



# 2014 ANALYST AND INVESTOR DAY

Transcript

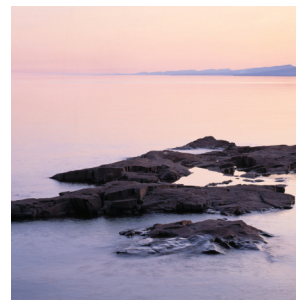
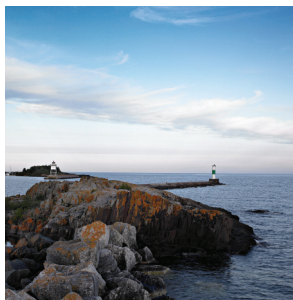
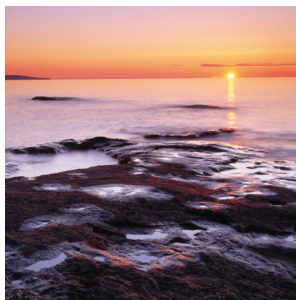
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**TWO HARBORS**  
Investment Corp.

A Pine River Capital Managed Company



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## **WELCOMING REMARKS, TOM SIERING**

Good morning. For those of you who don't know me, I am Tom Siering, the CEO of Two Harbors. Welcome and thank you for joining us for Two Harbors 2014 Analyst and Investor Day.

We are delighted to have Jim Grant, the founder and editor of Grant's Interest Rate Observer as our keynote speaker today. The Interest Rate Observer is one of the most quoted and influential publications on Wall Street. And I have to say for people like Bill and I who been around the markets for long time, this is sort of like playing catch with Mickey Mantle. Jim is a highly coveted guest on a variety of television formats. I am also excited to share that he has been recently inducted to the Fixed Income Analyst Hall Of Fame. Today, Jim will be addressing the consequences to the market from of Fed's impact on interest rates which is obviously very topical to the mortgage markets and to Two Harbors. With that, I am pleased to introduce Jim Grant.

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## **JAMES GRANT, GRANTS INTEREST RATE OBSERVER**

Thank you, Tom. Thank you, Bill. Thank you, Two Harbors and welcome to Lower Manhattan. We have an office directly across the street, that was why I was ten minutes late. I will now indulge in some special pleading by a fellow who has the words "interest rate" in the name of his publication. We at Grant's like our interest rates natural. We like green, free range, organic, local, sustainable interest rates. Instead the Fed insists on giving us the artificial genetically modified hot house kind, you know, supermarket tomatoes in February kind of interest rates. The consequences of these rates and of the...more broadly of the Fed reserves assault, I take it to be an assault, on the price mechanism is the topic of my remarks today.

In preview, I intend to describe what our central bank has been up to, review what it has hoped to accomplish and examine what it has actually achieved and failed to achieve. To see the present more clearly, I will lead you on a short temporal detour back to the 1920s. I will touch on the fraught subject of deflation and consider the particular ways in which ultra-low rates have distorted the financial landscape. And we will break for lunch at 3:00, oh! 2:00, okay.

Now, to [indiscernible] the forward-looking tone of these remarks, allow me to quote a few lines from Frederic Bastiat the great Bastiat who died in 1850, "in the economy" said this immortal, "in the economy an act a habit an institution of law gives birth not only to an effect, but also to a serious of effects. Of these effects the first only is immediate, it manifests itself simultaneously with its cause,

it is seen. The others unfold in succession, they are not seen. It is well for us if they were forcing.” The seen and the unseen; if only our policymakers would devote a little more time to the latter, to the unseen. So Bastiat of course, learned from Adam Smith who extolled the virtues of the invisible hand, something we today might call instead free markets or the price mechanism.

A couple of years ago, about this time of year, then Chairman Ben Bernanke was at George Washington University lecturing the students on the ways of the central bank and the ways of the world. And he gave them kind of a potted history of modern finance and he touched on the episode of the early 70s in which you will not recall, but perhaps you’ve read about that President Richard M. Nixon instituted wage price controls when the measured rate of inflation was about 4%, 4.5%. Can you imagine it? A wage-price freeze on the economy imposed from on high. Bernanke discussed this policy error, he shook his head, he could not...prices he said are very important, you can’t just, you can’t just manipulate them.

This to me was a telling lack of self-awareness on the part of our intellectually gigantic former Fed Chairman. What is ZIRP QE, the so-called portfolio balance channel except a kind of price control? The Chairman observed that price control has never worked and we are meant to understand that in this instance what we are not calling price control, will work. So it strikes me and perhaps you have observed that the prices of financial assets increasingly are administered from on high rather than discovered from us in the private sector.

I’d like to tell you actually given the sophistication of this audience, to remind you about the profound importance of this transformation. So let’s start with interest rates such as they are. You CFA’s out there know full well that the value of a common stock is or ought to be the present value of its future cash flows discounted by the appropriate rate of interest. Now Twist and ZIRP and the rest in the mind games fall under the heading of forward guidance, all of these, the Federal Reserve institutes to, I say to suppress, certainly to manhandle the yield curve and the level of rates. And in so far as the appropriate discount rate is suppressed, valuations are reciprocally inflated. And we hear these days about the Fed’s plans for the so-called exit the taper or the torpor and it does get boring.

But very few contemplate the significance of higher rates whether they be instituted by the FOMC or by individuals acting independently of the marketplace. Very few seem to contemplate the likely effects or possible effects of higher rates on the dividend discount model. Needless to say, the world would be simpler if humans were as obedient to the workings of this famous dividend discount model as BRICS are to the long gravity. Nothing in finance is cut and dry, certainly nothing in the drama of our financial markets with human interacting with human, none of this is cut and dry. But it seems to me we ignore at our peril the risks that our hot house interest rates institute throughout the entire length and breadth of our capital markets.

So the aforementioned immortal Frederic Bastiat talked about that which is seen, that which is unseen, that which is intended, that which is hit you upside the head and which is unseen. The Federal Reserve’s policy constitute what Bastiat termed as act or law and they have given birth to a series of effects, the first and immediate effect as intended was inflationary. Now, that is inflationary in the Wall Street sense, the happy capital gains and bonus enhancing sense of inflation, not to checkout counter variety. These are the effects that are seen, the other effects will unfold in succession and just as Bastiat says, it is well for us if they were foreseen.

So ultra-low interest rates, their consequences, their rationale, their history is the theme for today. And let us proceed with a few examples and a little bit of history. Oskar Morgenstern was a pioneer in game theory and one of the wisest certainly of our quants. He died in 1977, but he left behind a wonderful book called *On the Accuracy of the Economic Observations*, and I commend it to you. Easily available on used book sites in the web and it's written in English, a rarity, says Morganstern, "without the notion of price, there would be no economic science." Well, if so our Federal Reserve is not doing us any good, prices there are of course, we can't help but have them, and many are honest and freely arrived at. Wall Street however is a little bit different. On the street where I live, prices increasingly are administered. It is my contention today that the Fed; though it can't change how things look, it really can't change what things are.

Before getting into specific examples of what I will submit to you, are the consequences...unintended consequences, manipulations. I would like to...I'll go back a little bit in time and sketch the historic backdrop to this day and age of non-stop intervention. I have become a bit of a bore on the subject of the early 20s; I have written a book and Simon & Schuster represents it will finally publish it sometime. And the title of the book is "The Depression that Cured Itself" on the self-healing slump of 1920-21. This was America's last Laissez-Faire depression. Let me sketch for you the magnitude of the difficulties in 1920 and then I will tell you how the government met those difficulties. And then I will tell you what happened in the face of those policies.

There had been after World War I, a huge inflation, it caught everyone by surprise because everyone thought he or she knew that the aftermath of war brings deflation, depression. No, it was huge uplift in the price level. And in the aftermath of that inflation came a huge business slump. And the magnitude of it was horrific, industrial production down perhaps 30%. Never before and never since has there been such a violent and foreshortened in time deflation of prices. The wholesale price index was down more than 40% within the six months.

Unemployment was then unmeasured, it's a little bit unmeasured today too, but we pretend to measure it, but then it was really unmeasured. The best guesstimate on the part of the Federal Authorities was the unemployment range between 2 million and 6 million, this out of a workforce about 40 million. In any case it was distressing. So can you imagine today this collapse in prices, what would the government do today? Well we know a little bit, we can imagine what the government would do, what did it do then? Well, the Wilson Administration which was in office during the first of these travails was incapacitated. The President himself had a stroke; the administration was also on its back; and what the Wilson Administration did was nothing; although, it did balance the budget.

Now, the Federal Reserve was then run, not by PhD economists, but by ex-bankers and businessmen. They thought that the thing to do was to deflate because they thought that inflation was aberrant, abnormal and wholly undesirable, and what was wanted was a restoration of a normal price level. So the Fed actually raised interest rates in the face of a 40 odd percent crash in the wholesale price level. It was the only time in the history of the Fed in which interest rates were higher at the trough than at the preceding business cycle peak. And they were high, real deflation adjusted money market interest rates commercial paper rates, ranged between 13 and 20 odd percent during the trough...the summer of 1921.

Well, then what happened? Well, what happened was stock market fell by almost (Indiscernible) and a half, and at the lows there was a new growth stock called RCA, Radio Corp of America, and it traded exactly for what it would earn in 1923. Coca Cola, another up and coming name soon to be listed in the stock exchange was trading at about three times earnings and yielding, I think more than 8% if memory serves. A terrific washout in everything, if you have an idea of what a federally un-medicated depression looks like.

So Paul Krugman, tell us why aren't we still in this depression? The Fed raised rates, and the government balanced the budget, and indeed ran a surplus. Why aren't we still in the depression of 1920? But what happened was several interesting things to the marketplace, one, gold came to this country, gold then being the international medium of exchange because things were cheap.

Allan Meltzer, who wrote a very good exhaustive, indeed very exhaustive two volume history of the Fed, calls this, in economist talk, the real balances effect, meaning that the things were cheap. There was no social safety net; people saved. Indeed deposits at savings banks went up during the course of the depression, houses got cheap, stocks got cheap, gold came. The Harding Administration came with next election and Andrew Mellon had let us to lower interest rates which they proceeded to do. And the depression from start to finish lasted 18 months and what followed was terrifically dynamic and job filled, whoosh of recovery. And before 1921 was out there were labor shortages in Detroit, in the emerging auto capital of the nation. Well, that was then...that was a federally...that was a last Laissez-Faire depression.

Now, the attitude towards deflation then was bipartisan in politics at the time. It was "bring it on". What we wanted they said, Democrats and Republicans alike, was we wanted no inflation, we want something like a normalized price level. It was a brutal depression, but it ended.

Now, let us end the temporal detour and proceed to the present day. And by way of preface to a discussion about the consequences in the marketplace of lower interest rates, let us talk...me talk for now about this monster, this ogre, to quote Christine Lagarde, called deflation. She calls it an ogre.

By way of fact, in the history of modern economies prices have tended to fall in times of rapid material progress, and advances in the technique of production. That was the case throughout the 19<sup>th</sup> century. It was the case into the early 20<sup>th</sup> century, prices tended to dwindle because if it costs less to make things, it logically costs less to buy them, that was the idea. That was then, we have since absorbed, as if through osmosis, the approach of the Federal Reserve, in particular, ex-former Chairman Bernanke, who gave his famous talk about deflation, you know, it won't happen here or worse (indiscernible), that was 2002 I think, it was at the National Press Club. And he pledged on behalf of other Fed Governors, that it would not happen here because they had learned the lesson of the depression, not the depression of 1920-21, but the depression of 1929-33.

So we will not have deflation that is decided. The Federal Reserve and central banks the world over have decided that there will be no depression...no deflation. What they don't do is define deflation. They make no attempt to distinguish falling prices brought about through advances in the technique of production through the advances in digital technology, through the internationalization of the world's labor force. They made no distinguish between prices dwindling on account of progress, on the one hand, and prices falling on account of a crisis in debt, on the other. To me deflation properly

defined is what happens when during a debt pile up, people can't fund themselves and must liquidate assets, whether it be physical assets or labor, things that go on in the marketplace, prices fall, that to me is deflation.

Prices falling because it is cheaper to make things or to perform services; that to me is progress. We Americans seem to spend most of every weekend looking for deflation, we seem to prefer shopping at Walmart and Target, Sam's Club and the like. We don't seek out Tiffany every weekend, just like the first weekend of February. Nonetheless, the Fed insists, without informing us as to what it's thinking about, insists on pouncing on signs of dwindling prices as a clear and present danger to the solvency of world finance.

Now, if I am right about the normal tendency of prices to fall in times of progress in production techniques, that means the Fed must create more credit, it must be more aggressive at lowering rates to create enough redundant credit to lift the price level. The ECB, the central banks of New Zealand and Australia have shot and sometimes hit a target of 2% rate of rise in the general price level. Doesn't sound like much, it might not be much except, what if prices except for central bank intervention, would have fallen by 1.5% a year say as they did fall, according to Milton Friedman and Anna Schwartz, in the final quarter of the 19<sup>th</sup> century, a time of terrific progress in every mechanical art and transportation.

So to raise up prices requires just at the first estimate, a hugely aggressive central bank response. And if on top of that, the central bank has put it on its own shoulders to rescue every leveraged financial institution in time of contraction that puts an extra spring in the step of those who would manage an aggressive monetary policy. So it is my contention that to affect the goal of raising up the price level by 2% a year, the Fed has introduced yet another distortion, well-intended but nonetheless distorting.

So let us survey the landscape a little bit for signs and portents of trouble having to do with the unseen effects of the Fed's well intended actions. I want to...I am not going to talk about mortgage REITs here because the room is full of people who know something about them, a journalist would be crazy to do that. So I am going to stick to something that perhaps you might know less about, namely corporate credit, by way of attempted proof of the fact or my thesis to you, that the consequences of artificially low interest rates feature prominently the clear and present risk of mispricing of earning assets in the marketplace.

You know, there is a funny moment in a press release, if you can imagine a single funny moment in a single press release, Toll Brothers not long ago issued I guess fourth quarter results, and in doing so, announced that they had completed the acquisition of what was it, Shapell Industries, another home builder who paid a \$1.6 billion in cash. And the CEO of Toll Brothers, the big homebuilder, his name is Douglas Yearley Jr, and Mr. Yearley, the Toll Brothers, CEO, gave a shout out to his bankers. He said that, we would like to express our appreciation to our banks for their tremendous support, our new five year floating term loan is at a rate currently below 2% with generous covenants, if any.

Now, I thought that was most ungallant of Mr. Yearley not to mention Janet Yellen in the same paragraph, I mean, what's the source of less than 2% to buy other home building, what the heck are we talking about. Well, it might be a good rate, certainly a good rate for Toll Brothers, but is it

a....would it be a clearing rate in a normalized, organic free range, sustainable, local interest rate setting. I submit to you 2% looks a little bit aggressive.

Now, if you have read the Wall Street Journal this morning, which I guess people used to do that, but when you get around looking at the Wall Street Journal, check out the story on PepsiCo, which I think is also interesting and illustrative of the moment. Pepsi has been the quarry for a number of activist investors, Nelson Peltz most recently, and Mr. Peltz just will not relent. He has Pepsi in his sights. Pepsi says Mr. Peltz must do something besides what it is doing now. He has to create shareholder value. He has to get rid of this malignant, unhealthy, sweet beverage business and get into properly fattening salty snacks altogether, that's it 100% snacks. That's the indicated corporate strategy by Mr. Peltz and the incumbent management at Pepsi will have none of it, hence the drama.

This is not so unusual in our corporate affairs today. And let us review what Pepsi has done in response or in anticipation of the pressure placed on it by the likes of Nelson Peltz. I am going to compare magnitudes from the year 2006 and compare them to the third quarter of 2013. Okay. So Pepsi has been on a kind of a growth tear optically. Sales in 2006 were \$35 billion, sales currently running closer to \$70 billion. That is about a 9.5% compound annual rate of growth in revenue, which on the face of it is not shabby. But to achieve that in this time of very slow growth in almost everyone's top-line, debt has risen from \$2.8 billion in 2006 to upwards of \$30 billion at the end of the third quarter. So sales grew at 9.5% compounded over that interval, and debt grew at 40% compounded over that interval. ROA, as you might expect went from 9% to 18%, excellent. ROE counter intuitively actually declined. It was 38% in 2006, it is now 30%. Over the course of these years, Pepsi returned to the owners of the business upwards of \$53 billion in dividends and the like.

To the bond holders, let us spare one moment, one cotton-picking moment of sympathy for the debt holders, not that they deserve it because they are contractual lenders. They have no role in the ownership. They have made their own bed. We hear this all the time. They get no shout out, except occasionally from the Toll Brothers, but the debt holders have seen the EBIT coverage ratio decline from 27:1 in 2006 to 13:1 now. Now, I presented these data to the famous mutual fund equity manager, Bill Miller, I presented them to him in a state of constrained dudgeon from the point of view of the debt holders of the world, the creditor class we used to call them during Roosevelt administration the creditor class, and Mr. Miller said in response, that well, it was the logical thing and the defensive...more than defensible thing for the management of Pepsi to lever up the balance sheet because debt is cheap, because after all they offer fiduciary duty not to the lenders, but to the stockholders and besides, EBIT covers fixed charges now, redundantly 13 times over less redundantly than 27 times 2006, but still with great comfort and headroom. And that in fact might be....that might be a more than defensible response. I accept that might be the thing to think.

What I think is interesting and telling is the debt market's pricing of the Pepsi debentures, again, it might just be that Pepsi ought to have levered up, but should this now, a single 'A' credit, I guess be single 'A' is one question, I suppose it is, it measures up to the single 'A' kind of metric. But the Pepsi finds of 2018 traded at Tuesday at 113 and 5/8 to yield less than 170 the longer dated Pepsi bottling sevens, which are obligations of the parent traded at 131.8 to yield a little bit more than four.

Now, I am not sure what can go right for Pepsi from the point of view of the debt holders, but we can all imagine what might go wrong. There might be an unscripted acceleration in the growth of the

American economy. A friend of mine says, if something could go right, it is America after all. Well, that is a possibility; Baron's on its cover this week has 4%. That's somebody's called for inflation adjusted growth this year. It could happen. Who can be dogmatic about the future? Not somebody who has blown out as many birthday candles as I. No, there could be unscripted spurt of growth in America. There could be an unscripted bout of inflation. The Fed's balance sheet has gone from less than \$900 billion to more than \$4 trillion since our sorrows of 2008, that's possible as well. But what is the upside to a short dated note yielding less than 170, at a time when measured inflation is at about 170. And still more, what is the upside at 4%, over the course of so many years to 2029. I don't know. I ask these questions rhetorically, I simply don't know what the upside is, but the debt markets, I submit to you, are pricing things as if there are, in many cases, no down side. It's not just one or two companies that are being hounded or courted by the likes of...by the activists, if you, as I know you do, if you kind of take a tour of the debt markets both here and abroad, you'll find extraordinary sightings to me of not so much of...but eminent, dramatic difficulties, who knows they might be here. But a chronic state of being in which risk is being paid less than it perhaps deserves to be paid.

The Bank for International Settlements based in Basel Switzerland is kind of the central bankers owned Swiss Bank, they kind of go there and have secret meetings and count their gold. The BIS late last year ran an item in a quarterly publication detailing what it took to be some of the anomalies of the present day credit landscape. One was the notably markedly low rates of corporate default. Now, Moody's came out with a piece just last week saying the junk bond yields ought to be set as low as they are next to treasury yields, they have been near record tight with respect to treasuries because default rates are so low, which seems a little bit circular to me, and it seemed circular to the BIS when it seemed to have anticipated the Moody's arguments. What the BIS observed was that in the 15 years ending in 2011, high default rates and wide credit spreads were associated with weak growth or recession. No more in Europe or in the emerging world the BIS pointed out, default rates in the euro area actually fell from 2012 onwards, even as the region entered a two-year business downturn. Similarly, credit spreads in the emerging markets dropped between late 2011 and mid-2013 just when local economic growth showed clear signs of weakness.

And it seems to me, you can see much of the same in the United States as well, companies default less than you would expect because their bankers won't let them. It seems to me that people tend to define risk according to what they need to get ahead in life. They don't see risk as clearly as they might, especially in times of unusually or abnormally low interest rates and nor does it help the cause of analytical clarity when what they need to see depends so much on what the Federal Reserve may or may not impart. Now, there are, I think ten leading indicators, officially in the conference board's enumeration of which the Fed seems have three under it's thumb; credit spreads, the yield curve, and the stock market. So in so far as the Fed takes its cue from the financial markets, the policy makers are staring at themselves in the mirror.

I'm a little bit embarrassed to point this out. Tom might have mentioned this in his introduction if he had thought of it. But I was nearly the Federal Reserve Chairman. Yes, Larry Summers was to have been President Obama's Fed Chairman, but if Ron Paul had won, I would have been Fed Chairman. Yes, he said that on CNBC. So it's authoritative. And can you imagine basking in the glow of that, (indiscernible) six weeks it was great. And, the Federal Reserve Bank of New York invited me to come in and to talk, I guess in my perspective capacity as their boss on how I would do things

differently. That was a great honor, the Fed at that time, in fact was asking some of its more vocal, read annoying, critics to come in and unburden themselves. Now, I can tell you in conclusion the highlight of my 15 minutes...5 minutes with the Federal Reserve Bank of New York, I said to them, I don't want you all to worry about your jobs, not all of you because when President Ron Paul, ok fine he feel a few votes short, when President Ron Paul names me the Fed, the first thing I do is institute an office of unintended consequences and some you, some of you will serve in it. So they applauded and you should applaud, because now it's question time. Ladies and gentlemen thank you for listening.

And I don't have an answer to every question. But, I do have an answer. So, ask something please, and I'll...

### QUESTION AND ANSWER, JAMES GRANT

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**ANALYST:** [Inaudible].

**JAMES GRANT:** Yes, sir. Where should rates be? Let me give a cowardly but a historically grounded answer to this. In observing that the, you know, Sidney Homer, wrote this book called History of Interest Rates, and Richard Sylla is coauthor, is still around teaching at NYU. And I had lunch with Dick Sylla, and I asked, so what was the average American interest rate, going back to Alexander Hamilton? He said 6%, which is my...this would be the average corporate funding rate, it would be mortgage rates, it would be...and so you look, savings deposits rates would be 4%, funds raised in a low interest rate environment would be 2%. Long bond would yield...well for a little bit of perspective the 4.25 in 92 was the long-dated treasury in the late 50s, when the rate of inflation was much as it is today. That was when the Bretton Woods monetary system was enforced and the dollar was at least legally defined as 1/35 of an ounce of gold. So the monetary backdrop was different. But I would...so that's my idea of a yield curve kind of 2 to 6 and junk rates on top of that.

So the second part of the question is, will cause them to get there and when? I want to commend to everyone in the room an essay by the University of Chicago economist called John Cochrane, and he wrote a piece and you can access this on the grants...go to the Grants website and just look, I think there is a link Grants and John Cochrane. Anyways it was a National Affairs in 2011. I'm sure you can get the link through National Affairs. But the importance of this essay by Professor Cochrane is that he posits, and I think demonstrates convincingly that inflation is not always and everywhere a monetary phenomenon nor is it always and everywhere, anything except a fiscal phenomenon. Think of inflation as a kind of a measured sovereign default.

What happens...what precedes a proper measured inflation in the supermarket counter is the loss of confidence in the solvency of the sovereign...of the issuer of debt. They are not going to do justice to Cochrane's argument by summarizing in this fashion. But he asks us all to think outside the box of conventional thinking. He destroys the notion that inflation is for example, is impossible except for the existence of so called slack in the resource markets. You hear...also often hear it said that...Wall Street Journal they have to repeat this endlessly...that the borrowing, a tight labor market borrowing, rise in commodity prices, whatever borrowing high capacity utilization I should say, there can be no inflation. We need tightness and resource and labor markets. Well, Cochrane shows how frequently

inflation has been kind of the fourth horseman of the apocalypse with failed economies, with high unemployment, with the...all of the ills that the bad policy can impose on a society and economy, that's when you get inflation.

So again, I commend this to you...it really helped me think little differently about inflation and how it might occur and especially that it might occur unexpectedly. And Cochrane's underlying point is that we must appreciate how frequently problems come in challenging preset ideas; I think what the economist call model risk. And there is a certain kind of model risk in 2006 and 2007 with respect how structured mortgage products worked, and I think there is a certain kind of model risk today with the Fed's dynamic stochastic general equilibrium model and all of the offshoots of this, algebraic gobbledygook. So Cochrane writes in English, as did Morgenstern I commend both of those things to you.

I can comment, on the curious case in Japan with great depth of knowledge. My friend Alex Potter and I started a partnership in 1999, it's called Nippon Partners, and we sent a guy over there to be our scout and we invested for more than ten years in the...in kind of Graham & Dodd net-nets. And it was hugely frustrating because the managements never owned any stock and they seemed bound and determined, they not only wouldn't they get rich but also we wouldn't get rich, and we closed the partnership just actually a couple of years before the recent elevation in all of the Japanese equity averages. But Japan is a special case of social and financial rigidity it seems to me.

In 1920, in this country, wholesale prices fell 40%; wage rates fell 20%, and because wage rates were flexible to the downside businesses treated the collapse and product prices as temporary as it was. And the wage bill was such that profitability was almost instantly restored after the cyclical turn. In Japan there is nothing...that's one example of markets at work, of un-doctored markets at work. Japan is exactly the opposite. And people say that we are like Japan, we have to expect these years of slow growth, of stagnation, and this new/old idea secular stagnation which dates from Professor Alvin Hansen in the 1940's, late 30s and 40s. All this said, we have to be...we are going to be like Japan. Well, I don't believe we like Japan for the simple reason that this society is still, despite all the manipulations and the like, is relatively supple. We have immigration, we have the free exchange of ideas, we allow failure without shame. In Japan, you may not fail without embarrassment; and to a great degree, without shame. And one of the great America...not speaking directly to the monetary side of things, but I think it speaks profoundly to these, to the structural side of things. One of the American...secret paradoxical American strength is our attitude towards failure, okay, failed, great, when do we start the next venture? Now, that is a rarity in the world, and Japan doesn't have it. As for the Bank of Japan, it is now doubling down on QE, stock market was up 3%, that is where we...that's where we came in, that's when Nippon Partners came in. It was the top down imposition of policies met to raise up enterprise, which enterprise is not there. Enterprising people may be there, but the institution of a dynamic enterprise is not there. So yes, we have some similarities in this country to Japan's sorry state of stagnation, but substantively and more importantly I think we are...the two societies are very different.

**ANALYST:** [Inaudible].

**JAMES GRANT:** Sorry inflation or deflation, yes?

**ANALYST:** [Inaudible].

**JAMES GRANT:** I think in the event, I mean as it is now, the Fed is not so-called achieving, I can't [indiscernible] to say that, it's not achieving its target of 2% inflation. The PCE is rising about 1.1% or something, and...Janet Yellen is kind of stuck, she said, she was the one who wanted 2% to be nailed to the door and it is nailed to the door. They have...it seems to me to be true to themselves, they have to do this. Also to be true to themselves, they have to own the solvency of the financial system. They are in a bit of a bind. I think that if inflation continues to dwindle, which to me it ought to because it costs less to make things and provide services, it seems to me. They will meet this with still more aggressive policies and still more aggressive mind games about forward guidance. And woe betide our capital market because they will be distorted like pretzels I mean it might be a friendly and bullish distortion., Can you imagine how things would react Janet Yellen comes there, look, we are not getting the inflation we want, and until we do, it is all hands on deck for more QE and still more QE. Now, that would be some sugar high, but it would not necessarily improve the integrity of the pricing of our credit markets.

One last and I've got to get a plane, but one last thing on the mortgage REITs is the Bank for International Settlements I guess and some federal officials as well toying with idea of mREITs being like a systemically important part of our capital markets. To consider the...again to get back in closing to the idea of unintended consequences, zero percent savings rates for you Mr. and Mrs. Prudent American Saver, there must be some of them out there, zero percent for you, so please look for your income elsewhere. So five or eight years ago what was the total asset capitalization, not capitalization, what was the asset level of mortgage REIT business, \$50 billion perhaps, now it's \$500 billion. Now, it's systemically important and now the Fed is talking about a taper, an artful exit from its manipulation of money rates, and so what might be the unintended consequences on the so-called systemically important secular capital markets if REPO rates suddenly go crazy because the Fed forgot to calculate that part of the algebraic equation. It is a conundrum, but then again, tell us why you make big bucks.

So ladies and gentlemen, thank you, what a delight it's been to be here. Thanks for listening and I am going to go to Lagoon Airport, if it's possible.

**TOM SIERING:** Jim, before you go we have a little goody basket for you. We know your analysis of the markets is often global, so we wanted to make your wine collection just a bit more global. So please [inaudible] and could we have one more round of applause please for Jim Grant. So that's a tough act to follow. So we are going to have a bit of lunch and then we are going to break the segment up into actually four parts. So I am going to talk a little bit about 2013. Brad is going to give a financial update. Bill is going to talk about the markets. And then, I am going to come back and talk about how we think of the world going forward. So we will talk to you in a few minutes and please enjoy your lunch.

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## SAFE HARBOR, JULY HUGEN

Good afternoon. Sorry, before management begins its presentation, I would like to review our safe harbor statement. For those of you joining via webcast, I am July Hugen Director of Investor Relations. We wish to remind you, that remarks made by Two Harbor's management during this

event 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 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 and uncertainties contained in our filings with the Securities and Exchange Commission, which may be accessed on the SEC's website at [www.sec.gov](http://www.sec.gov). Our forward-looking statements are based on factors that are subject to change and therefore these statements speak only as of the date there given. We do not undertake any obligation to update or correct any forward-looking statements if later events cause them to change or become inaccurate.

With that, I'd now like to turn the program over to Tom Siering, Two Harbors President and Chief Executive Officer.

### **EXECUTIVE OVERVIEW, TOM SIERING**

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Thanks July. Great, for the benefit of the people listening to us on the webcast, I am going to be referencing slides; obviously those in the room will see them live. Before I dive into our presentation, I would like to thank PRCM Advisers, Parent Company Pine River and our Chairman Brian Taylor, without Pine River, Two Harbors simply would not exist. Special thanks to our board and all Two Harbors' personnel. To our investors and analysts both present and on the webcast, I would like to thank you for taking the time to attend our event today.

As I look across the room, I see many familiar faces, but also some that are new to us. So let's take a moment to discuss Two Harbors' history. We started very modestly in October in 2009 with \$124 million in total capitalization. We are excited that this fall will mark our fifth year of operation. Today, we are the largest hybrid mortgage REIT and we have delivered 88% in total shareholder return and 91% return on book value to our stockholders since inception.

Our total portfolio is over \$13 billion and we delivered a 10.4% total return on book value in 2003, handily outpacing the sector. Some of you may recall that in 2011, we identified an opportunity to begin acquiring a portfolio of single-family residential rental homes due to our analysis and experience in the residential mortgage market.

Many of the homes acquired were representative of the homes that populated our non-agency pools. After amassing a portfolio of homes, it was our belief that stockholders would benefit from the creation of a standalone pure-play single-family residential property REIT allowing greater scale and operational efficiencies.

In connection with the IPO of Sliver Bay Realty Trust, we contributed our portfolio of homes in exchange for Sliver Bay common stock. We were pleased to have met our goal to distribute this stock to our stockholders in 2013 by means of special dividend. It should be noted too that on a generic basis, this was done on a tax neutral basis.

As some of you may know, we are externally managed by a wholly owned subsidiary of Pine River Capital Management, a global asset management company. This structure affords us the access to

Pine River's extensive infrastructure and respective portfolio analytics and risk management. We also benefit from their imprimatur (Ph).

Turning to slide seven, I will admit I am proud of this graph. Since inception, we have grown from that small beginning of about \$124 million to \$3.6 billion as of few days ago after consideration of the Silver Bay common stock dividend in 2013 which amounted to a distribution of approximately \$346 million. This growth can be attributed to successful portfolio management and risk mitigation by Bill and his team and diligent financial stewardship by Brad and his department. This is a really nice segway into the next part of our presentation.

So for better or for worse, you often hear from me as well as Bill and Brad, but I would like to take a time to introduce you to other critical people on our team. Please stand as I call your name. Firstly, Rebecca Sandberg is our General Counsel and Chief Compliance Officer. She has been with Two Harbors since 2010, first serving as Corporate Council. In 2013, she succeeded Tim O'Brien as our GC. Tim remains Pine River's General Counsel. Rebecca's background includes extensive work on securities laws, M&A, capital market transactions and corporate governance, not surprisingly our businesses is increasingly leeway (Ph) and tense (Ph).

Matt Koeppen, Matt is to my right. Matt has been with us since 2010 and is most focused on portfolio management and hedging. Matt came to us from Black River Asset Management, a Division of Cargill. Interesting to note that Brian Taylor and I are also Cargill alum and has most...his efforts primarily on our agency positions.

Bill Greenberg, Bill joined us in 2010 from UBS, he has extensive...an extensive background in both mortgage trading and portfolio management and has also spend a bit of time in academia. You often hear the expression, well, gee it doesn't take a rocket scientist, well, sometimes in the mortgage market it does, and one of Bill's many accomplishments is that he has PhD in Nuclear Physics.

Here we are. Victor Baev, Victor joined Pine River's RMBS team in 2009, today is a key member of our non-agency and credit trading effort. Non-agency performance has been a significant source of alpha in our portfolio.

Nick Smith, Nick joined Two Harbors in 2010 after serving as a CIO of Green Tree's capital markets division. Nick oversees our MSR and conduit platforms.

Dan Koch, I'd like to tease Dan that he pronounces his name situationally, so if he is looking for a hotel room in New York, its Koch, if he is discussing politics, its Koch, but in fact its been...it has a most...the least familiar pronunciation of Koch. Dan came to us from Redwood Trust; he has tremendous experience in sourcing prime jumbo mortgage loans and developing strategic initiatives with our origination partners.

Diane Wold, Diane has been key member of our business development team since she joined in 2011. Her background at GMAC ResCap included a variety of roles ranging from structured financing and master servicing to investor relations. Diane also serves on the board of SFIG. Interestingly too, she has a very long history with the agencies and the rating agencies.

Bob Rush, Bob joined Two Harbors in 2013 and previously served in a senior risk management role at UBS. Bob works closely with Paul Richardson, our Chief Risk Officer, who unfortunately isn't here with us today.

Marcin Urbaszek, Marcin came to Two Harbors from Credit Suisse. He has a strong skill set in business development and evaluating strategic opportunities as well as a deep knowledge in our mortgage REIT and banking sectors.

And we just heard from July. Some of you know, July our Director of Investor Relations. I would like to thank her for amongst other things, putting on this fine event. I would also like to thank Beth Thompson and Maggie Field for their help in arranging today's presentation.

So let me take a moment and talk about 2013. In 2013, we increased our market capitalization by about \$400 million, even after the distribution of Silver Bay. In the second quarter, was really a watershed period for us as we closed on the purchase of Matrix Financial Services Corp., which had agency seller-servicer approvals, this represents a significant step towards adding mortgage servicing rights to our portfolio.

In the third quarter, we were pleased to close on two small bulk MSR portfolios and completed securitization using our own depositor. We are very excited to announce both the flow sale and bulk agreement to purchase MSR in the fourth quarter.

Lastly, I'd like to note that our wholly-owned subsidiary was granted membership in the Federal Home Loan Bank of Des Moines, representing another excellent long-term source of financing, as well as other services.

For those of you who are listening to us via the web, I am now on slide 20. Let's take a look at what we have accomplished in the past four years. After Bill's remark, I will talk more about the opportunity ahead.

In 2013, as I mentioned, we delivered a total return on book value of 10.4%. This was a very strong performance relative to our peers, and in a challenging year for the fixed income markets this alpha generation can be attributed to thoughtful security selection and sophisticated risk mitigation protocols. Bill and the investment team enjoyed excellent results, despite volatility in rates and a turbulent environment for MBS spreads.

One of the most important things we accomplished in 2013 was the preservation of our book value given the market environment. This is critical as protecting book value will allow us to deliver dividends for our stockholders in the future.

We can see on this slide a breakdown of the returns we have generated from book value and to dividends historically. We are proud of the fact that we have had positive shareholder return every year since our inception in 2009.

Turning to slide 21; we measure total return as a combination of dividends and capital appreciation, both of which have contributed to our strong historic performance. You can see here, our total return relative to the Pine River Mortgage REIT index, we have established....an established track record of

delivering attractive total return. We remain committed to delivering strong returns in the future, and we'll talk later about some of the ways we think we can achieve that.

This is I think an interesting slide. It is worth taking a moment to consider our results relative to the performance of the 10-year Treasury Index. In 2013, the total return on the 10-year was negative 7.7%, as a reminder, we delivered total return on book value of 10.4%. Our performance contradicts the notion that all mortgage REITS are built upon carry, interest rate risk, and leverage. These metrics really frame our results relative to the macro background during the year.

I will now turn the dais (Ph) over to Brad for a financial update.

## FINANCIAL UPDATE, BRAD FARRELL

Thank you, Tom. Good afternoon everyone, it's a pleasure to be speaking with you this afternoon. It does not feel like a year and a half has passed since our last Analysts Day. The time flies when you are busy, and we admittedly have been very busy.

Today, I would like to reiterate my views on the key fundamentals of financial stewardship. While our business has become more diversified, and to a certain extent more complex, since we last met, my role as CFO remains grounded in these items on slide 24. But I will not touch upon all of these items in my prepared remarks; I do intend to discuss our 2013 financial performance and our dividend considerations; comment on our expenses and ongoing expense management efforts; provide an update on our financing profile and emphasize our approach to counterparty management, including further color on our subsidiaries recent FHLB membership. And conclude my remarks with a brief review of two accounting matters we introduced in 2013.

Our primary objective is to deliver total return to our stockholders over the long-term. We accomplish that through dividend distributions and book value growth, as well as preservation during times of volatility. We use fair value accounting where allowed under GAAP, as we continue to believe this allows for our book value to be monitored by our stockholders, and represent a true reflection of our portfolio performance and dividend power. As a REIT, we also focus on taxable income when considering our dividend as we distribute 90% of our taxable income via dividends, and specifically in 2013, it was our aim to deliver a 100% of our taxable income in order to return capital to our stockholders that was equivalent to the value of the Silver Bay common stock distribution

You will note that the core earnings metric is not disclosed as a key operating metric on this slide. As we have noted in past earnings calls, core earnings is not a driver of our dividend as we make total return decisions which can often reduce core earnings for a period of time. We do not intend to generate an inflated core earnings metric by increasing leverage, rate exposure or other portfolio risks when we believe the introduction of such risks could lead to book value deterioration. As such, we focus most on two operating metrics, and I can expand upon further, comprehensive income and taxable income.

Let's look at our historical record on slide 26; and our record of growing and preserving book value or generating dividends for our stockholders. While there is quite a bit of data here, a few observations can be made. You will see our year-over-year comprehensive income on the upper left.

This metric was truly outsized in 2012, but we are actually just as proud of the strength of this metric in 2013 given the performance of this sector.

With this in mind, the upper right quadrant shows that our cumulative comprehensive income performance has exceeded our cash dividend distributions by more than \$400 million. As one would expect, our taxable income has consistently aligned with our dividend distributions and complies with our REIT requirements. And on the bottom right, we depict our book value and dividends declared. At year end our book value was \$10.56 per share, and we delivered \$2.18 in dividends per share including Silver Bay stock. And investors, since our inception in 2009, has received \$7.23 per share in dividends.

Together these four quadrants illustrate how we have achieved our objective to date, to deliver total returns to our stockholders. While we do not intend to provide guidance on our dividend for future periods, we thought it was important to illustrate the significant gap between our consolidated core earnings and our REIT taxable income.

As you can see over the past few years, REIT taxable income has consistently varied from core earnings, primarily due to discount accretion on non-agency RMBS, capital gains from our RMBS portfolio and our use of our TRS or taxable REIT subsidiaries to conduct meaningful business activities. These differences are inherent in our non-agency holdings, our use of robust hedging tools and a diversified operational platform which includes licenses and approvals to acquire loans and MSR in our taxable REIT subsidiaries.

Before moving on from taxable income, I will briefly reiterate some tax information for 2013 and how we achieved our objective to return capital to our stockholders. In 2013, we declared dividends of \$772.9 million, the combination of four cash dividends and our Silver Bay stock. Separate from Silver Bay dividend, it was our goal to distribute 100% of our taxable income and any prior year carryover through our cash dividends. Excluding the Silver Bay stock distribution, we distributed 427.1 million which equated to approximately 100.3% of our taxable income at December 31, when combined with the carry-over from the prior year. That being said, the Silver Bay special dividend did make 2013 a unique year from a 1099 perspective.

Specifically, in accordance with US Tax Law, the Silver Bay shares could now be treated separately from our cash distributions. As detailed on slide 28, we had taxable income of \$425.6 million which represented 55.1% of our total distributions of \$772.9 million for the year. As such 55.1% or approximately \$1.17 per share of our total distributions for the year were treated as dividend income with the remaining \$0.95 per share treated as return of capital to Two Harbor stock holders.

Before, moving off our financial performance, I did want to make...I did want to make some comments on expense management and the correlated growth in our operational platform. The upward trend in our expense ratio as percent of average equity over the past six quarters has been driven not only by our variable expenses that correlate with the size of our investment portfolio, but new business opportunities related to our conduit and NMSR (Ph) investment, as well as other initiatives, which creates franchise value and should ultimately drive shareholder return.

Internally, we are active in our expense management oversight focused on minimizing overhead cost and maximizing our allocation of dollars whereby the cost incurred contribute to the returns on our new business initiatives.

Going forward, other operating expense ratio will ebb and flow based on certain variables including asset volumes and transaction expenses. It is hard to predict an exact number as many of our investments in our operational platform will be dependent on the market opportunity. But generally, we feel the current expense ratio is a good reflection of our near-term expectations.

Moving to slide 30, this slide provides a nice overview of our portfolio as of December 31, with respect to the way we think about our capital allocation, portfolio liquidity and financing sources. Some of the brief highlights of our capital and financing structures are; our overall capital allocation at year end was 57% rates and 43% credit. We have a variety of funding sources for both our rates and credit portfolio as you will see on the far right.

Our allocation to agency RMBS declined from 54% to 44% at year-end as we shifted capital toward MSR, which we believe is the most attractive area for us to invest in today. Our MSR increased from 1% of capital to 13% at year end with the announcement of both bulk and flow arrangements. We expect to allocate more capital to MSR going forward. From a financing perspective, MSR is cash funded today although we may apply leverage in the future if financing becomes available.

As we noted on the slide, we view MSR as a less liquid asset and we will continue to adjust our liquidity management and response. Although MSR currently has an active buyer demand in the marketplace, it also has a lengthy settlement process that includes the approval of the GSEs.

Our non-agency RMBS declined from 45% to 43% at year end, as we sold some bonds that had reached their full potential. We utilized repo to finance non-agencies and can use the FHLB for financing bonds with current ratings of Single A and higher. I will discuss the FHLB more in a moment.

We have two warehouse facilities in place to fund our CSL or Credit Sensitive Loans and Prime Jumbo Mortgage Loan Collateral. And can also use the FHLB to finance mortgage loans. As noted, we also have a depositor in place Agate Bay and can establish term financing through a securitization market if we deem beneficial.

As of December 31, we had a total of 20 repo counterparties with amounts outstanding providing RMBS financing for approximately \$11.1 billion in the form of repurchase agreements. We have been successful in diversifying our funding across counterparties over time, as we have raised capital and grown our portfolio.

Our counterparties did not change significantly in 2013 as we were comfortable with our available capacity and counterparty mix. We've spend a great deal of time focusing on liquidity management. We have historically disclosed what we believed to be a prudent duration and laddering of repo maturities across both our agency and non-agency portfolios.

Internally, we have a dedicated margin team and robust proprietary tools that allow us to monitor and project excess liquidity on a daily basis and frequently stress test our portfolio against a number of potential shifts in market value and/or shifts in counterparty advance rates.

We believe our focus on liquidity and stress testing is an important facet of our risk management process. While the increase quantity of our counterparties is valuable, we also believe the quality of those counterparties are equally important, you will recognize the slide from prior presentations, but it is an important focus of ours.

I would specifically note on the slide, our non-agency portfolio is heavy weighted to high credit quality of our counterparties with a less liquid asset, 100% of our financing is held with counterparties that have CDS spreads less than 150. The financial health of our counterparties is something our counterparty management team monitors on an ongoing basis.

An illustrative example of some of the things we focused on are included on slide 33. Discussion on our focus on diversification of our counterparties is a nice introduction to the next topic. As briefly discussed by Tom, after several months of discussions, our subsidiaries grant membership in the FHLB in the fourth quarter.

Our subsidiaries intent to establish FHLB as counterparty was largely focused on our objective to provide capital to the residential housing finance market. This objective aligns nicely with FHLBs remit (Ph) to provide funding and liquidity to its members. So in turn, they can provide capital solutions to their lending counterparties.

Currently, we have access to \$1 billion of available uncommitted credit for borrowings, which may be secured by conventional 1-4 family residential loans, agency mortgage-backed securities and non-agency mortgage backed securities with an A rating and above among other collateral types. The amount of available credit can increase or decrease at the FHLB's sole discretion as it is uncommitted in nature.

Before, I briefly detail some of the benefits of FHLB membership; I would like to clarify two key points. First, our ability to borrow from FHLB is subject to our continued credit-worthiness, pledging of sufficient eligible collateral to secure advances, and compliance with certain agreements between us and FHLB. Second, we do not envision using the FHLB as a replacement for the repo market, which continues to function in a highly efficient manner.

Our primary intent with regards to financing is to optimize our overall funding structure. Thus you can expect us to utilize the FHLB to finance whole loans and/or highly rated tranches generated by private label securitizations as they finance well within FHLB, and we also may utilize the financing for agency mortgage-backed securities.

We believe FHLB membership is a novel accomplishment for Two Harbors and a few of the inherent benefits of FHLB advances include diversification of our counterparties so we can be more efficiently respond to market events as well as optimize our daily funding mix relative to advance rates and borrowing rates.

We have financing maturities up to five years for eligible collateral and in certain cases longer. Lending rates are generally LIBOR to LIBOR plus 30, with advance rates comparable to a little lower than market terms. FHLB offers fixed and floating rates which provide us flexibility from a hedging perspective. And advances are not a direct repo against the security or a loan. So there is much more flexibility to pledge collateral over time.

Given we are the first public mortgage REIT to have a captive insurance subsidiary gain membership to the FHLB, we thought this would be a good opportunity to share some additional illustrations on how we might look at the FHLB advances versus the available market funding terms.

I would stress these are only illustrations, you will see through these comparatives, they are not all eligible collateral that makes sense to be funded by the FHLB depending on our objectives concerning the term of the funding.

As called out, the repo terms of a short-term funding of agency pools is typically more appealing do better advance rates. In this case, FHLB offers only a further level of diversification in our financing platform.

What the slide does illustrate is that the ability to borrow for more than one year in the non-agency and mortgage loan space provide this opportunity to generate additional investment returns. Again, our subsidiary has limited funding capacity from the FHLB but the FHLB does... furthers our ability to manage our financing in terms of diversification, advance rates and borrowing costs.

As Tom highlighted earlier, MSR has become an important part of our portfolio. The accounting for MSR is governed by ASC 860. ASC 860 allows for servicing assets to be valued by either the amortization or fair value method. And with our other assets Two Harbors has elected to account for MSR at fair value, this is an important note as we believe it reflects the economics of our business.

As of December 31, the fair value of our MSR asset was approximately \$515 million versus approximately \$16 million as of September 30, 2013. The majority of this increase stems from the Flagstar bulk transaction, which was announced in December. Going forward, fair value will fluctuate based on coupon rate, prepayment speeds, delinquency rates and discount rates among other variables. I would note that MSR can be a volatile asset that can be subject to significant swings in net present value. The MSR valuation should not be viewed in isolation as it serves as a hedge to our agency RMBS portfolio.

In the chart on the right side of the slide, we detailed the fair value assumptions of our current portfolio. During the December quarter end...during the December month end, the company recognized \$10.8 million of servicing income, \$2.2 million of sub-servicing expense and \$13.1 million increase in fair value of MSR. The positive fair value change includes an underlying estimate of amortization expense of \$5.4 million which represents the run-off and unpaid principal balance on the underlying collateral including prepayments. When modeling our MSR yield, it is important to include the amortization component.

Throughout 2013, we completed two securitizations. Our net economic interest in securitizations was a \$153 million at December 31 or 1.1% of the aggregate portfolio. The accounting for securitizations is also governed by ASC 860, which outlines two primary accounting paths for securitization transactions; sale treatment and financing treatment. Two Harbors has deemed the primary beneficiary of the trust through its subordinate in IO servicing bonds as we retained both the power to direct the activities of the securitization trust and its servicer which impacts the trust performance and the ongoing obligation to absorb losses or the right to receive benefits of the trusts. As a result, we consolidate these trusts on our balance sheet.

In the future we might determine our underwriting and due diligence procedures in regards to the collateral, allows for us to not hold these rights and recognize gain on sale accounting treatment. But for now, we feel these rights assist us to optimize the performance of the collateral. And with our fair value election for the mortgage loans held for investment and collateralized borrowings on the balance sheet...on balance sheet treatment mirrors the economics of the retained interests in all material respects.

Thank you for your time today. Now, I'll pass the podium over to Bill.

## STRATEGY UPDATE - BILL ROTH

Good afternoon and welcome everyone and to those on the phone. My presentation begins on slide 39. As we've discussed a couple of times earlier today, our overall philosophy is to deliver attractive returns on a risk adjusted basis; and in doing that, we intend to opportunistically allocate capital to those opportunities that we see in the market that we think are most favorable.

We focus at Two Harbors on two distinct strategies; the rate strategy and the credit strategy which we'll talk a lot more about in a little bit. But before we do that, let's take one more look back here. And you'll see on slide 39, a total return on book value since inception of a little over 91%. That's all well and good, but equally important to us is the volatility around those returns, and as many in this room know sharp ratio is a measure of the quality of return which compares return to the volatility associated with that

You can see our quarterly book value, volatility versus peers, as well as the fact that our share price volatility is substantially below the peers; and importantly to us, actually is almost quite as good as the index which for you math folks out there is... will recognize as quite an accomplishment to be proud of.

So moving to slide 40; our rate strategy intends to extract value from the agency RMBS market and focusing on all sorts of asset types in different sectors. We intend to apply sophisticated hedging techniques, utilize our MSR platform to enhance returns and reduce risk, and protect book value exposure especially as it relates to tail events, one of which we just experienced in 2013. And then lastly; to use tactical trading, primarily in the TBA market to generate additional alpha.

On the credit side, it's our intent to apply a substantial credit expertise to add value in the non-agency market, to create new products through our conduit platform, and then continuously evaluate and assess any other new opportunities that might make sense for us to add value through our use of credit. Finally, to utilize credit and/or interest rate hedges were appropriate. And then finally, at the end of my section after reviewing the rates and credit strategies more thoroughly, we will talk a little bit about Two Harbors looking forward.

On slide 42; we will see that our total portfolio composition at the end of the year was \$13.7 billion, \$10.2 billion of this which is in the rate side of the equation with the balance in credit. If you do the math in terms of our capital allocation which was 57% to rate and 43% to credit, you will see that our

combined leverage overall was in the high twos. Within rates, agencies made up 44% of that allocation and MSR 13%. As has been discussed earlier today and in past public forum, we've said that, we anticipate that our MSR allocation will continue to grow as we increase the use of that platform.

On the credit side, it's our intent to continue to focus on assets with upside potential which we'll discuss in great detail in a little bit. So first let's talk about the rates side of the equation. On slide 44, you will see the rates component to the portfolio. Our focus here is to utilize as we mentioned as many hedging techniques as we can think of to drive value and protect book value.

At the end of the year, we had \$10.2 billion in this portfolio, including the MSR, as well as all our agency securities, and our rates leverage on a combined basis was 3.6 times. Keep in mind, if you've listened to us over the past several years, we've said that, our target long-term range is for a lot...is more in the 6 to 7 times for the rates for agency strategy.

We will talk about why we are caring lower leverage today than that historic target range. And if you look at the bottom, you will see there is a little bit of lead in here, trend in rates we heard Mr. Grant speak eloquently about the Fed and it's impact on the markets. You know prepayments is something we certainly think a lot about; although given that the market has sold off somewhat in much of the agency RMBS universes is out of the money that's less of a concern today. Everyone in this room and in this space is obviously paying attention to the fates of the GSEs.

The second bullet point, we are going to spend some time on here, and that is that agency spreads remain tight and generally not that attractive to us, which is why our leverage is low at this point in time. Furthermore, we expect that as the Fed continues to extricate itself from the market, that spreads will revert to more attractive levels.

So let's take a quick look at the overall landscape here. What we saw last year is...we saw on the top left is a dramatic increase in the tenure rate, although, recently we've seen a stabilization with it bouncing sort of between 2.5[%] and 3%. We've seen the curve steepen out; on the top right you will see 2-5s and 2-10s. And then on the bottom, I think this is a really interesting bar chart to take a look at.

On the bottom of the slide 45, you will see, courtesy of our friends at Barclays, a 10-year history of OAS and ZV-spreads on agency mortgages. And what you will see is that the average OAS over this time period, and this is a long time period, it includes time periods and spreads were very wide as well as very tight, is about 12 basis points wider than where we are today. At least as interesting is the Z-spread is substantially tighter 81 is the average and more recently we were at 47. So what are the implications of this? Well, OAS is...it's always good to have a high positive option-adjusted spread because that's what you think you are going to earn over a long period of time. But when your spread...your nominal spread is so tight and part of that is due to the great decline in volatility that we've seen in the last six months, it just makes it very hard to extract a net interest margin that's attractive.

On slide 46, we point to some more indicators as to why we might see spreads widen. Many people like to look at agency mortgages versus the five- and ten-year blended average as an example and we

can see here that the historic average is 148 basis points and as of the end of January, we were 21 basis points tighter than that.

Furthermore, if the Fed is not buying them, might money managers buy them? If you take a look on the right, you will see that agency mortgages versus investment grade corporate bonds aren't that interesting either. So if you listen to Mr. Grant's comment about corporate bonds, you could extract the same comments about the richness of corporate bonds and apply that to agency mortgages as well.

Lastly, on slide 47, you will see that when you cut through all of this, you say well mathematically, are they attractive, or are they not. So one thing that you can look at is what are the ROEs to actually buying these things and hedging them. Before I go into the slide and actually when I am done with this slide, I am going to say the same thing, that the numbers you see here do not include hedges for volatility. And that's very important because if you buy mortgages and you just hedge with a single point on the curve and you don't hedge the convexity risks, you are putting your book value in danger to moves in rates. So that being said, if you take a look at left side of slide 47, you will see that for the lower coupons, ROEs are actually negative. I've got to advance the slide, sorry guys, thank you. I had done it on here. It didn't help anybody else though. So you will see on the left hand side of slide 47, that ROEs are anywhere from awful to not too bad, but I remind you once again, this doesn't include volatility hedges, which are going to bring these numbers down several hundred basis points.

Furthermore, if you look back on the right, we have a 13-year history of historic agency ROEs. And I am going to emphasize this is a toy model and I just quoted that for those of you who are on the phone, which is just meant to be an indicative model to tell you where ROEs are in any given point in time. And what you'll notice is that basically for the last couple of years, agency ROEs have generally not been that attractive. So I will circle back to our positioning. I will circle back to our positioning in a minute and indicate where we stand, but if you look at our low leverage, you can understand why because if mortgages widen, we want to have low risk on the table and be able to apply that to better opportunities.

So let's switch for a minute to the mortgage servicing rights part of the rates discussion. Why we are interested in MSR? We are interested in MSR because they have positive yield, negative duration and they help hedge mortgage basis risk. Now, there are two types of MSR. The first is legacy MSR, which are generally originated during or before the crisis, typically have a HARP recapture component, exhibit high delinquencies and need substantial amount of high-touch servicing. That is the sector of the market that we are not generally interested in. We are interested in a very high quality, new issue, highly negatively lead durated (sic) and low credit risk asset, which really relates to new issue MSRs you see on the right hand part of this slide.

Moving to slide 49, and we've covered this a little bit before, so I won't go into it in great detail, but we made a lot of headway in 2013 going from being approved as a Freddie servicer, acquiring Matrix, to at the end of the year having two very high quality relationships in place, and a market value portfolio in excess of \$500 million of MSR.

So, let's turn to slide 50, this is the slide that we are really happy to talk about today because we had a number of questions in terms of, "Well, if you own MSR, what does that do for your returns et cetera, et cetera?" So here we have two illustrative portfolios. The portfolio on the left is an agency

only portfolio with no MSR. So we start with \$100 of capital, we are going to use debt-to-equity of seven times. So we end up with \$800 of agency RMBS and for simplicity sake, we are going to hedge them with just a five-year swap.

Now, I am not trying to say that this is the best strategy. We saw what ROEs...potential ROEs were on a prior slide, but this is just for example purposes to show no MSR versus MSR. So you can see at the bottom in the red circle, the expected ROE here to this portfolio is about 7%. It's got 7 to 1 leverage and to the extent that agencies widen 10 basis points, this portfolio would suffer a book value loss of about 6%.

Now, if we move over to the right and we take that same \$100 and we divide it a little differently, 25% to agencies and 75% to MSR, you will see that we end up with \$200 worth of agency bonds, \$75 of MSR, but yet we generate — assuming that the MSR yields 8%, — we generate an ROE of little over 12% with much lower leverage and the same interest rate exposure, which is we're duration neutral. However, if you look at the far right and at the bottom, you will see that this position is actually net short-mortgages, which means that a widening in agency mortgages means that you make a little money. Now, these are two dramatic extremes. Once again, neither of these includes hedging volatility and it's a lot more complicated than what you see on this slide, but the point is that if you add MSR to a portfolio, in this case we are showing about 500 basis points pickup to the ROE with lower leverage and reduced basis risk. The reality is that when you get through with the variety of other hedges you have to add and excess margin you carry, you pick up several hundred basis points, but the point is this is a much higher quality return and with lower risk.

So, how much MSR could Two Harbors reasonably utilize in our portfolio going forward? So this is a look back in time to the amount of capital that we had allocated to agencies in any given point in time based on our total market capitalization and ranges from 50[%] to 100%. In other words, if we had allocated 50%, 75% or 100% of our capital just to rates; and so if you look at the far right, today we have about 57% capital allocated to rates. So you will see the little red X is how much our market value of MSR is today, a little over 500 million, but yet without changing our capital allocation we could actually move up to that grey line and have over a billion of MSR without changing capital allocations to increase more to the rate strategy. Certainly in the extreme, if we allocated all of our capital to the rate strategy, we could have much more than that. But in the past, we've said that we are very comfortable going up to a billion of MSR and this sort of shows you why that is the case.

Okay, based on what we have talked about so far today, we've determine agency spreads aren't that interesting. MSR is actually very interesting and we are hoping to have opportunity later this year to take advantage of more normalized or attractive spreads in the agency market.

So what slide 52 shows is our positioning as of the end of January. And there are a few things I would like to point out here. First, and by the way this includes TBA short or long positions. You will see at the top in the 30-year bucket, we are primarily positioned in higher coupons, which if you think back to that slide where the attractive ROEs were, that's exactly in line with our positioning. If you look at that slide from before with the negative ROEs on the lower coupons, you can see that generally we are net short that to the tune of about \$0.7 billion. Furthermore, you can see the MSR, which has negative duration of 600,000 or so Dv01, and what Dv01 means, is that the dollar value of a one basis point move, so in other words if mortgage rates go up one basis point, MSR is expected to make \$600,000.

So as you move down the slide, at the top part you will see that the bulk of our long positions are in fairly short duration instruments, hybrid ARMs we have about a billion of those. Those are typically three to four year average life. HECM's those are typically shorter average life et cetera. So if you look at our overall rate exposure as of the end of January, negative \$190,000. That's essentially flat in the grand scheme of things given our \$3.8 billion equity base.

The other thing I'd like to highlight on this slide is our basis exposure. One of the things we saw last year was when rates went up and mortgage spreads widened, that caused a lot of highly levered agency strategies to have problems. So you will see that our basis exposure here for agency's positions greater than five years in average life is only 474,000 per basis point.

Now, I want to make a comment. There is a line here that says CMM/CMS exposure. What that position is, it's a synthetic position that is meant to capitalize on wider mortgage spreads. So it's like a CDS, if you will. So that means if mortgage spreads line, we actually make money on that position. If mortgage spreads tighten, we would end up losing. So while we are still net long, that's part of the short position of the current coupons.

And then finally, our net long basis exposure for shorter instruments is actually substantially more. So when you add it altogether, it's about 2 million per basis point, which if you look at the bottom right, means that for a 10 basis point change in the mortgage basis, we expect to make or lose roughly 0.2%. Now, I am sure I am going to have some questions on this slide when we are done, so I am going to keep going, and we'll talk about credit.

We are now on slide 54. So our credit portfolio as we talked about in the past is about \$3.5 billion. And I would like to point out that we did see very strong returns, not only last year, but in prior years to the credit strategy, and in addition, we are very proud to have made a lot of progress building out the foundation of our mortgage conduit program to help make create our own credit investments as the legacy portfolio pays down over time. The leverage on the credit book as of the end of the year was 1.1 times.

So for the outlook, we have a couple things. We see continued improvement in housing metrics. I think the general analyst projection is about up 5% this year with some continued growth in the further years at a small pace. We continue to see and expect better borrower performance, and one thing we will touch on and see how impactful this can be, is we expect the prepayments on legacy securities over time to improve. And this will be non-trivial in terms of our long-term returns to that portfolio.

So if I had had time, I would have taken Jim Grant's little cartoon about the guy crawling in the sand saying, "I need yield. I need yield." But unfortunately, I couldn't get him on to the slide, but I think you will get the idea. The Fed's QE program has investors searching for yield; they are searching for kind of anywhere they can. And if you look at credit performance in 2013, that's exemplary of that. Both IG high yield and ABX are at or near post-crisis highs, and I am not going to opine on the relative attractiveness of IG or high yield, but what we will see is that non-agency mortgages still provide attractive returns relative to other opportunities.

And on slide 56, you can see exactly that. You will see that this is a variety of instruments from corporate bonds to CLOs et cetera, and you'll see that the red circles generally cover non-agency

sectors that are interesting to us. And you can see that while yields are well below what we saw in 2011, they are still at the top of the stack.

So people said, “Well, geez, non-agencies have done well. Why is that the case? Is there still upside, what’s your expectation on that?” So let’s just take a minute to talk about what’s driven non-agency performance and what might drive it going forward?

So as many of you know, the bulk of our holdings are in sub-prime space, and those are in areas that have had strong housing performance, not since 2006, but for the last few years.

Last year the national average HPA was about 11%, but in predominantly subprime areas HPA actually was much higher. Furthermore, nationally, we are well below the peak, in excess of 20% below the peak prices that we saw in 2006 and if you look at almost any measure, affordability still remains high, well below historic average. So why don’t we take a visual look and see what’s happened in various parts of the country that have predominantly subprime exposure?

So we are going to start with one here that may not be the highest proportion of subprime, but Phoenix area is generally a poster child. From ’06 to ’09, Phoenix went down 46%, and while the last two years have seen about 13% per year, you’ll see the yellow bar there still shows Phoenix 30% below the peak. Probably the biggest area Riverside San Bernardino got crushed down 50% and that yellow bar shows they are still 34% below peak.

If we move to the northwest, the Seattle area didn’t fare as bad going down 18% but has had only a modest recovery and is still about 11% below the peak despite a nice year last year. Moving to the mid-west, down 24% ’06 to ’09, down again 13%, they only had a modest rebound and are 26% below the peak. If we move to the nation’s capital, you’ll see 25% drop, followed by a couple of years of up a little bit to leave them about 13% below.

Closer to home here, Nassau and Suffolk County down 18%, which was probably a great outperformance but then didn’t do much, and it’s still 20% below the peak. And then for any of you who can get a flight to get down to Southern Florida, where the weather’s been a lot better, down 46% and despite all the stuff you read in the press about this great recovery, up 10% the last few years leaving it 35% below the peak.

So if you look at this, you see an overall conclusion, is that while we had some really nice price performance in different housing markets, in the last year or two years, many markets remain well below 2006 levels. With affordability about 25% better than historical average, we expect to see continued HPA performance although at a lesser pace, which we think will help drive our non-agency performance going forward.

So for those of you who’ve been with us for a while, we are going to take a trip through memory lane. Slide 58 is a slide that we have pulled from a presentation in 2011 that showed, why we so much liked non-agency discount bonds. And I am not going to spend a lot of time on this one or the next slide, but the point is to sort of talk about where are we now. So you will see this bond was 54 bucks in September of 2011. The expected returns were 10% plus or minus and there was generally no expectation that we would recover par on this bond.

So let's take a look at this bond today. For a variety of reasons, some of which we discovered on that little video, this bond at the end of the year was marked at \$87 or up 33 points or roughly 60% in two years. Furthermore, the yield was still actually reasonably attractive around 6% and you can see at the bottom, that there was very little chance that this bond does not receive par. In fact, this bond next month will start to get its first principle payments at par as it becomes the senior bond; the bond in front of it's paying off.

So you are going to go like, "Geez Bill, that's great. Can you do that again?" And the answer is, well probably not. But nonetheless, we think there is still a lot of excitement in our portfolio and in the markets today.

So taking a look at slide 60. In this slide we are going to spend only a bit of time on, I didn't want to go through all of the nuances of this bond. But if you look at this bond, here are the important points to note. It's priced at \$58. The expectation is that it's going to return about 6% and it might be less if things get a little hairy. But what's really interesting is what it might do in a continued recovery. And I think the biggest thing that drives this is the second line called expected prepaes. This bond obviously has a decent amount of delinquencies in it, about 40%, but that still means 60% of the guys were paying and every month it goes by that their house price might go up a little bit and that they keep making the payment, they get more and more equity in their home. So this bond has been prepaying at 2% voluntary, meaning either turnover or refi or whatever. But if you expect that to persist for the remaining 24 years of its life, that's, in our option, fairly unrealistic. And you can see that if you just move prepaes up to 4%, even though we are assuming some lesser defaults, the biggest driver here is in the prepay. So we are not expecting that to happen tomorrow, but this just gives you an example of the kind of things that are still out there in the market that could drive value through our portfolio.

So, turning to slide 61, what you will see is that our portfolio remains firmly entrenched in the lower dollar priced sector of the market for all the reason that I have just discussed, senior bonds, mezz bonds and total. The market price, the average market price of the portfolio at the end of the year was about 66 bucks. What we have been doing is we have been selling out bonds that are priced at much higher dollar prices where the upside has actually been realized, and recycling that money back into the lower dollar priced bonds such as what we just saw.

So let's take a look on slide 62 at our overall positioning and credit. What you will see is, as I just mentioned, we have been selling higher dollar priced bonds and rotating into lower dollar priced bonds. We have about \$3.5 billion market value primarily in non-agency subprime, but also in some loans as you will see in the next two lines. And from a rate standpoint, we have added hedges although only on a partial basis because our concern was that if rates go dramatically higher, that might impact the values, okay. Oops sorry, I apologize. This thing didn't work, that's why.

Okay, so let's talk about credit going forward. As we talked about before, our intent is to diversify our business model to become more operational, to be able make credit investments for our portfolio out our conduit platform. You will see here that we have approximately 30 originators in some stage of approval, and we are targeting to have 40 onboard by the end of the year. Our intent is to source a variety of products. Today we are focused primarily on prime jumbo, but it could also include MSR, which dovetails nicely with that platform and at some point in the future potentially other products.

So moving to slide 64, prime jumbo. The intent here is to capitalize on a reduced role of the government in our business. As Tom mentioned, we completed a couple of securitizations last year, including our First Agate Bay deal. Our expectations is that securitizations won't be substantially higher in 2014, but if you look at the chart on the bottom, you will see that there is demand over time and while maybe \$250 billion of securitizations in 2003 wasn't the right number, \$10 billion in 2014 also isn't the right number. So if you look at our long-term average, and we say \$90 billion a year, even a small market share of 5% can drive several hundred million a year of bonds for our portfolio.

You can see on here there are some impediments, I think they have been pretty well discussed, but we are looking at this as an opportunity not just for this year, but for long-term. One thing we get asked a lot about and there has been a lot of chatter in the market is this whole line in the sand of QM and non-QM. I'm not going to spend a lot of time on this, but just to say that non-QM actually represents a very large segment of the market. What you will see is that there is about \$800 billion that are not in the agency securities of some sort. We are talking about of the securitized base. There is \$6.3 trillion total and about \$5.5 billion in GSE and Ginnie. Of that \$800 billion about \$500 billion is below 720 FICO. Now, I think everyone here would all agree that not all of that \$500 billion are worthy of being home owners. Some of them may be in homes, but they are highly delinquent et cetera. But even if you haircut that number dramatically, you can see that at some point in time, there is going to be an opportunity to provide credits to those borrowers. Currently, we are focused primarily on our prime jumbo and expanding that network, but I wanted to point this out just because it's not an insignificant part of the market.

Lastly, it's important to note that being involved in the MSR space as well as having a conduit does require infrastructure. This year, we have made substantial progress developing a scalable platform that allows us to respond quickly to opportunities that we see in the market. We have added over 30 full time employees dedicated to Two Harbors with the specific focus on MSR operations, technology, risk management, compliance et cetera. We think that having a first class platform demands first class people and the ability to interact on a high quality basis with our originator partners.

So let's take a look real briefly before turning it back to Tom, as we look at Two Harbors potentially looking forward. On slide 68, you will see an illustrative future capital allocation. Our goal, as I said at the beginning, is to drive attractive risk-adjusted returns for shareholders. What you will see here is that, we've shown quarterly how we move our capital around. This is more of a forward-looking. So what you will see is our rates, which at the end of a year ago, 2012 was 53%, was all in agencies. Today, the rate's allocation is higher, but you see the agencies have come down and our expectation is the agencies will continue to fall as you see by the arrows in column three. We also see MSRs probably going to go up; legacy credit, as you could imagine, they don't make bonds at \$50 anymore, that's going to probably go down and new issue credit will most likely go up.

So if we take those capital allocations and we take our \$3.8 billion of equity capital and apply it, you will take a gander of what we might look like as this plays out over the next several years. What you will see is that our leverage remains low at about two and a half times, total assets at about \$13 billion, and the mix obviously is going to change. But interestingly, even if agencies go down into the much lower percentage you can see that we very easily meet the REIT test of having at least 55% whole pools.

Thank you for your time, and I'll turn it back to Tom.

## 2014 AND BEYOND, TOM SIERING

Thanks Bill, for those listening on the net, I am on slide 71. So I am going to be brief on my comments on policy, obviously tapering talk has displaced baseball as our national pastime. So I'll move through this section quickly. From a policy standpoint there continues to be a plethora of headlines. As we all know, in February Janet Yellen was sworn in as the next Fed Reserve Chairperson. Mel Watt has been appointed as Director of the Federal Housing Financial Agency. It's widely perceived that Ms. Yellen will follow, retiring Chairman Bernanke's policies closely at least during the initial stages of her tenure. Mr. Watt, on the other hand, has announced he intends to delay the implementation of higher G fees or guarantee fees, until further review of the policy can be completed. It's also widely speculated that he may tweak the home affordable refinance program.

The future of the Fed's QE program is another variable obviously that we are glued to. The Fed, as we all know, has announced its intention to reduce its purchases of MBS and treasuries by about \$20 billion per month. We continue to believe in GSE reform and that there will be a reduced footprint and role for the GSEs. However, we think this rationalization will take many years.

In 2013, the CFPB announced new rules for qualified mortgages designed to make loans safer by prohibiting high risk features, which took effect in early 2014. New QRM rules as mandated by Dodd-Frank are being finalized now. A variety of federal agencies, including the Fed, FHFA, the FDIC, and the SEC amongst others are negotiating finer points of these rules. It was announced in January that the Basel committee may loosen its capital and leverage ratios, which is certainly helpful to maintain the ongoing stability of the repo markets.

Turning to Slide 72; obviously the Fed remains the biggest buyer of mortgages today. While the Fed's participation is still formidable, we believe this is the first of multiple steps in the tapering process that will likely unfold through 2013.

During the 2008 credit crisis, the \$11 trillion RMBS market became massively dislocated as the GSEs were essentially taken over by the federal government and were mandated to reduce their portfolios. The Treasury became a large owner of non-agency RMBS, through financial rescue packages and commercial banks and proprietary trading desk exited the market due to mounting capital and regulatory constraints. The void left in the market due to these actions created the perfect opportunity for private capital, including mortgage REITs like Two Harbors to step in and provide liquidity to the mortgage market, and that's exactly what's happened. I think we've demonstrated a strong track record of providing industry-leading total return; above all else of course, we are here to drive shareholder value.

The development of our operating businesses we believe will drive the creation of franchise value for our stockholders. These platforms will enable us to deliver total return across a variety of housing and interest rate environments, and we've made substantial commitments to these initiatives and we will continue to invest in our team and infrastructure going forward.

The team is run from various organizations but central to all of these have been origination and servicing roles, and our goal is to create a best-in-class platform making us an attractive partner to origination on MSR counterparties. Finally, we have demonstrated a strong commitment to industry-leading disclosure, governance and transparency, which will remain of course a key focus.

Turning to slide 73, our mission is simple, but its execution is complex. We strive to be recognized as the leading hybrid mortgage REIT. After identifying the significant market opportunity in 2009, we structured Two Harbors as a hybrid mortgage REIT so that we could invest in agency and non-agency mortgages. Keys to achieving our mission include a robust risk management system, strong administrative infrastructure to support our company, and best-in-class disclosure and governance. I believe that today that we have a great team in place.

Turning to Slide 74; our hybrid structure allows us to fluidly allocate capital based upon relative value of various sectors. Today, the most attractive opportunities are part of our operational platform including MSR and the conduit platform. MSR is a marvelous complement to our existing portfolio for reasons that Bill has described. Our conduit platform enables us to generate attractive investments and create credit for our portfolio. We have the ability to control and manage the loans we purchase and securitize. We have also been working on diversifying our financing profile as we have announced by our membership, by one of our subsidiaries in the Federal Home Loan Bank of Des Moines.

So finally, what does all this mean? What's our vision? How do we make people money going forward? I mean at the end of the day that's why we are here. We think our diversified business model provides us the breadth and flexibility to capitalize on compelling opportunities as they arise in the market. So how do these new initiative fit into our vision? Well, as I said, they allow us to allocate capital dynamically, because the mortgage market is very ephemeral and the opportunities that affords participants. We believe that this will help us maximize the return profile of our business, while damping volatility in our portfolio, due to various risks, including shifts in mortgage and interest rates. Bill mentioned this, but it's something that he and I talk about with obsession, so-called sharp ratio theory, in other words, maximizing return, minimizing volatility.

Also it is clear the market favors operational businesses today, such as conduit and MSRs over traditional mortgage REIT portfolios. This building of franchise value, we believe is very important to our shareholders. Ultimately, our diversified business model will enable us to achieve our most important objective of optimizing total shareholder return.

Thanks for listening to us today. With that, I'd like to open the floor for Q&A. A couple of ground rules, if you would like to ask a question, please wait for the microphone, so those on the web can hear your question. And secondly, I'll be announcing just for the benefit of those in their office or at home who is actually answering the question. Thanks very much.

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#### QUESTION AND ANSWER – TOM SIERING, BRAD FARRELL, BILL ROTH

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**MARK DEVRIES:** Thanks. I've got two questions. First one is, Bill given the backdrop you gave that you expect OAS to widen and agencies over the course of next year. Can you just share your

thoughts on...in the near-term potentially shifting even more of your capital from rates to credit until that happens to kind of further mitigate book value volatility? And my second question is for Brad, if you could just speak qualitatively, and if possible quantitatively about what might drive any kind of disparity between core and taxable income in 2014?

**BILL ROTH:** So before I get going, do I need to...am I okay here with just sitting and talking?

**TOM SIERING:** Yep. I believe you are wired.

**BILL ROTH:** I am wired. Okay, so Mark, I am going to flip back to slide 52. I think it's important to take a look at our basis exposure today. First of all, if every time we thought something that might happen, happened, our predictive powers would be extraordinarily high and it would be much easier to make money than we had uncertainty as to what might happen. So while we expected spreads to widen, we don't know for sure. So once again we are a mortgage REIT, we are required to meet the whole pool test to qualify amongst other tests. So we do need to have at least 55% of our assets in the whole pools. That being said, that doesn't necessarily mean we have to have them in the sectors that would suffer the most damage if spreads widen. So what I tried to show on this slide here is that our longer duration positions, if you look at the bottom, you will see we are net long \$1.4 million per basis point. But, we are also short synthetically (Ph) the current coupon 30-year spread.

So, what that means is, so with a \$0.5 million a basis point, if spreads move out 10 basis points, we lose \$5 million, which is 0.1% of book value. If you look at that other slide I showed, we are 10 basis points for just standard you know, 7 to 1 levered, we would lose 6% of book value, okay. So we think that we are actually being very prudent by having such a small risk budget to that part of the market that's fairly expensively priced today.

Now you know, the other thing I would say on this slide is, if you look back at those expected ROEs, the ROEs on the higher coupons actually look pretty decent to us, which is where the bulk of our positioning is. In terms of credit, we are delighted to buy bonds that look like the bond I showed on the slide; that's got a base case return between 5% and 6%, but still has decent upside. So, if those show up, we are going to buy them anyway. We have plenty of...our leverage is extremely low, and we have plenty of dry powder, so we don't necessarily have to reduce agency more to continue to buy bonds like that. Brad is going to take the second part of your question.

**BRAD FARRELL:** Now, just one moment, I think slide 27 is I think it's good to speak in context of those numbers. For those on the phone, I am just trying to reposition that to presentation slide 27.

Yes, so again the question was focused on, what does core earnings look like, what are some of the potential gaps to REIT-taxable income? And I think the simple answer is it's not going to be that much different than what the last two years have really shown. If you think about the total return approach, we have built in gains in our portfolio that will likely naturally have some harvesting. And so obviously, any form of capital gains that are realized is obviously going to be a meaningful change. Now, obviously that's already build into our book value to a certain degree, but that's one large driver as it was in 2012. Non-agency portfolio is embedded in who we are, what we do, and there is this, the GAAP to tax difference there between, I think we spoke about this at the last Analyst Day for

those who aren't aware of this. For tax purposes, you really don't assume any sort of debts or bad...a credit loss. You accrete your discount to par. For GAAP you do establish a credit reserve, and so you let's say buy a 50% par bond, for tax you are accreting to a 100% value until you realize losses. For GAAP let's say, we think that bond is only going to recover to 65% and we will recognize that accretion which ultimately drives the yield.

That gap will continue to narrow, obviously if the market continues on a path of home price depreciation, other positives, obviously GAAP could drive upward and then in theory over time the tax would drive down and narrow that gap. But at least for the short-term horizon, that gap will still exist. And will largely be kind of similar to...I would expect similar numbers in so far that we kind of maintained a portfolio that looks like it is today. So those are the two biggest ones, capital gains and then the GAAP to tax non-agency discount accretion. And then the other one, which could drive either way, is taxable REIT subsidiaries. I mean we do conduct our loan aggregation; it's done in a taxable REIT subsidiary. So in so far we maintain loans that are not in trusts and hold them in our balance sheet that will create income in core earnings that would not be in the REIT. So obviously that could maybe narrow the gap and actually take it the other way. As well, the MSR strategy should actually not really have that much of a driver because we are stripping off the excess and putting it into the REIT. So again, there should be some drivers, I think they are going to look very similar to what they did in the last few years, but to quantify that would be very, very challenging.

**TOM SIERING:** Yes, just to add a little bit to Brad's comments, Mark The reason we actually prepared these slides is that we get a lot of questions, well gee your core EPS is "x", so doesn't that mean your dividend must be "x". And I've told people steadfastly, that no, doesn't mean that, it could mean that, but really what drives the dividend is comprehensively income, and taxable income. And so we wanted to show mathematically you know, historically how those metrics have deviated from one another in response to that question which we get often. Is there another question to pose?

**ANALYST:** Thank you. On Slide 50, could you describe how your MSR strategy would behave if spreads tightened, which I agree is unexpected, but I just wonder about the symmetry of the protection that the MSRs affords?

**BILL ROTH:** Yes, sure that's a great question. If our portfolio looked like slide 50, and spreads tightened, we would lose money. Because we don't have enough mortgages and mortgage basis exposure relative to our negative position in MSR, okay. Now we try to make this as a simple illustration, but clearly, if we had a little bit less MSR and a little bit more mortgage, we could make that number of 0.4, we could make that zero, or we could make it anything we want. The beauty of having MSR frankly is that if we don't like the mortgage basis, we can add more MSR relative to pools, and if mortgage spreads widen out, we've got sort of a built-in basis. Sure, we can add pools and make that number very large. But, to get to your first question, the one on the right would lose money if mortgage spreads tightened. But the truth is somewhere between the one on the left and the one on the right, because it's very hard, given our size, for us to get to the one on the right anytime soon.

**TOM SIERING:** Yes, I mean the point of the slide is not to represent...the chart on the right is not to be representative of our portfolio, but rather to show in isolation how MSR can add to ROE and reduce leverage, and not meant to be representative of our portfolio today or in the future.

**ANALYST:** Yes, my question is a sort of a follow up on that, but switching to slide 52, how does the portfolio as a whole respond if we have a meaningful rally in rates and basis tightening on the mortgages?

**BILL ROTH:** Sure, so if we look at slide 52, as of the end of January, you will see that the portfolio was net short \$190,000 of basis points, so 10 basis points is \$1.9 million, 100 basis points is \$19 million which is 0.5% of our equity. So as you could see that a move in rates generally as of the end of January were about as flat as you could be, right. In terms of basis exposure, we are still net long in the basis, although in a very small way. So if you look at the basis exposure at the bottom, \$2.1 million per basis point, so 10 basis points is \$21 million which would be...10 basis points would be 0.2% there you can see on the bottom right. So very low basis exposure, very low rate exposure; and the reason for that positioning is frankly to us based on what we talked about today, is we think the Fed is going to continue tapering absent any dramatic change in the economic landscape. We think that we just came out of a cyclically low production cycle for mortgages. If you think about it, seasonality is such that the number of new mortgages produced is generally at a low point, in the winter months, but yet they have been buying the same amount. And as we go into the spring season and we see...start to see a big pick-up, the Fed is not only going to buy the same amount, but presumably they are going to keep reducing that amount. So we think the supply demand technicals will start to change, and we think we'll see somewhat wider spreads. We've never really take a big exposure to interest rates in order to generate excess return, any positions we've taken have really been more to protect ourselves. So you shouldn't expect to see a big change in our interest rate exposure, and when we put out our quarterly disclosures, you will see that historically those numbers are generally pretty small, in terms of rate exposure.

**TOM SIERING:** Yes, and if you...just to add to Bill's comments. If you look at 2013, we have always been very close to home, in respect of duration one way or the other. The one exception to that was in the second quarter of 2013, where we had a pretty sizeable short position. In other words we would benefit from rising interest rates that was the one deviation from how we've historically run the portfolio. So we benefited a lot from that, we did that well, and I say that with all humility, because Bill runs the portfolio. The one thing that, I think to be honest, that we got wrong was in the rising rate environments that mortgage spreads hung in very tightly, and in fact, and you know certain periods of that time actually narrowed, which we fully did not anticipate, and that was driven by the fact that the Fed kept buying and origination started to fall fairly precipitously as rates rose. But I would say that, as a matter of course, our mindset is to be pretty duration neutral.

**ANALYST:** Thanks for putting us on. How should we think about your leverage ratio in conjunction with your capital needs in tapping the equity markets? Should I...before you...this is ex-acquisitions of course, you've come to market from time to time, when you saw really good opportunities, and given how low your leverage ratios are across the book. Should I expect to see leverage go up before I see you come back to market, should you see good opportunities? Could you just kind of frame that for me please?

**TOM SIERING:** Sure, this is Tom for those on the web, I will handle that and Bill please chime in. So, obviously our shares are trading below where announced year-end book value was...and there has not been you know a sea change in the mortgage market, and, the six or so weeks since the end of the year. So it would be reasonable and given that this is a reg FD form, I can say it would be reasonable to assume that they still are; our stock price is still below book value. And so historically that's not a market set of conditions where we've raised money. And additionally, we have a lot of liquidity, and so, will our leverage go up? Well, it will be a direct function of the opportunity. The reason our leverage is low, is we just don't like agency spreads particularly, and given where they are which is somewhere, there is...you know, I think Bill would say they were small pockets of opportunity within the agency space that we are trying to exploit, but there is broad clause statement, agency spreads from a historic basis aren't that exciting. And, arguably there is probably only one way for the Fed to go, which is less activity within the market. Given those facts or those assertions, it doesn't seem prudent to us to take a lot now. Things can change if agency spreads change dramatically, and/or there is some other broad opportunity then we might ratchet up leverage. Obviously we are well below where we've been historically.

To get back to capital raises, we've always said that there is got to be two criteria that are fully satisfied for us to raise equity, and that is that it's got to be a good deal for our existing shareholders. So every deal that we've done except for our first one, which we felt that we were in the liquidity box, we are too small, our operating expense ratios were a disaster, liquidity was tight; we were almost forced to do that capital raise, but every one since then has been accretive. And given that the opportunity set is very interesting in certain spaces, MSR is interesting, securitization is interesting, some non-agency bonds are interesting, but where you can really put the wood to work with a phone call, the agency spaces is not. Never say never, but if you look at the landscape, it's not consistent with how we've raised money in the past.

**ANALYST:** Question for Bill. Could you talk a little about MSR, ROEs and there's been a lot of demand for...the price of MSRs have gone up a lot. Is that impacting at all in terms of the rates return that you think you can get on the MSRs; and how attractive is it in terms of getting in via origination versus buying them in the secondary market? Is one versus the other?

**TOM SIERING:** Sure. By the way we appreciate all the questions we are getting in the call, we were expecting that they would ask what kind of guys is Jim Grant really like. But these have been great. Please, Bill?

**BILL ROTH:** Yes, so for the benefit of those are not in the room, but still alive and kicking out there we are going to refer back to slide 50. So if you look at slide 50, and you look at that bottom right; we've said that MSR today expected yields are in the high single-digit to low double-digits for new production prime MSRs, okay. So on this slide; we've assumed a yield of 8%. Now, have MSR prices gone up, absolutely. Well, rates have gone up, so you would expect MSR prices to go up, because the expected prepay of loans that were made a year ago is much lower, because they are out of the money. So if you want to look at, was there a great opportunity to buy MSR back when the tenure was 160, yes. But, that's kind of hard to look back. It's easy to look back and say, "coulda, woulda, shoulda". But what we've assumed here is that yields are 8% which is at the low end of our range and that is absolutely consistent with where we see valuations today, whether its bulk purchase or flow whatever. And so you can see; and I sort of caveated this by noting that neither the portfolio on

the left or on the right includes volatility hedging; in other words buying swaptions to protect for tail movement. And you still have over 500 basis points of increased ROE. Now, I also mentioned during my remarks, that you need more protection when you include MSR, then you do if you don't. And so, that brings that down several hundred basis points. Nonetheless, if you look at 500 and you take a couple hundred off, and then you include the fact that it does cost us money as Brad pointed out our GNA has bumped up somewhat, okay.

Having MSR in the portfolio is still a dramatically better place to be, for several reasons. First of all, the ROE is higher, second of all you have less leverage, and third of all you have less basis risk. And we saw what basis risk did, you know, what the impact of that can be when spreads are tightening wide. If spreads were really wide, and MSR were cheap, we'd still buy MSR, we would just make sure that we had enough positive basis to try to extract that value from the agency market that's there. We would just own more pool. So we would change the slide 52 that we talked about earlier, such that we would have more exposure. But the bottom line is that whether MSR yield is 7% or 9% or 11%, in the context of the portfolio, it's very, very powerful.

Now, in terms of bulk versus flow, there are a myriad of opportunities that come up more than one day a week from the servicing brokers, small guys selling positions or larger guys who show out a bulk package et cetera. We are involved in all of those discussions and many times it comes down to what we are working on at any given point in time, as to how much time we can dedicate to it, what the portfolio looks like, how big it is, there is all sorts of consideration. So what we intend to do is use our originator network to source not only jumbo loans, but also MSR over time, because many of them would an outlet for MSR, and as long as they are signed up for us and selling us loans, selling us servicing is really not much extra effort for them. And then, at the same time, we are happy to look at bulk transactions, where you can put a decent amount of money to work in one fell swoop, although those are less frequent. But we are looking at both.

**TOM SIERING:** And just to add to that real briefly. One thing; we hope we have conveyed...one of the new things about the MSR business and the conduit business in conjunction with one another is the commonality of the counterparties and the infrastructure necessary to support both initiatives. Please we have question in the back of the room?

**ANALYST:** Sure, this is on FHLB financing. Could you guys easily grow debt financing outside of the Des Moines bank or is that membership exclusive?

**TOM SIERING:** For those, I'm going to let Brad answer them?

**BRAD FARRELL:** Yes, I'm not going to have a great answer for you. I mean we have not pursued looking at other FHLB locations, nor do we currently intend to. We really value the Des Moines relationship. It's a new relationship where a new vehicle type parent working with the FHLB. So to be honest, we are very, very focused on the existing relationship that we have. I'm not aware of whether we can even apply to another FLHB in full honesty, but it is really not on the horizon, nor do we really have a view on that. Again, the FHLB has a billion dollars today; one should not expect that that's going to exponentially grow because obviously they need to look at us from a counterparty perspective. So I would offer those comments, I think right now we need to focus on using it, building the relationship, expanding it to a certain level where we think that can expand further and

that the FHLB can work with us. And we will pursue other avenues down the road if they are available to us.

**TOM SIERING:** You know, like any other relationship, it's built upon mutual comfort and we want to make sure that we are giving the Des Moines Bank what they need in respect of disclosure and reporting and that sort of thing. And that's what we are committed to today.

**BRAD FARRELL:** Yes, and one maybe more technical. The FHLB is regulated by the FHFA and the FHLB individual banks do have a lot of independent risk management autonomy, but they are governed in totality. So any access to their membership is going to be viewed in total risk measures. So that needs to be really understood and taken into consideration.

**DAN ALTSCHER:** Thanks, Dan Altscher from FBR (Ph). You know, one of the benefits of the MSR portfolio is the ability to lay-off some swap exposure, but is there an unintended consequence potentially being mismatched if, god forbid, short-term rates were to raise where the net interest margin could compress if you are essentially under-hedged on that front. And then, a second question also is, you are always in focus on the residential side, but is there may be some potential to focus on maybe the commercial MBS side or the commercial whole loan market using the competitive advantage of understanding credit risks?

**TOM SIERING:** I will take the second part of about commercial and then hand it over to Bill to talk about MSR and hedging and various curve exposures...

**BILL ROTH:** Oh, you wanted to do that first?

**TOM SIERING:** Yes, I will take commercial first. To be perfectly honest, I have an absolute crackerjack residential mortgage team. Bill Greenberg, who I mentioned earlier, has some experience on the commercial space, but I would say that we don't nearly have the native intelligence and expertise that we do in the resi. space. Now down the road, might we do that, yes we might, but I would say that it would require real commitment from us and that we would want to somehow acquire or develop a team that's strictly expert in the commercial space. There is a lot of commonality to the commercial and the residential space, but there's a lot of differences too. And we have a nice little business, could we go over to commercial, yes, but we would only do it in the way where we were confident that, like in the residential space, that we would drive alpha through the portfolio. We are committed to delivering shareholder return and not just growing an equity base. If we never raise another dollar, we have a great little business. But maybe down the road, but today, I would not expect us to show exposure in that area.

**BILL ROTH:** This is Bill. So as to your first...the first part of your question, that's actually a great question. So we are going to stick on slide 50, seems to be the slide du jour. So I think a couple of things to note here, first of all, to the extent that let's say repo rates go up.

Well, first let me say that, it's totally unrealistic to assume that the portfolio on the right is the end state. As I said before, the reality is this is more to be illustrative than factual. So the way we hedge our portfolio is we actually hedge multiple points across the curve. So MSR has the biggest exposure to the mortgage rate, which is typically the 10-year bucket followed by the 5-year bucket. So we would get negative duration there, but we wouldn't have any negative duration on the short end. So

to the extent rates go up, that you know, we would have exposure there. So the reality is, that the position that we intend to run, and if you look at our book as of 12/31 you would see that we have swaps across the curve as well as MSR. So you shouldn't ever expect us to get into the right part of the slide and have that in and of itself.

Now, that being said, let's just say that you took a portfolio that looks like the slide on the right and you said repo rates went up 1%. Well your agency repo which is \$175, that would cost you an extra \$1.75 that you would have made if you would have had swaps. You are repoing and now instead of paying 0.4, you are paying 1.4. So, that costs you an extra \$1.75. I think it's not unreasonable to assume that if rates go up, the speeds on servicing go down. So if instead, the MSR yield is 10% instead of 8%, you are going to make an extra \$1.50 on your MSR.

So well, the first, what I said, at the beginning is absolutely important to understand. It's also the case that higher rates and slower prepaes means higher yields, so there is somewhat of an offset. I'm just going to close by reiterating that part of the slide on the right is not the end state, we hedge every part of the curve and we are very aware of our exposure to repo.

And the last thing I will say, although I said that was the last thing, I'm going to say this is final, final, is that if you look in our disclosures on a quarterly basis, you will see that if LIBOR goes up, we actually make more money than if LIBOR stays where it is. In other words, we are rate sensitive to the positive from an income standpoint, because the amount of notional swaps that we carry as well as floaters in the non-agency space are well in excess of our repos.

**TOM SIERING:** Yes, since I didn't comment to, this was my final statement I'm going to add something. I would say that to Bill comments, it would be virtually impossible and I'm adding the word virtually, I wanted to Rebecca happy, to envision a world where the agencies that we would like the best would match up with available MSR such that that's all you had within the portfolio. So said another way, the expectation should be that MSR are part of our hedging mix which will continue likely to include over time swaps, swaptions, IO's and inverse IOs, et cetera. As Bill said, we hedge points along the curve, and one thing about the mortgage market obviously is interest rate, exposure is not linear, it's fluid because of the embedded options within mortgages. Do we have another question?

**ANALYST:** Hi, a couple of questions on the FHLB relationship. I guess first, can you talk about the mark-to-market process and collateral calls, across really whole loans and how they would look at that? And secondly, are there any other credit sensitive assets through which the FHLB provides financing that would make a natural expansion for your portfolio? Thanks.

**TOM SIERING:** For benefit of those at home, Brad is going to answer that.

**BRAD FARRELL:** Yes, so the first...focused on kind of the mark-to-market margin collateral calling it...I was very much assimilated to a standard repurchase agreement structure, they have the ability to fair market that. And so, just to be very clear, I am specifically speaking to the relationship we have. I think FHLB has unique relationships between captives, such as bank members. So I just want to be very careful that I am speaking to our relationship, and they have the ability to mark the asset obviously with us working within around those valuations, obviously having margin requirements which is either posting additional collateral or posting cash or other types of backstops and then vice

versa. So obviously, the nice thing about it, and I mentioned this [indiscernible] the repo. Repo is really matched to a specific instrument. This is really pool of eligible collateral, and that could in loans, as I mentioned, private label securitizations, and that value is looked in totality, and that's where you can advance off of. So that gives you a little bit more nimbleness in taking advantage of market shifts, either direction, and how to respond. But you should think about it very similar types of protection that they have established. The only other one nuance, there is much more physical delivery with the FHLB around custodian relationships and things that aren't necessary standard structure may be in a repo warehouse facility. Hopefully that answers that piece.

As far as other credit or...the answer is, no. I mean, I am sure there are, I mean they post actually a lot of transparency on their website, and there is a lot of diverse asset classes. And I think we've mentioned the ones today that were rooted in, which are, the prime jumbo, obviously other types of loan collateral. We do have credit sensitive loans. Part of the MSR structure is you do have obligations to buy out loans every once in a while from the servicing platforms. That's the breadth of what we look at today. And obviously, we would evaluate the ability for FHLB to support us in other means if we ever head down an asset..., more folks on the [indiscernible] for the asset side not because of FHLB.

**TOM SIERING:** And also obviously, we have socialized with them what we are likely to put on the facility, and so given the nascency of the relationship we probably aren't going to deviate very strongly from that in the early days. Over time obviously the relationship will mature and it's possible there will be other things. But you shouldn't expect dramatic changes from what we've socialized here today. Any other questions?

**BRAD FARRELL:** Can I add one more; I think this may be the first question on the core earnings of REIT taxable income. I think that we hit kind of all the key points. One of the points I started thinking about is we talked about the complexity of our hedging. If you really, really think about it, that is your biggest answer to what is the delta between the REIT taxable and core earnings. All of the things that we've mentioned, not all of them have the same type of yield structure to them. They kind of label into our core earnings and that's why we struggle the most with the core earnings. We do respect to the ability to try to project a consistent yield metric. But the reason we are really...we really try to focus more on total return is that, that core earnings doesn't really fit well with our broader platform that we use. All the swaptions, the IOs, the combination of MSRs, and how those flow. So I want to go back to that point is, we'd rather have a protection of book value versus a couple of cents on core earnings, and I think we wanted to stress that there is a natural delta between REIT taxable and core earnings, and a core earning metric is not a driver of our dividend. Our dividend is a much broader view of how we are generating return, which includes a variety of elements, including derivatives, including all these other things. I thought maybe that helped...a little bit more context to the question.

## CLOSING REMARKS – TOM SIERING

**TOM SIERING:** Well, great. Thank you for everyone who is here physically. And for those who are on the web, thank you for attending our event. Thanks again to Jim Grant, I thought as always he was great. Thanks to July and her team, Maggie, Beth and Nicole for really doing the heavy lifting and making this happen. And everyone have a terrific day and we'll talk to you soon. Thank you.

**CONTACT INFORMATION**

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Thank you for joining us for today's webinar. If you have any questions, please do not hesitate to reach out to the Investor Relations contacts listed on this page.

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