



Credit Suisse Financial Services Forum

February 24, 2021



TWO HARBORS
Investment Corp.

Doug:

Great. Good afternoon, everyone. Thank you for joining us. Happy to have Two Harbors back with us here at the Credit Suisse Financial Services Forum. Joining us from the company today is CEO Bill Greenberg and CIO Matt Koeppen. With that, why don't we get started? I would say 2020 was definitely a year of transition for Two Harbors and both of you guys individually. Can you just talk a little bit about stepping into the new roles you did last year and what was obviously a challenging year and how that unfolded?

Bill:

Sure. Thanks very much, Doug and I just wanted to just first say thank you very much for having us here and for hosting this conference. We always like this conference and you guys always do a great job. So thank you to you, Doug, first point, as well as to Credit Suisse. We're happy to be here.

Doug:

Thanks.

Bill:

Yeah, there's no doubt about it, 2020 was a very challenging year. It was especially challenging to step into my new role in the midst of this market volatility and the pandemic issues, which required everyone to transition to working from home right away, as well as the portfolio repositioning that we embarked upon during that time period as well, so it was really a lot going on for us during that time.

Bill:

Nonetheless, I think, when looking back at that time period, I'm pretty happy with the way things ended up. I think the team really performed very well during all this. We were able to execute on a whole bunch of stuff that we'd worked on during the year. We completed the internalization of the company in August. We right-sized our portfolio and we repositioned the portfolio as an agency plus MSR, only focused REITs. And most recently, as I think you've seen, we were able to take steps to right-size our capital structure through the issuance or refinancing the convertible note and calling some preferred stock.

Bill:

In terms of me personally, one of the things that's been most interesting to me, maybe not surprisingly you might say, is that as I've gotten to work more closely with, with people in some of the other departments that I was less exposed to before people in the finance department or the legal department, the IT department or HR departments. I've, of course been very impressed with just how

smart and dedicated and engaged everyone is and obviously very appreciative of them, very proud of the whole team and everything we've accomplished this year and I'm super optimistic for the future, so stepping into new roles and has really given me a new perspective, maybe sort of obviously on the company and future.

Matt:

I would add, and also thanks for having us today, Doug, I agree with Bill's comments and from my perspective, I think it hasn't been as dramatic of a change as what Bill's been going through and experiencing, having been co CIO for a year or so really put me solidly into that role. So it's mostly a continuation of those duties from my perspective. One thing I would add is that one thing that's been a constant is Bill and I have been working here together since 2012 and we've developed a great partnership. So I think we're both looking forward to continuing on that path and I'm also optimistic for the future of the company.

Doug:

Great and Bill, as you mentioned, you guys completed your internalization in August of last year, just talk how you view, are there any changes to the day-to-day running of the business and then also where you are in terms of cost saves from that internalization?

Bill:

Yeah, sure. As a direct result of the internalization, there's very little changes in business strategy that will occur. As Matt said, we've been running the portfolio together, we've been co-CIOs for the last year. We were important members of the development strategy in the years before that. So it's a business strategy is one that we've helped to create, that we believe in fully, and internalization doesn't really change any of that. As far as the cost savings in terms of what was projected versus how things are unfolding, I would say that in general, we're running better than what we had initially anticipated. I don't have the exact numbers in front of us. Mary has those in detail, but I'd say in general, better, more favorable in terms of cost savings that were projected.

Doug:

Yeah. Now why don't we pivot to, to just the broader market, obviously been rates front and center with a significant move, if we could just start there, how you're viewing this move in rates and, and how you think that might continue to play out over both the short term and the longer term.

Matt:

Sure. I can start with that one. I guess, so we've seen a couple in the last couple months, I think we've seen a couple of bouts of curve steepening, and both of those really were combined with some current coupon spread widening. I guess I would say there's a few things you can say about that. I guess I would expect that if the curve continued to sort of bear steepen like that, I think you'd see a continuation

move in mortgages as well. I think the things that have been driving that really spurred in the last couple of months from sort of positive developments on the vaccine front and positive developments on the fiscal stimulus fronts, all of that leading to expectations of future economic growth in GDP, unemployment falling, maybe actual realized inflation and higher inflation expectations, which then would lead people to probably conclude that maybe, the fed could, could slow down or taper it's buying activities to some extent.

Matt:

So that's what we've seen. This steeper curve is nice for mortgage investors of course, so that's going to have the effect of probably causing a reduced re-fi response. So we could fall into a little bit slower speed environment, which I think could be a relief for us and others.

Matt:

You know, one interesting thing that we've seen also in this little move recently is that the primary secondary spread, which I think we all know has been holding at steadily wider levels actually decreased pretty significantly. I mean, I think depending on exactly how you measure it, it's probably within 10 or 20 basis points of long-term averages now, so that's getting much more normalized and things are moving quickly, but it's certainly been more normalized. So you can see in further interest rate increases it might actually flow right through into the primary mortgage rate, which again, would dampen fast pre-payment speeds.

Doug:

Great. I guess you mentioned fed expectations around taper. Can you just talk about, how you're viewing ... what your expectations are for taper and how you think that the market is positioned for that inevitable taper today versus 2013?

Matt:

Sure. I think there's been a general consensus out there that the fed probably wouldn't really begin any meaningful tapering until we got into 2022. Given the improvements today and the prospects for today's economy, I actually think that there's a possibility they could start to taper, or at least indicate that they're going to taper maybe even in this year. That might be sooner than broader market's expectations, but I certainly think that it's possible. In terms of positioning, one interesting thing about today is that a very, very big component of the mortgage market is owned by the fed and banks.

Matt:

So the convexity selling that you might typically see in an interest rate selloff in other environments when the mortgage market's owned by active hedgers, or in the past, it's been owned by GSEs and people stay on top of that, in the past, I think that effect could be less. In addition to that, I think that the Fed has a memory of 2013 and when they sort of surprised the market back then with an

announcement about tapering and so I'm sure they have that in their minds and the combined effect of sort of the Fed being more gentle about it and the lesser impact of convexity selling probably makes it a less violent episode, I would say. I mean, it'll still move the market certainly, but I don't think it would be as violent as we saw in 2013.

Doug:

Great. With your earnings you had an interesting slide talking about spread levels today and what that could mean one year forward in terms of spreads. I guess just for anyone that didn't see that, can you just talk through your outlook for spreads and I guess in that just how spreads have been performing recently with this move in rates.

Bill:

Sure. I can do that one. So we did show a fourth quarter investor deck out there today, so if people have that in front of us, they could potentially look at it. I think the slide is on page 14 of that deck and what it shows with the two graphs there that are displayed, and the main results of the graph, I'll take the the answer first, is that a portfolio that includes MSR in its composition is expected to have more stable returns under various scenarios of mortgage spreads than a portfolio without MSR. Right and so what the graph shows is, the two graphs, is the top graph shows 10 years of daily OAS data from JP Morgan data query on an MBS index. Now, along the X axis is a starting spread, starting OAS, and on the Y axis is the change in the spread one year hence, right? So all the dots above the x-axis indicates spreads were wider and all the dots below the x-axis indicates that spreads were tighter one year forward. And what it shows is that when we made this chart on January 4th I think it was, we were at like 16 or 17 OAS, which is indicated by the dashed vertical blue line.

Bill:

Now, what this chart shows, is that in a hundred percent of the cases over the last 10 years of daily data, which do include the other historical periods where the fed was involved in purchasing and other elements of quantitative easing, that in exactly zero of those cases where the spreads the same or tighter, one year forward. Now, I'm not saying they're going to tighten tomorrow. There's certainly lots of tailwinds here. Funding rates are very low. The fed is continuing to buy. They say they're going to be here for a long time. The rolls are still somewhat special, but as Matt said, these come off a lot, but if you have to say about the risk, the risk is to wider spreads and not tighter spreads, in our opinion.

Bill:

Thank you, Doug. Yeah. So on average given ... during the course of the quarter so far, we saw the current coupon tighten a lot so that the starting OAS went from 16 or 17 basis points, the vertical blue line to probably 10 or lower. So all the way off the left-hand chart of that graph, right since then, they wind down a little bit and we're probably between 10 and 17 right now, but still, what it shows is that based on the last 10 years of data, on average, one would expect if you believe in history that that OAS could widen 25 basis points or so, on average.

Bill:

What the bottom chart shows is, if you assume for any given starting spread level that mortgage spreads instantaneously adjust to that average widening or tightening indicated in the graph above, and you create a portfolio with... includes assumptions about leverage and duration hedging, and all of those things, and you created two portfolios, one that is agency only hedged with swaps, which is indicated by the solid blue line. And one with our rough amount of MSR in the portfolio as indicated by the black line. And if you start, and look at the point where we are at the dashed blue line for at 16 or 17 OAS. What you find is that if spreads were to widen 25 basis points, which is the average amount shown the top graph, you'd expect an agency only portfolio to earn zero or minus one percent as shown where the solid blue line intersects the dashed blue line.

Bill:

In contrast portfolio like ours with, again, roughly our hedge ratios of MSR to RBS, our portfolio, is still expected to return in the high single digits, right, and in fact this graph shows what the result would be for any starting spread and you see that for large areas of starting spreads a portfolio with MSR outperforms, except in areas where the starting spreads are on the wider end of the range and so what I like to say is, today, I think it's easy. Spreads are tight. Everyone believes spreads are rich. I don't know when they're going to tighten, but I believe they will one day, but even if you're uncertain about the direction of spreads, as I often am, I think that our strategy where we keep mortgage spreads low, keep that exposure low, is preferable to one where the spreads are higher.

Doug:

So, clearly it looks like the flatter black line, which is higher in a lot of scenarios and definitely flatter, would be preferable, I guess, how do you think ... what are the trade-offs or the risks that you have to make in order to achieve what looks like a higher and more stable return profile?

Bill:

Well, there's certainly some liquidity issues. The MSR asset itself is not trading on a T plus two basis. You can't in one phone call, move the risk around that easily, trades take longer to take, but on the other hand the funding facilities are multi-year in nature, right, and not exposed to short-term repo dynamics either. It takes a lot of effort to create an MSR platform. I think many people know we have about 110 people who work at Two Harbors. We have a dedicated department of about 35 people that whose function is to oversee the job of our sub services, to make sure that the payments are going where they're supposed to be going between the borrowers and the GSEs, to make sure that the tax escrow payments are being handled correctly.

Bill:

We have some people in our legal department, in our mortgage compliance department that review every single borrower complaint that is made against each of our sub-servicers. So we have a flow

program where we buy flow on a daily basis, managing that process, and we have 20 sellers in this program. Many of the data flow in and out requires beefed up IT and so forth, so there's a lot that goes into it, and it requires a commitment to do that. We think it's worth it because it gives you the black line rather than the blue line. So we like that but it's an effort to do it and I appreciate that it's not for everyone.

Doug:

Great. I guess maybe just putting a little context or around the environment today is there any update you can give us as far as how the portfolio has performed sort of quarter to date?

Bill:

Yeah, maybe Matt, you can do that one.

Matt:

Sure. Well, the quarter is far from over, obviously, and no results through February have been finalized through our normal processes, but we're estimating that through last Friday, we're seeing total return in the three to three and a half percent range.

Doug:

And I guess just, if you could put a little more context around that, I mean, it seems like January was very strong month from a spread tightening standpoint and the last week or two in February has seen spreads widen. Just to put that black line in the context, can you just ... any color you can give us around how you've performed in each of those two parts of the quarter to date?

Matt:

Well, I think you'll find that a good bit of the performance is coming from higher coupon performance and specified pool performance, especially in the January time period. I think servicing is performing in line with expectations, but that will have been one of the drivers so far.

Bill:

I might add, Doug, maybe this is what you're getting at, is that in January we had said in our earnings call that said that our performance at that time was I think around one percent, so I think what we said at that time, if you compare with other people who reported, some agency only reits that reported during that period, they were up more than us. So I think that is very consistent with what that graph shows, which is that we would underperform when spreads tighten. Right. But that when spreads widen back out, I mean, I don't know what other people are doing, but I would think that would be consistent with what we're seeing.

Doug:

Great. Then I guess if you could then ... given where spreads are, if they are on the tighter side today, can you just talk about where you see returns on an incremental basis? Whether that be just the agency pools, or where are you seeing the paired strategy and the relative returns you're seeing today?

Matt:

Sure. I'll take that one. On the agency, PNI side of things, even with the recent [inaudible 00:21:33] that we've seen in the current coupon complex, I think spreads remain really at multi-year tightness. In February things tightened in and then sort of widened out to net to flattish, but that's a pretty tight level, so I think in the current coupon complex, I think we would cuff gross static returns as being in the mid to high single digits for both TBAs and pools. TBA's had an interesting funding advantage in Q3 and Q4, which was a great edge, and that was caused by the dynamics of the Fed buying in the front months and originators selling in the back months. At one point, that was probably a hundred basis points through repo funding, which is obviously a huge advantage. The Fed in December started buying, they started rolling and buying mortgages in the back months to match where sales were coming through and that really dramatically reduced the funding advantage. I think it went down to something like 20 or 25 basis points through instead of a hundred.

Matt:

So it's far less interesting at a tight spread without funding specialness attached to it. I think we think that similarly, mostly because they're struck off of, sort of a tighter spread TBA, new specified pools in the current coupon complex are also going to be at the lower end of the mid to high single digit range. So we don't find that particularly interesting. I do think that these and higher coupons, we have a specified pool book that's higher coupons with some seasoning and loan balance and geography stories, I think those spreads are still attractive. Of course, that's difficult to add to because they're not making any more of those, but really I think are our main focus and what we find most interesting is adding new servicing through our flow arrangements. We're finding that to be the most interesting thing available. We've participated in a few bulk transactions, but, those were a little opportunistic and most of the time I would say bulk is probably trading, I don't know, 200 or 300 basis points tighter than in the flow market.

Matt:

So we see those gross static returns is getting you into the low double digits when you pair new flow with, with RMBS and like Bill was talking about a little bit earlier our platform is, is quite a competitive advantage to us, right? Not everybody can do this. Like Bill said, there's lots of significant hurdles to entry into the business and the licensing approvals and, and the operational aspect of it and infrastructure and we're in a good position to take advantage of that today.

Doug:

Great. I mean, I guess, you are mentioning the TBA specialness being less attractive today do you see that changing the mix of your holdings of agencies towards more pools or how do you see that progressing over the next several quarters?

Matt:

Yeah, that's a good question. I mean, we've reduced both recently actually which is taken our mortgage spread risk exposure down to pretty low levels. I mean, we're definitely cautious about it. The whole page that Bill described gave you a good idea about ... probably what's in our minds about the direction of spreads at tight levels. So I certainly, as long as spreads are at tight levels like this I wouldn't expect us to significantly increase our exposure. It probably takes wider spreads to get us more excited about adding more RMBS.

Doug:

You mentioned relatively low spread exposure. Any numbers you can put around that, what's your sensitivity to a spread widening and how that would compare to a straight agency only portfolio?

Matt:

Sure. The number that we published in Q4 is the most recent disclosure that we made, where we said a 25 basis point immediate widening in mortgage spreads would cause a decrease to common book value of about two point seven percent, down two point seven percent that is.

Bill:

If you could show page 13 of your deck you can see it there. Yeah. That one.

Matt:

There you go. So we think that's ... we consider that a pretty low number for a mortgage portfolio. I think you could see, in an agency-only portfolio, like we were describing without the effect of MSR, that could be, two or three times that that sort of exposure easily.

Bill:

So if you look at the chart there, the blue chart, the blue bar on the right shows minus six and a half percent, that's the exposure for a 25 basis point spread widening, immediate 25 basis point spread widening, on the agency part of our portfolio. The plus three point eight percent in the gray offsets that, so the whole thing nets to two point seven, now compare this to what would be an agency only portfolio. You would also have to take that capital that's, right now, giving plus three point eight percent and add it back to the blue bar, which is getting negative six point five. So the negative six point five

would actually be even bigger than minus six point five and compare that to two point seven, so that's the numbers that Matt's talking about would be two to three times bigger in terms of exposure.

Doug:

So I guess philosophical question, as you're thinking about portfolio construction, is the ultimate goal to be able to source enough MSR so that you know, that the green bar that the combined basis exposure gets you to zero or close to zero, or how do you think about it from a philosophical viewpoint?

Bill:

That's a great question and it's one that we spend a lot of time thinking about internally. We actually think that the best portfolio for us, the best risk adjusted return portfolio is where that number is small but positive. So I don't think you would expect that number to be negative, really, that's not what we're trying to do. And even zero, we think that generally mortgage spreads are positive and add incremental return to a portfolio and so adding some of that to the portfolio mix is generally a good thing to do. So it's a question about relative size and it's a question about relative opportunities. And we view that amount of how much positive you want it to be, to be a lever that we can use to move around whether spreads are more or less attractive.

Doug:

Got it. Yeah. And then I guess just thinking about the other levers you know, I guess, how do you think about your capacity to add risk, whether that's through MSRs, through additional agency, through MBS, as you see them attractive, I guess, how do you view your current capacity to add risk today?

Bill:

Yeah, well as Matt and I have discussed already we've taken down our risks somewhat. As a reflection of slide 14, we've lowered our leverage. We've created some more capacity in the portfolio. Of course, it depends exactly how the thing unfolds and how orderly such a spread widening event is and we expect that spread widening will probably be accompanied by a move higher in rate, maybe with some convexity hedging flows and so forth. So it depends exactly on how that unfolds, but the intent is that we've created some capacity in order to be able to add the more when spreads are wider and we continue to like MSR here and IO as well, opportunistically. And so we've positioned our portfolio to be able to do that, should that occur.

Doug:

So I guess just thinking about the market and the risk, clearly we've seen a move higher in rates. I guess, is it possible that you have a decoupling of the move between rates and spreads and that we've seen the move in rates already and that the move in spreads happens closer to whenever the Fed begins to taper? Or do you think that they ... that that rates would, would still move with spreads at that point anyway?

Matt:

Well, I'll answer that and then Bill can answer. I'm not sure we have the same answer, but I think that those things are quite coupled, I would be quite surprised to see a move higher in rates not accompanied by a move higher in spreads, because I think the thing that makes the move is that it's the same event, which basically is, like I was saying a little bit before, GDP growth, growth expectations, inflation, inflation expectations, falling unemployment. I think those things all combined to force the price action that we saw happen in the middle of January, and then just in the last week.

Bill:

I would agree with that, but I would just add that there's nothing really about our position in our portfolio that depends on that being true or not, so it's interesting, but it's not ... that view is not really expressed anywhere in our portfolio.

Doug:

Okay. You know, and then I guess just a question as to are you seeing anything yet or any early indicators from what you see in the market that you're seeing any burnout in terms of refinance or any change in activity, or is that more just if rates continue to rise you'll likely see it?

Bill:

I would probably say not yet, the sign ... Maybe, I'd say it's a definite maybe. Some of the data from the most recent speed reports maybe indicating some of that, but I think the last thing you said is probably the most correct. I've been in the mortgage market since 1993, I've never seen a prepayment slowdown just because everyone's refinancing desire has been sated and everyone's done right. Refinancing waves always end by rates rising and speeds slowing from that. So is this the beginning of it? Maybe, time will tell.

Doug:

Got it. I guess during 2020, you guys had to make the decision to part with the credit portfolio during the volatility. I guess as you think about portfolio construction long-term, to the extent that credit markets would offer opportunities, what would be something that you would be willing to get back in, or is the agency plus MSR the right strategy long-term.

Bill:

We really like the Agency plus MSR construction and we like the liquidity profile of being an Agency-only REIT, we think that provides just a much better risk profile in liquidity stress environments like the one that we saw and should there be a repeat of such a thing being an Agency plus MSR construction, would serve us much, much, much better than the position we were in before with the credit portfolio.

Bill:

Now, I would say in terms of would be able to get back in, we even previously our previous credit experience was only really in legacy non-agency securities. We did not participate in any of the new credit markets at all and so I would say for us to re-enter that space, they would have to be something that would be strategically additive to the agency plus MSR construction. We really like that as a strategy, as a mousetrap, we think it's a better mousetrap and so whatever we would do would have to be complimentary in some real way, other than just, "Hey, there's some of this getting made and we think it's cheap, someone's buy something." We're not going to do that.

Doug:

Right. Yeah. I guess earlier, Bill, you mentioned some of the capital structure improvements that you have made recently I guess when you're thinking about the mix right now, between preferred and common, I guess how comfortable are you with the current levels. Do you think you need ... is there anything more that you need to do there?

Bill:

Yeah. Thanks for that question. I always think in terms of a blank piece of paper test, if you were to create ours from scratch and you were to make a capital structure from scratch, what would you do? I think the actions that we've done when we think about our funding mix in terms of common, preferred, convertible and the leverage that we employ both from the balance sheet and security side, as well as the internal leverage from MSR and IOs, we actually think that this is pretty close to what we would write down on that blank piece of paper, so we've done what we need to do, what we intend to do and we think it looks pretty good.

Doug:

Got it and then, I guess you also recently issued a convert. Could you just talk about the attractiveness of that, and how that compares to the cost of the preferreds that you have redeemed?

Bill:

Yeah, so we think convertibles do have a place in our capital structure. We like the diversity of funding sources and investors that provides. It's certainly a lower cost of capital than preferreds. It's one thing to compare versus the ones that we call as well. You could also compare with where do we think a new issue preferred would have cleared on the same day that got done and we think that difference is in the 200 basis point area and so it's a lower cost of capital and diversifies the funding sources and yes it has a finite maturity, but we also think that also provides us with some flexibility around our capital structure to that it's not permanent, and we can adjust it in the future as well, so we like those three aspects.

Doug:

I guess, just the last ... your stock, the sector has improved. You've seen a little bit of equity issuance in the space. Just along that tying to your viewpoint on the attractiveness of markets today. I guess, how willing would you be to grow the size of the capital base today?

Bill:

Yeah. I think our approach there is the same it's always been. We want to do something that's good for existing shareholders and we have to have something good to do with the money. And by good for existing shareholders, I would mean that we think that would be accretive to EPS and be able to make back ... it would either be accretive to book value, or if it's not accretive to book value, be able to make back the money in a very short period of time, so that we can see visibility of that if there's a real opportunity of some very attractive investment that we need the money for right then, so we're open to it. We obviously think it's good - increases scale, increases liquidity, and decrease costs, all of those things. So we're open to it but we've been very disciplined in the past about raising capital. We'll continue to do so in the future, but we're open to that.

Doug:

Right and I think with that, we're out of time. So, Bill, Matt, thank you both for joining us today.

Bill:

Thanks so much for having us, Doug.

Matt:

Thanks so much for having us, Doug.

Doug:

Thanks.

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