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Michael Smyth - KBW
Kenneth Lee - RBC Capital Markets
Richard Shane - JPMorgan Chase & Co.

PREPARED REMARKS

Operator: Good morning, my name is [operator] and I will be your conference facilitator.

At this time, I would like to welcome everyone to Two Harbors' first quarter 2022 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 over the call to Paulina Sims.

Paulina:

Good morning everyone and welcome to our call to discuss Two Harbors' fourth quarter 2021 financial results. With me on the call this morning are Bill Greenberg, our President, Chief Executive Officer, and Chief Investment Officer and Mary Riskey, our Chief Financial Officer.

The earnings press release and presentation associated with today's call have been filed with the SEC and are available on the SEC's website as well as the Investor Relations page of our website at twoharborsinvestment.com. In our earnings release and presentation, we have provided a reconciliation of GAAP to non-GAAP financial measures and we urge you to review this information in conjunction with today's call.

As a reminder, our comments today will include forward-looking statements which are subject to risks and uncertainties that may cause our results to differ materially from expectations. These are described on Page 2 of the presentation and in our Form 10-K and subsequent reports filed with the SEC. Except as may be required by law, Two Harbors does not update forward-looking statements and disclaims any obligation to do so.

I will now turn the call over to Bill.

Bill:

Thank you, Paulina. Good morning everyone and welcome to our fourth quarter earnings call.

Please turn to **slide 3**. At quarter end, book value was \$5.87 per share, representing a negative 5.6% total economic quarterly return. This underperformance can be attributed in approximately two equal parts: firstly, to spread widening in higher coupon RMBS and IO securities, due to slower-than-expected declines in prepayment speeds and higher volatility, and, secondly, to a 20 basis point widening in the spread of the MSR asset, which we see as being within the typical period over period variability of MSR spreads and which arise from using the simple average of 3 independent broker marks.

The overall environment in 2021 was challenging, as the market wrestled with continued waves of coronavirus infections and uncertainty around the path of economic growth and monetary policy.

For the year, we delivered total dividends of \$0.68 per share, equivalent to an average dividend yield of 10.0%. With a starting book value of \$7.63 at the end of 2020, the total economic return on book value equates to -14.2%.

In many ways, the underperformance in 2021 was a continuation of the market stress of 2020. While the Fed came to the rescue in 2020, buying unlimited amounts of RMBS and stabilizing the market, the Fed's continuing monetary accommodation also had two other effects. First, with the Fed having bought almost \$3 trillion of RMBS during QE4, spreads collapsed to all-time tight levels, which reduced the tailwind of carry meaningfully. Second, the Fed's asset purchases also reduced mortgage rates to all-time lows, igniting a prepay wave that hasn't been seen since 2003 and creating a very strong headwind for a portfolio such as ours with premium and interest-only cashflows.

Nevertheless, we took proactive actions during the year which benefitted the company. We issued and repurchased convertible notes last February, redeemed our Series D and E preferred shares, and we raised common stock through two public offerings. On the asset side, we grew our MSR portfolio, acquiring over \$88 billion of UPB, at very attractive levels. And, in expectation of spread widening we reduced leverage, increasing the amount of dry powder to be deployed in a more attractive investing environment.

Indeed, over the past few weeks, it has become clear that the Fed has shifted to a much more hawkish stance and mortgage spreads have reacted by widening about 20 basis points during the month of January. Despite the rapid and large spread movement, we think there is more to go - and expect more volatility in the near-term as the timing and pace of rate hikes, balance sheet normalization, and other supply/demand dynamics are sorted out. It is in precisely these kinds of environments that our Agency + MSR construction should benefit and indeed, our best estimate of book value through the end of January is approximately +2%.

Looking ahead, we see a path towards normalization in RMBS spread levels. The refi wave appears to be over, and the prospect of higher rates and slower prepayments points to a more constructive environment for both RMBS and MSR. We are well positioned to capitalize on the improved investment opportunities as they present themselves in the coming year.

Please turn to **slide 4**. During the fourth quarter, economic data, Federal Reserve commentary, and market expectations converged on an accelerated timeline to higher rates and the removal of monetary accommodation. As we see in Figure 1, the 10-year rate fluctuated between 1.4% and 1.6% during the quarter before breaking out in January to the 1.9% range where it sat pre-pandemic. The prospect of more rate hikes pushed short-term rates higher, flattening the yield curve by 53 basis points during the quarter. The market has continued to reprice and expectations have become more front-loaded with almost 5 and a half hikes now expected in 2022 and with a total of 7 by the end of 2023.

The Federal Reserve has announced it will complete its monthly purchases of Treasury and Agency RMBS by March, as seen in Figure 2. More recently, while the Fed has said that interest rates will be their primary tool in implementing monetary policy, they do recognize that the balance sheet is "bigger than it needs to be" and have expressed a desire for the balance sheet to return to a Treasury-only portfolio. Chairman Powell also said that the pace of balance sheet normalization could be faster than it had been in past episodes. The timing and pace of any runoff or outright sales should also affect mortgage spreads.

We have consistently said that mortgages at historically tight spreads would need to widen eventually. In our view, the question was not "if" they would widen but how quickly and by how much. With the Fed removing its accommodation and banks likely having less appetite for securities as a function of lower reserves and increased loan demand, some mortgage analysts are projecting the private sector may need to absorb up to \$700 billion of mortgages in 2022. Current coupon spreads remained near historical tights throughout the fourth quarter, although as I mentioned, have swiftly widened out by roughly 20 basis points since year end, as shown in Figure 3. However, spreads still remain approximately 15 basis points tighter than other periods where the Fed had not been net buying, let alone periods where the Fed is net shrinking. Indeed, relative to the last period of quantitative tightening in 2017 through 2019, spreads were at current levels or tighter only 8% of the time; 92% of the time they were wider than they are now. In the shaded area in Figure 3, we show how wide mortgage spreads might be able to go. We don't expect spreads to widen and stay at levels much beyond historical averages, but it's instructive to note that during the last period of quantitative tightening, mortgage spreads overshot the long-term average by an additional 20 bps.

Please turn to **Slide 5**. Since the beginning of the pandemic the average coupon of the mortgage universe has declined by approximately 75 basis points, from 4.25% to 3.5%. As a result of this re-striking of the mortgage universe and the upward trajectory in mortgage rates, the percentage of mortgages in the Fannie/Freddie universe with at least 50 basis points of refinance incentive has fallen to around 30% at year-end 2021,

compared with roughly 80% at year-end 2020. With the jump in mortgage rates in 2022 to north of 3.5%, that percentage is projected to fall further to roughly 11%. With such a small percentage of the market eligible to refinance, we are looking at an environment of sharply lower prepayment speeds.

How much slower is shown in Figure 2. The dark gray bars indicate the realized prepayment speeds for our current specified pool coupons over the course of 2021. Yes, these speeds were much faster than what was expected at the beginning of the year as a result of high HPA and GSE policies to make refinancing easier. But higher rates will necessarily lead to slower speeds, and we show our projections for those TBA and specified coupons in the light gray bars, assuming current interest rates stay unchanged throughout the year.

With prepayment rates projected to come down sharply, and quickly, the economic carry and cashflows of our paired MSR strategy are expected to dramatically improve. In Figure 3 we show the components of economic carry of our MSR portfolio for 2021, and the projected amounts for our current portfolio over the next year, assuming rates are unchanged and we do not replace or add any MSR. In 2021, the value lost from prepayments, labeled "runoff" in the chart, overwhelmed the MSR cashflows, despite contributions from our recapture agreements, resulting in total net economic carry of close to negative \$200 million. Our static projections for 2022 change this picture dramatically. Runoff is forecast to drop by over 50% and we project the net economic carry of our MSR to be close to positive \$200 million, nearly the inverse of last year. Of course, these projections are model-based and reflect a single point in time with a number of assumptions. But the idea is that the fast prepay headwind that we experienced in 2021 has shifted, and our base case expectation is for a much more favorable environment in 2022.

Now I will turn it over to Mary to discuss our financial results in more detail.

Mary: Thank you, Bill and good morning everyone.

Please turn to **slide 6** to review our financial results for the fourth quarter. Comprehensive income was negative \$128.6 million, representing an annualized return on average common equity of negative 24.7%. Our book value was \$5.87 per share compared to \$6.40 at September 30th. Including the 17 cent common dividend results in a quarterly economic return of negative 5.6%. As Bill mentioned earlier, the result mostly reflects spread widening in high coupon RMBS, IO securities and MSR.

Moving on to **slide 7**, Earnings Available for Distribution was \$0.22 per share compared to \$0.24 for the third quarter and compared to fourth quarter dividend of \$0.17. Overall, the benefit of our investment in MSR served to partially offset reduced RMBS balances.

Net interest income declined by \$1.3 million with lower RMBS balances translating into lower interest income and repo funding costs. Interest expense was further reduced by a decline in MSR borrowing costs. Gain on other derivatives was \$39.5 million compared to \$46.3 million in the prior quarter. The result was driven by a reduction in TBA exposure, which was largely offset by roll specialness, and a lower notional position in US Treasury Futures.

Turning to MSR, servicing income rose by more than \$4 million to almost \$61 million, as average UPB balances continued to grow and prepayment speeds slowed. As Bill noted earlier, we expect to settle on \$39 billion UPB of MSR in the first quarter and expect to see the economics of that growth come through over the next couple quarters.

Lastly, operating expenses fell by \$3 million to \$31.4 million due to compensation accrual adjustments offset by the rescission of the CARES Act employee retention credit that we benefited from in the first three quarters of the year.

In the table on the lower right, we show our portfolio yield. Our realized net spread in the quarter rose by 44 basis points to 2.99%. This net increase was attributable to the combination of higher yields on recently purchased MSR and a greater proportion of MSR in the portfolio. Net spread as of December 31st, which reflects our estimate for the near term, increased further to 3.10%, but will depend on our portfolio mix and pace and impact of interest rate hikes.

Please turn to **slide 8**. Our liquidity position continues to be strong with unrestricted cash of \$1.2 billion at quarter end. Funding in the repo market remains liquid and well supported and we retained balances with 19 different repo counterparties. While funding costs for Agency RMBS through the repo markets rose late in the quarter on an absolute basis as the market priced in rising short term rates and Fed hikes, the Spread to OIS and SOFR remains low, currently right around 10 basis points for both 3-month and 6-month maturities, as shown in the chart in the upper right. We maintained access to diverse funding sources for MSR and our unfunded and committed MSR asset financing capacity stands at \$313 million.

Turning to leverage, in conjunction with the reduction in our RMBS position, economic debt-to-equity declined to 4.7x at quarter-end, compared to 6.1x at the end of September. Average economic debt-to-equity in the fourth quarter was 5.1x compared to the third quarter average of 6.0x.

As a final note, we have included information on REIT taxable income and the tax characterization of our dividend distributions on Appendix slide 28. For additional information regarding the distributions and the tax treatment, please reference the dividend information found in the Investor Relations section of our website.

I will now turn the call back to Bill for a portfolio update.

Bill: Thank you Mary. Please turn to slide 9.

As spreads fluctuated during the fourth quarter at tight levels, we became increasingly concerned about the potential for a more aggressive Fed and, in early December, we reduced our overall mortgage exposure to be more defensive, reducing our portfolio leverage to 4.7 times. As we did this, we also utilized options structures to replicate the convexity and volatility characteristics of RMBS, which preserved virtually all of the carry, but without the spread risk. Within our specified pool position, we rotated out of our seasoned 3% pools into new production investor property, loan balance, and geography stories. We also added some very low payup 2.5% bank-serviced collateral which we think will outperform TBA as the deliverable worsens. In high coupons, we were not active, and we let that position continue to run off without replacement.

Please turn to **slide 10**. Figure 1 shows our story and coupon distribution of specified pools and includes the bank-serviced and new production Investor stories that I just mentioned.

Figure 2 shows the quarterly total return performance, by coupon, on TBA contracts and on our specified pool holdings. Here, we can see that every coupon, with the exception of TBA 2's, underperformed their interest rate hedges along the curve, and higher coupons suffered more.

Finally, Figure 3 compares, by coupon, TBA speeds to those of our specified portfolio. Overall, prepayment speeds in our specified pools declined 8% to 27.7 CPR and remain much slower than TBA. To the extent that this quarter's underperformance in higher coupons was due to the market being disappointed by the pace of deceleration in prepayment speeds, we are optimistic that that may be short lived, as prepayments should begin to slow materially in the coming months. Indeed, the February report released last Friday showed speeds declining by 21% in aggregate, and the market is expecting an additional 15% decline next month too.

Please turn to **slide 11** where we will discuss our MSR portfolio. Our flow and bulk additions almost exactly offset our runoff, and market pricing was indifferent to the large curve flattening experienced during the quarter, as the long end of the yield curve was essentially unchanged.

The percentage of our MSR portfolio which is in forbearance has declined to below 1% by loan count. More than 80% of our borrowers are exiting forbearance in a contractually current state through payment deferral or loan modification. About half of the remaining 20% have prepaid while the other half continue to work through loss mitigation solutions including modification. Because forbearances are now very small relative to our portfolio, we will not continue to report it going forward. Our 60 plus day delinquencies are still elevated from pre-pandemic levels by about 100 basis points, sitting now at 1.4%, and we will continue to monitor this closely.

In Figure 2, we show the trend of our settled UPB for our flow and bulk channels over the last five quarters. While flow channel settlements have continued to decline, we were able to capitalize on the elevated activity in the bulk market and committed to purchase another \$22 billion of UPB. In total, we expect to settle on \$39 billion of UPB in the first quarter.

In Figure 3, we compare our servicing prepayment speeds versus TBA. Overall, prepay speeds on our MSR portfolio declined considerably, by 17% to 22.1 CPR. This is a much greater slowdown than we experienced in our specified pool position, and is the result of having more exposure in the lower coupons which are more reactive to changes in interest rates.

Please turn to **slide 12**. One of the main differentiating features of Two Harbors is the extensive and robust platform we have created to acquire MSR on a flow basis from multiple counterparties. Two Harbors has been a consistent presence in the flow market through many different environments, and this is shown in Figure 1. The same 10 buyers have accounted for 83% of the flow market share in the last 5 years. During those years, Two Harbors has had an average market share of 25%, and we have been the top buyer of flow servicing in 4 of those years, and number 2 in the fifth.

During 2020 and 2021, our flow acquisition volumes essentially offset our portfolio runoff, as seen in Figure 2. While we are not an originator or a correspondent lender, our flow channel platform acts similarly in many of its effects, one such effect being the ability to source more product in a low rate / high refi environment.

Lastly, in Figure 3, we show the volume of transactions in the bulk MSR market as well as our participation in that market. Since 2014, the amount of MSR coming to market in bulk transactions has been between \$150 and \$250 billion of UPB, and a typical success ratio for us during those years ranged from 5% - 10%. For reasons we have discussed previously, a record high amount of roughly \$450 billion of UPB came to market in 2021. And 2022 is shaping up to be another record year, as we have seen roughly \$125 billion of UPB come to market in January alone.

This slide is meant to give a better sense of the supply dynamics in the MSR market and in our ability to source the MSR that is a core part of our investment strategy. We are very proud of the platform we have built, and the reliability to our portfolio balances that it provides.

Please turn to **slide 13**. As we have discussed previously, the MSR asset acts in many ways like a short position in RMBS as shown by the gray bars in the top left chart. The blue bars represent RMBS hedges and the amount is chosen to be equal and offsetting by construction.

After allocating the RMBS positions necessary to hedge the MSR, we are left with additional RMBS that we hedge with rates as seen in the middle chart. As you can see, we were net short close to \$2.5 billion in the 2.5 coupon and small positive positions in higher coupons. The short 2.5 position resulted mainly from de-levering the portfolio

as we believed the 2.5 coupon looked rich and had the most to lose given a reduction of Fed support.

In the second row, we show book value exposure to changes in current coupon mortgage spread.

The chart on the bottom right shows a total of 0.8% exposure for a 25 basis point spread widening in the current coupon mortgage spread. This estimate assumes a parallel shock across the coupon stack, and is not relevant for the book value sensitivity to spreads on higher coupons moving in isolation, or on MSR. Besides the presence of MSR in our portfolio, this number also reflects the fact that we have very low leverage.

Please turn to **slide 14**, where we show our interest rate and curve exposures. We are carefully monitoring and hedging the shape of the entire yield curve in general and we are focused, of course, on the very front end of the curve in particular. With inflation fears in the foreground, the obvious concern is a shock upward in the front end in a continued bear flattening move. In Figure 3, we show that in this scenario, our portfolio has low sensitivity with only a -0.3% impact to book value.

Taken together, these three charts demonstrate our commitment to hedging the full yield curve exposure and our desire to have little book value volatility no matter the rate environment.

Finally, I'd like to discuss our outlook for Two Harbors and our return expectations for new investments on **slide 15**. The most notable change from the third quarter is the sharp move in current coupon pools hedged with interest rates. The rapid widening of spreads earlier this year has pushed returns from the low to mid-single digits to the very high single digits. These assets are getting close to our target returns and we believe that they will be an attractive use of capital early this year.

In high coupon pools, although we saw some widening in the fourth quarter, they have outperformed somewhat in January and so combined with a much flatter yield curve, we see static spreads roughly unchanged in the high single digits.

TBA roll specialness remains elevated and thus the duration hedged carry — which is not particularly impacted by the recent spread widening - continues to look attractive on the surface. However, despite the specialness, we believe the supply/demand imbalances will weigh on actual realized returns in the near term and so we are taking a wait-and-see approach to TBA investments.

The paired construction of MSR and Agency RMBS continues to be the most attractive way to deploy new capital with returns in the low- to mid-teens. Although the MSR market is competitive, we continue to find pockets of opportunity through our market leading position in flow and our disciplined pricing of bulk packages.

This environment, with prepayment speeds beginning to slow, and current coupon mortgage spreads widening, is one for which our portfolio strategy was designed. As a result, we are very constructive and optimistic about the forward outlook for Two Harbors and our paired Agency + MSR portfolio construction.

Thank you very much for joining us today, and we will now be happy to take any questions you might have.

Operator:

Thank you. At this time, we will be conducting a question-and-answer session. If you would like to ask a question, please press "*", "1" on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press "*", "2" if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick you handset, before pressing the star keys. One moment, please, while we pull for questions.

Our first question is from Trevor Cranston with JMP Securities. Please go ahead.

Trevor Cranston: Hey, thanks. Good morning. You talked a lot about the widening of current coupons in January and performance somewhat of higher coupons, which kind of reversed what happened in the fourth quarter, I guess. Can you talk about going forward as taper progresses and the Fed embarks on monetary tightening, how you expect the kind of performance of the coupon stack to evolve over the course of the year? And if you could also provide any commentary on sort of what risk scenarios you guys think about that would, potentially, cause high coupon underperformance, going forward? Thanks.

Bill:

Yeah, sure. Thanks, Trevor, and good morning. As we've sort of been saying for a while and shown by the chart on Slide 4 of the presentation, we've been saying for a long time, we think spreads on current coupons are going to--should continue to widen towards long-term averages.

And given the environment that we're in, with the Fed still removing accommodation, talking about balance sheet tightening, and all those factors, I think the possibility of an overshoot of long-term averages in spreads is possible. And so we are positioned, accordingly, for that.

As rates continue to rise, what is known as current coupon migrates up, also. So, looking at the current coupon chart like the one that we show here is talking about not a single coupon in the coupon stack. It changes, over time, a little bit. Currently, right now, they're the high coupons called 3.5 and above. They haven't made any of those for a long time, right? And so, as rates rise in the current coupon shifts up there, the current coupon now is probably in the 3% area, right. You should start to see more supply come in those coupons, as well. But refinancing speeds across the entire stack, not just the current coupons, will start to fall, as the entire machinery of the refinance universe starts to sort of power down. I'm not sure if that answered your question.

Trevor Cranston: Yeah. Yeah, it does. That's helpful. And then, when you were talking about the attribution to the book value performance in 4Q, I think you mentioned about half was

underperformance of high coupons and then the other component was widening of MSR.

And I think there was a comment that it was partially related to just the pricing variance, based on how MSR marks are provided. Could you clarify that a little bit or just elaborate on if the MSR widening was just sort of that pricing variance or if there was anything sort of fundamental related to expected prepay speeds or anything else going on?

Bill:

Well, I'll start with that, right, and maybe Mary can jump in, also. Our fair value marking process is to take the average of three independent broker marks, right? And they have their own information and look as to what the--what their estimates of our portfolio are. And we think the best way to manage that is to take the simple average of those. And within that process, we saw a 20 basis-point widening of that average level.

Trevor Cranston: Got it. Okay. And then the last question for me. I think when you were talking about the refinanceability of the market, I think you gave a number something like 11% after the move in rates in January. Do you have the number offhand for how much of your MSR portfolios remains in the money for refinancing, or if that's generally kind of close to what the market level is overall?

Bill:

Yeah. I think that's one of the charts, actually. You see it tracks pretty closely on Page 5 of the presentation. We show this percentage in light blue is the Fannie, Freddie universe and the dark blue line in the chart on the upper right is our servicing portfolio. So, it's tracking pretty closely with the universe. There was a little bit of divergence in 2020, but it's largely converged now to the universe.

Trevor Cranston: Gotcha. Okay, appreciate the comments. Thank you, guys.

Bill: Thank you.

Thank you. Our next question is from Doug Harter with Credit Suisse Securities. Please Operator:

go ahead.

Douglas Harter: Thanks. Bill, you talked about--you've talked about for a while that kind of the construct

of the portfolio with Agency MBS and MSR is meant to dampen volatility in book value. I would say, for 2021, that didn't work. Can you just talk about lessons learned and how you might--whether there's any changes to portfolio construction or hedging that you

might do to accomplish that lower book value volatility?

Bill: Yeah, sure. Thanks for the question, Doug. Thanks for joining us. In 2021, our

> performance, you can phrase in two different ways, really. One way is, the portfolio construction and the sensitivities that we show, as we say on Page 13, right, really reflect parallel changes in spreads across the stack. And what we saw in 2021 with the Fed continuing to buy lots of mortgages that current coupon mortgages didn't really

widen at all, during 2021.

They stayed at very, very tight levels, even through the end of the fourth quarter. At the end of the fourth quarter, they were within 8 basis points, or thereabouts, 8 or 9 basis points of the tight levels experienced, throughout the year.

So, we didn't see any current coupon widening during 2021. What we did see was high coupon spread widening during the year, which as rates fell and the Fed started buying more low coupons, they weren't making any more high coupons. It was sort of a static pool of portfolio which you couldn't trade in it particularly, couldn't add to it. I mean, you could sell, and we did sell a fair amount of that asset. But what happened was prepay speeds were, generally, faster than the world expected, right.

And as a result of that, those coupons suffered in actual realized cash flow performance, as well as forward-looking spread performance on the high coupons, alone. And the portfolio was not able to benefit from the offset of the MSR, which benefits from low coupon spread widening.

That's what we're seeing, today, in the early part of the first quarter, a very rapid 20 basis-point move in January, mortgages are under stress, again in February, as I'm sure you're aware. And so, in that environment, the MSR does provide an offset. And here, we're switching to a turnover environment, out of a refi environment. And so, I'm much more confident in the ability of the MSR to provide the offset that is designed to do in this environment.

Douglas Harter: Okay, makes sense. Thanks for the answer, Bill.

Bill: Thank you.

Operator: Thank you. Our next question is from Eric Hagen with BTIG. Please go ahead.

Eric Hagen: Hey, thanks, good morning. So, maybe two questions on my end. Before any offsets

from MBS and hedges just by itself, can you say what the total return has been, year-to-date, for the MSR portfolio? And then separately, what were the unlevered yield-what was the unlevered yield for the \$39 billion that you bought, so far this quarter?

Bill: Good morning, Eric. Thanks for joining us. I don't think I have the returns broken out on

just the MSR of the portfolio, without hedges. If I understood your question correctly, that's not something we regularly compute or monitor. We look at the portfolio on a hedged basis and it's not, particularly, interesting to me what the return of the individual sides of that construction are. So, that's not something I have at my fingertips,

for sure. Not sure it seems something we calculate or monitor.

In terms of the static yields of the portfolios that we've been buying, we see, in general,

static spreads in the very high single digits on an unlevered, unhedged basis.

Eric Hagen: Okay. Gotcha. Thanks. And then, maybe you can shed some more light on the decision

to rotate back into specified pools and really just how you expect the premium there to

hold up if the expectation is for wider spreads like you guys did note in your prepared remarks?

Bill:

Yeah, so, we talked about this in the past, and there have been many questions about this in past quarters. With the Fed tapering and removing their purchases, we expect the roll specialness to decline and that should cause TBA--that's one effect which would cause TBAs to underperform specified pools. In addition, when you talk about TBA investments, that's also a--refers to what is--it's the cheapest to deliver concept, right. And so investing in a pool, which is static, which doesn't change over time, unlike the TBA, what's implied in the TBA prices, should also benefit the specified pools relative to the TBA.

And so over time, as we've discussed, as roll specialness declines in that market, we expect to rotate more into specified pools, and this was really the beginning of that shift, and we started by buying very low pay up securities which shouldn't--that pay up should not be particularly at risk, as spreads widen.

Eric Hagen: Gotcha, thanks. And then one point of clarity. The book value color quarter-to-date,

does that include an accrued dividend? Or is it net of an accrued dividend?

Bill: Well, as you know, the dividend is--I'm sorry, go ahead Mary.

Mary: I was just going to say that it would not include a dividend as those aren't set until the

Board declares them in March.

Eric Hagen: Sure. Okay, thank you.

Operator: Thank you. Our next question is from Bose George with KBW. Please go ahead.

Michael Smyth: Hey, everyone. This is actually Mike Smyth on for Bose. Just a couple of questions on

the Fed balance sheet. I'm just wondering if you can talk through your expectations for runoff and how that may compare to what we saw, last time? And then maybe if you can just talk through where do you think the incremental demand comes from, as the

Fed moves away?

Bill: Thanks very much for the question. Look, I have no particularly better insight into what

the Fed is going to do than anybody else. They've said that after liftoff, after rate hike liftoff, they will start to consider the normalization, right. They said it could be faster than other periods. They've said that they want to get to a treasury-only portfolio. I take them at their word. I think the inflation fears have been internalized by the Fed. I think

they will act accordingly.

And I think if anything, in this episode compared to the last one, there's probably a higher risk that the Fed acts more quickly and more aggressively to take their mortgage balances down than they did in the past. And I think it results--that obviously puts

higher risk on mortgage spreads.

Michael Smyth: Great. That's helpful color. And then just one more. Leverage declined quite a bit, again. I'm just wondering if you can kind of discuss where you're looking forward to go on offense and take that up, and then maybe the timeline for doing so, given that your targeted returns on assets have improved modestly, quarter-over-quarter?

Bill:

Sure. I mean, the overarching environment here is one where the Fed is stepping away and where there's still lots of supply of mortgages and spreads are tighter than they've been in other periods where the Fed has been removing accommodation.

And so, we're watching spread levels, carefully. It's a day-by-day decision about the environment and the relative value. I think that, in the past, we've said that our leverage could go up to 8x or 9x. And of course, I'll remind you, leverage for us means something different than it does for portfolio without MSR, because we have this MSR offset.

And so, we really look at the spread exposures that we show on Page 13 more carefully than we do at the nominal leverage, although we're respectful of the number. But given the amount of MSR in our portfolio today, we think that our leverage can go up into the 7s. If spreads overshoot towards the higher end of that range on Slide 5, then it could probably touch in the low 8s or something like that. But we're watching the overall macro environment, the spread environment of the MBS market, carefully, and we'll make decisions when we think it's attractive to start increasing that, over time.

Michael Smyth: Great, that's really helpful. Thanks a lot for taking the questions.

Bill: Thank you.

Operator:

Bill:

Thank you. Our next question is from Kenneth Lee with RBC Capital Markets. Please go

ahead.

Kenneth Lee: Hi. Good morning, and thanks for taking my question. Just one on the risk positioning and hedging profile. Just based on the Slide 14, it looks--it sounds as if Two Harbors is biased towards protection around a bear flattening scenario. Just want to gauge if that's--that would be a correct reading, or is there a couple of other scenarios that you

guys are particularly focused on? Thanks.

Thanks, Ken. Good morning and thanks for joining us. Well, yeah, we're most focused on that because that's where all the action has been in the last several weeks, for sure. But as--and we all knew where this market was heading, which was towards Fed liftoff

in rate hikes.

And typically, when that happens, the yield curve flattens substantially, and so on. And the market is moving very quickly. It shows how quickly the market moves. We actually prepared our remarks last night. I mean, I said there were almost five and a half hikes priced in the front end and after today's CPI number, right, there's more than six hikes

priced in 2022.

So, it just shows how fast the market is moving, here. We try to hedge all along the yield curve, right, and to protect against bear flattening, as well as bear steepening or bull flattening or bull steepening. We try to not run large interest rate risk positions. We view our job, our mandate is to provide mortgage exposure and it's mortgage exposure with MSR and not to make guesses on the direction of interest rates.

Kenneth Lee:

Gotcha. Very helpful. And just one follow-up, if I may, in terms of the MSRs. You mentioned there could be a pickup, in terms of potential available acquisitions on the bulk side. Just wondering if you could just talk a little bit more about what could be driving the increased availability this year?

Bill:

Yeah. The supply side in 2021 is really the same thing that's driving what we're seeing in 2022, which is that, during the extraordinary refi wave that we saw in 2020, many participants chose not to sell their MSR into the market, because they felt that--that rates were low or that multiples were low.

Remember, back in those times, primary-secondary spread was very wide. And so, price multiples on, what I would call, at the money servicing during those days was probably in the three area, as opposed to where it more normally is in the four to four and a half area. And market participants saw that, and they said, I don't need to--I'm going to hold on and wait, because I think the price is low. And the primary-secondary spread was so wide, so they were making enough money that they didn't need to sell their servicing to monetize it in order to run their operating businesses. And so they just held on to it.

And rates rose, the market healed, price multiples improved. And so, now those participants are looking to sell those balances into the market. And what we saw in 2021 was not all of that. And of course, 2021 also saw large refinances. So, while they still had the 2020 backlog, they were still making just as much in 2021 as they made in 2020. And so, not all of that pipeline has cleared. And so, 2022 should probably see a continuation of that as servicing participants work to monetize their servicing holdings off their balance sheets.

Kenneth Lee: Gotcha. Very helpful. Thanks, again.

Bill: Thank you.

Operator: Thank you. Our next question is from Rick Shane with JPMorgan. Please go ahead.

Richard Shane: Hey, Bill, thanks for taking my questions. And I want to follow up a little bit on the last question. You guys point out sort of the differential in the market in terms of bank service versus nonbank originated lenders. I am curious if you are starting to see any

consolidation in the nonbank channels. And I'm also wondering, one of the things the nonbank originators talked about in terms of their volume opportunity going forward, even as the rate term refi wave ends is the cash out refi opportunity. How are you sort of mitigating that risk within the portfolio? And are you seeing peering in pricing

between bank and nonbank originators, related to that adverse selection?

Bill:

Thanks, Rick. I'm not sure I understand your question, exactly. So, let me just talk for a little bit and see if that helps and answers your question. If not, you can steer me back on course.

The addition of some bank service specified pool collateral was really just a relative value trade between TBA which, as I said, I believe, will worsen as spreads widen, as the deliverable worsens. Bank service collateral prepays a little bit slower than the generic cohort, and so forth. But these are low pay-up pools. And it's not a big risk position that we have, in general.

The cash-out refinances is certainly a thing. We've seen more of that in 2021. That's already known in the market. That's what's keeping turnover speeds higher than it has been in the past over--in other turnover episodes. I think that's already priced into the market at reasonably fast levels of cash out refi's. And so, I happen to think that, if anything, the risk of cash out refi speed is probably to the downside, more than to the upside.

I think that's true of cash out refi's; I think it's true of prepayment models, in general, as a result of this episode that these were faster-than-expected speeds across the board and models have been--and expectations, not just models. Models and market expectations have been calibrated to these very fast speeds. And I think it's just as likely that speeds can be slower than those expectations. Then--I think it's just like if not more likely, that there will be slower expectations rather than higher, going forward.

Additionally, I'd say in our servicing portfolio, we do have recapture agreements in place with our sub-servicers, and we're able to monetize some of that value as cash out refi's happen, as well.

Richard Shane:

Got it. Okay. Yes, that's helpful. I mean, I think one of the assumptions that we all often mistakenly make is that normalization is back to normal but, oftentimes, normalization episodically overshoots, before it returns to normal.

Bill: Yeah, I agree with that.

Richard Shane: Okay. Well, thank you. I will say we enjoyed the slide deck. I think every one of them, it

could be a syllabus for a course on mortgage-backed securities with each slide being one daily lecture, and we're going to have to delve into all of them a little bit deeper.

Bill: Well, happy to help in that if you need me to. Thanks very much.

Richard Shane: Thanks, guys.

Operator: Ladies and gentlemen, we have reached the end of the question-and-answer session.

And I would like to turn the call back to Bill Greenberg for closing remarks.

February 10, 2022

Fourth Quarter 2021 Earnings Call

Bill: Just want to thank everyone for joining us today, and thank you, as always, for your

interest in Two Harbors.

Operator: This concludes today's conference. You may disconnect your lines, at this time. Thank

you for your participation.

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