that? And just help us understand, when you think about the alpha and the outperformance this quarter, what the puts and takes were.

Tom Siering: Yeah. Thanks for that question, Rick. Bill Greenberg's going to take that one.

Bill Greenberg: Yes. Hi, Rick. Good to talk to you. You mentioned some causes for our outperformance this quarter and I would say they're really three-fold. One, (inaudible) one is the asset selection that we have, our focus on being exposed to higher coupons is one. The existence of MSR in our portfolio, which reduces our overall mortgage spread risk is another. And then lastly, as was alluded to on the call, our active hedging strategy and experience. I think all three of those things really contributed a lot.

I think, without going—without diving too much into detail, so like that we're talking about, I would expect that those realized gains on those derivatives resulted from realizing gains on options that we had. Typically, when we buy say out-of-the-money options in order to hedge for tail risk and the market rallies, those options become in the money or at the money. And rather than keeping them there with reduced convexity

benefit, we will roll those options into ones that are further out of the money and I expect that those gains result from that.

Rick Shane: Got it. And is that why the notionals on the swaps and the swaptions didn't seem to change much, is was that you took the swaptions and rolled them?

Bill Greenberg Yeah, that's right.

Rick Shane: Great. Thank you, guys.

Bill Greenberg So things—so you buy swaptions at some—again, forget about the portfolio effect, at some price, the market rallies, they go up in value. Their convexity increases for a little while and then it starts to decrease. And in order to maintain the convexity benefit, the protection that we want for continued rate rallies, we basically will sell those and buy other ones, oftentimes at (inaudible) notionals and we'll reset the value of the convexity and the portfolio protection characteristics.

Rick Shane: Got it. Okay, perfect. Thank you very much.

Operator: Thank you. We will now take our next question from Matthew Howlett. Please go ahead, Matthew, your line is open.

Matthew Howlett: Hey, guys. Thanks a lot. And Bill, congrats.

Just two questions. First, on the MSR. Bill, did I hear you correct that you said the UPB sort of would start to pick up, the portfolio on a UP basis would start to grow again in the third quarter with the full arrangement? And then what would it take—you said you're out of the bulk market. What would it take to get more active? Is that more just where prices come down to or is it just more of an outlook of where you think speeds are going to ultimately end up?

Bill Roth: Hey, Matt, thank you. Appreciate the good wishes.

So a couple things. First, we have seen flow volumes pick up, which is not surprising given that we've started to see higher refinancings come in. Just to be clear, we are not out of the bulk market.

Matthew Howlett: Okay.

Bill Roth: We bought a number of packages first quarter, as you know. And we did not buy any—close any in the second quarter, but that was more a function of what was available and the prices and the collateral. So it was more sort of like saying, well, we didn't see any bonds we liked at the prices that they were trading at. We do expect to see an increase in our bulk volumes through the remainder of the year.

Matthew Howlett: Okay.

Bill Roth: Obviously, there's a lot of volatility lately so there might be a little bit of a pause from potential sellers until the market settles down a bit. But given that re-fi volumes are clearly picking up, we would expect the second half of the year eventually to see a pickup in bulk volumes and we anticipate participating if the prices make sense to us.

- Matthew Howlett: Got it. Okay. And what explains sort of the lack of packages coming out in the second quarter? Was it just—the sellers just didn't like the prices or (inaudible) just have improved that they don't need to sell MSR's?
- Bill Roth: Well, we don't originate loans and look at whether we should keep the servicing or not. But I could tell you first that volumes earlier in the year were quite substantial. One thing that we did see as the market rallied, was we did see people who wanted to get a certain price hold off because they thought, well, they wanted yesterday's price, effectively. So there were a lot of packages that didn't trade that might have traded. But if somebody makes them and maybe they don't hedge and keep the duration in line with what the market's doing, they might just say, well, I'll wait. So I think it was a combination of factors. As you know, once the rates get to a certain point and stabilize and there's more visibility and clarity, what I'll call the bid offer, if you will, will tighten up and you'll see a lot more transaction volume.
- Matthew Howlett: Got it. Okay. And by the way, just one quick question. The FHLB advances. I know you took that down. Just curious on why you decided to take that down.
- Mary Risky: Sure. So we had advances that were rolling off. We still maintained a \$50 million position with a much longer term. We value that relationship, but we—with an Agency book, the advances and rates are not better than what we can get in the repo market.
- Matthew Howlett: Right—
- Tom Siering: Yeah. We're always going (inaudible) to most economically is the short answer.
- Matthew Howlett: Right. The wholesale market's better financing, a little bit better. Okay. Then the last thing. Just on the—I know you guys said sort of low double-digit on the Agency, just the Agency. This is putting aside the MSR's for a second. But is there sort of—if we look at the spread, it was starting to realize—probably was 1.1%. When you look at sort of 3Q you have this dynamic where, the Fed cut and swap rates are going down, yet prepa's looked like they were up about 30% in July and the yields were lower. I mean is there—can we expect that spread to be stable sort of all else—sort of everything taken together? Any sort of just color on where that spread could head in 3Q?
- Bill Roth: Sure. Yeah. I mean—some of the things you say about, well, obviously prepa's were up, etc., and there's a question of what are the yield on the cheapest to deliver, if you will. When we look at deploying capital, whether it's in the credit side or in the Agency side, we're basically serving across all coupons, all collateral types, all specified pool types, etc., and accessing what we think is the most attractive. That's sort of what we view our jobs as, to drive long-term returns. So as a result, when we cite those kind of returns, we're really looking at what we think is the best of what we can purchase, which is definitely not necessarily the cheapest to deliver or the TBA, which is arguably not going to be nearly as attractive as certain specified pools.
- Matthew Howlett: Right. Got it. So it's very just really asset selection. That's really what it all really comes down to as you look at—
- Bill Roth: That's correct.
- Matthew Howlett: The portfolio.

Bill Roth: That's exactly correct.

Tom Siering: That's the name of the game.

Matthew Howlett: Okay, great. Well, congrats on a really solid quarter. Thanks again and congrats, Bill.

Bill Roth: Thanks, Matt.

Tom Siering: Thank you very much.

Operator: Thank you. As there are no further questions, I will turn the call back to Miss Field for a concluding comment.

Maggie Field: Thank you. And thank you for joining our conference call today. We plan to participate in the Barclays Global Financial Services Conference on September 10th and our presentation will be webcast live on our website under the Events & Presentations link. We look forward to speaking with you then. Have a wonderful day.

Operator: Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.