

An aerial photograph of a suburban neighborhood with numerous houses and trees. A semi-transparent blue rectangle is overlaid on the center of the image, containing the title and date. The background image has a warm, golden-hour light.

Two Harbors Investment Corp. Third Quarter 2023 Earnings Call Transcript

October 31, 2023



TWO HARBORS
Investment Corp.

PRESENTERS

Margaret Karr, Head of Investor Relations

Bill Greenberg, President and Chief Executive Officer

Nick Letica, Chief Investment Officer

Mary Risky, Chief Financial Officer

Q&A PARTICIPANTS

Bose George – KBW

Trevor Cranston – JMP Securities

Arren Cyganovich – Citi

Eric Hagen – BTIG

PREPARED REMARKS

Operator Greetings and welcome to the Two Harbors Investment Corp. Third Quarter 2023 Financial Results Conference Call. At this time, all participants are in a listen-only mode. A brief question and answer session will follow the formal presentation. If anyone should require operator assistance during the conference, please press “*”, “0” on your telephone keypad. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Maggie Karr, Head of Investor Relations. Thank you, Maggie. You may begin.

Maggie Karr Good morning, everyone, and welcome to our call to discuss Two Harbors' third quarter 2023 financial results. With me on the call this morning are Bill Greenberg, our President and Chief Executive Officer; Nick Letica, our Chief Investment Officer; and Mary Risky, our Chief Financial Officer.

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

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

I will now turn the call over to Bill.

Bill Greenberg Thank you, Maggie. Good morning, everyone, and welcome to our third quarter earnings call.

Today, I'll provide an overview of our quarterly performance and the markets. Mary will cover our financial results in detail and Nick will discuss our portfolio and return outlook.

Let's begin with Slide 3. Our book value at September 30th was \$15.36 per share, representing a negative 3.5% total economic return. Income excluding market-driven value changes, or IXM, was \$0.51 per share, representing a 12.6% annualized return. This backward-looking metric or realized return is analogous to the forward-looking metrics on Slide 14, but includes actual cashflows, actual prepayments and actual costs incurred in the quarter.

Please turn to Slide 4. Undoubtedly, the highlight of our third quarter was the closing of the acquisition of RoundPoint Mortgage Servicing, which reinforces our commitment to MSR as a core and essential part of our strategy.

When we first envisioned acquiring a servicer, our goal was to achieve economies of scale, improve MSR economics, and be able to leverage a more expansive set of opportunities in the mortgage finance space. Everything we have seen at RoundPoint in the last year, from the announcement through the closing, has given us confidence that our visions were not misplaced.

Let me expand a little more on this topic. The sub-servicing model works well when you have a small portfolio, because the cost to service is a fixed number of dollars per loan. However, when a portfolio gets to a certain size, it becomes more expensive, since the marginal cost to service is lower than the average cost.

For instance, it costs less to service the one millionth loan than it does the 100,000th loan or the very first loan. Conventional wisdom says that portfolios with approximately 500,000 loans are about breakeven, and this conforms with our own observations and estimates. As a reminder, we are owners of MSR related to more than 850,000 loans.

By bringing our servicing in-house, we can enjoy all cashflows related to the asset, whereas previously, we only participated in a fraction. Although we were already receiving 100% of the float income associated with holding the principal and interest, and taxes and insurance, we only received about 15% of the late fees and other ancillary income, and we did not receive any incentive payments from the GSE's for helping delinquent borrowers. These extra cashflows can be quite meaningful on a large and growing portfolio.

In addition to the immediate economics I just described, we intend to grow RoundPoint's third-party sub-servicing business. RoundPoint currently services approximately 80,000 loans from a total of six true third-party clients. We believe that we can grow this significantly. Furthermore, we will be, as they say, "eating our own cooking," which means that we can provide the same experience to clients as they tag along with what we will be doing for our own portfolio.

To-date, we have transferred approximately two-thirds of our MSR portfolio from our sub-servicers to RoundPoint. We have three final transfers remaining, and expect the last one to take place in June 2024. At the end of that process, we estimate that RoundPoint will have approximately 930,000 loans on the platform, which will make it the eighth largest servicer of conventional loans in the country.

The team at RoundPoint has done an excellent job of facilitating these loan transfers. October 1st, 2023, marks one year since our initial servicing transfer. RoundPoint has been able to keep up with the expanding portfolio through successful recruiting, technology refinements, and a commitment to delivering exceptional service to every customer.

Since last October, RoundPoint has completed eight reallocation transfers totaling approximately 600,000 loans. As one measure of the capabilities of the RoundPoint team: the average 30+ day delinquency rate, 90 days post transfer, is 16 basis points lower than it was before the transfer.

Additionally, with an operating entity, we can also participate more fully in the structured finance housing market. This includes areas like new loan products, reverse mortgages, HELOCs, second liens and other ancillary products.

We have an incredible opportunity to grow RoundPoint's and Two Harbor's businesses, together. Most importantly, this acquisition results in a bottom-line benefit to stockholders. We anticipate that the operation of RoundPoint will be accretive to our 2024 pre-tax earnings by \$25 to \$30 million dollars. Mary will detail this and the purchase price more fully in her remarks.

Turning to Slide 5, I'd like to engage in a brief discussion on the markets. The fixed income markets fluctuated during the quarter as participants tried to understand potential future Fed action or inaction. The June reading of headline CPI of 3.0% showed good progress coming down from a high of 9.1% the year prior.

However, CPI readings in August and September increased back to 3.7%. There are, of course, more factors that go into determining the market's reactions, but it all led to interest rates generally rising over the quarter. With greater acceptance of Fed Funds rates close to their peak and likely "higher-for-longer," along with concerns about greater treasury supply and spillover effects from overseas central bank tightening, the SOFR interest rates swap market curve repeat materially bear steepened as the quarter progressed.

The 10-year swap rate rose 68 basis points from 3.6% to 4.3%, while the 2-year swap rate rose 15 basis points from 4.8% to 5.0%, as you can see in figure 1. The rate on current coupon MBS increased 60 basis points from 6.7% to 7.3%.

Note that these rates are current coupon rates and not primary mortgage rates, which are often 75 to 100 basis points higher.

At quarter-end, the market's projection for short-term rates was that they should come down moderately through 2024, landing at around 4.7% at the end of next year, as seen in Figure 2 on the right-hand side of this slide.

Compared to the shape of the front-end of the curve in previous periods, current expectations have changed, calling for fewer cuts in total and extended out in time. The Fed has been clear that interest rate cuts are not imminent, and it seems that the market has finally taken the Fed at face value.

Elevated rate and spread volatility can pose near-term challenges to the sector. But, if rate volatility moderates, spreads at this level are very attractive for investing our agency portfolio. Additionally, with our MSR weighted average coupon at 3.4%, it is so far out-of-the-money that we have a very low convexity, low duration asset with stable cashflows. As you will see on our Return Potential slide, we believe that our combined strategy can generate low-to-mid teens returns in this environment.

October has seen continued difficulties in the MBS and interest rate markets. While rates have continued their upward trajectory, geopolitical volatility and its attendant flight to quality have not tempered the upward rise and caused large movements to intraday levels of rates, as well as in mortgage spreads. This is why we believe it remains prudent to maintain a neutral leverage position and low risk exposures.

Despite the continued market volatility, this is an exciting time for Two Harbors. We are uniquely positioned to capitalize on opportunities in agency RMBS and MSR, and our size allows us to be nimble enough to do so. The addition of RoundPoint improves our outlook as we expect to realize further operational and cost efficiencies, as it becomes fully integrated into Two Harbors.

Finally, we posted the first of our conversation series of videos last night. You can find them on our website under Investors and Insights. Each quarter, we plan to release videos on special topics in the REIT industry or specific to Two Harbors. We hope that you find these helpful and interesting. With that, I'd like to hand the call over to Mary to discuss our financial results.

Mary Risky

Thank you, Bill, and good morning.

Please turn to Slide 6. The company incurred a comprehensive loss of \$56.8 million, or \$0.61 per weighted average share in the third quarter.

Our book value was \$15.36 per share at September 30th, compared to \$16.39 at June 30th. Including the \$0.45 common dividend results in a quarterly economic return of negative 3.5%.

Let's take a moment to review the RoundPoint acquisition purchase price and anticipated post-closing adjustments. As a reminder, we paid a preliminary purchase

price of \$23.6 million, which was equal to RoundPoint's tangible net book value, plus a premium of \$10.5 million, less certain purchase price adjustments.

Additionally, we agreed to pay certain post-closing adjustments, which reflect the earnings of RoundPoint from October 1st, 2022, through September 30th, 2023. While these adjustments will be finalized in the next 30 days or so, and are subject to change, we currently estimate that this adjustment will add approximately \$21.1 million to the aggregate purchase price.

The estimated final purchase price of \$44.7 million is reflected in our financial statements at September 30th, 2023 and resulted in Goodwill and other intangibles of \$28.4 million.

In addition, we expect to pay a total of \$16 million dollars in departing fees to move our loans from our sub-servicers to RoundPoint. It's worth noting that \$10 million of these departing fees have already been realized and paid and are reflected in our current book value.

In combination with the expected incremental earnings of \$25 to \$30 million that Bill highlighted, we expect a return of approximately 60% on the invested capital.

Please turn to Slide 7. IXM for the third quarter was \$49.3 million, or \$0.51 per share, representing an annualized return of 12.6%. This was within the range of our estimated return potential of \$0.45 to \$0.61 at the end of last quarter.

Moving to Slide 8, let's look at some detail of the quarter-over-quarter variances in IXM. IXM is lower quarter-over-quarter, by \$8.2 million. Although it appears that IXM was primarily impacted by increased funding costs, these individual components shouldn't be viewed in isolation. In fact, the primary driver of the overall decrease in IXM was a reduction in asset balances and the large move higher in rates, which pushed the portfolio further out of the money.

As you will see on Slide 10, there's a steep slope to static spreads, which shows that MBS spreads are tighter for securities that are further out of the money. This had the effect of lowering the aggregate spread of the assets and IXM over the quarter as a whole.

As a reminder, IXM reflects our daily adjusted holdings over the quarter, as opposed to our return potential, which reflects a snapshot of our holdings as they existed at quarter-end. There can be quarterly distortions in IXM – like rolling repo or the timing of MSR cashflows – but we believe it is the most helpful way for our investors and analysts to understand the current quarter return contributions. IXM is complementary to the Return Potential and Outlook slide later in the presentation, which reflects our view on prospective returns.

Please turn to Slide 9. Spreads and repurchase agreements remained stable and liquid with financing for RMBS between SOFR plus 19 to 23 basis points.

At quarter-end, our weighted average days to maturity for our agency repo was 99 days, which helps us maintain stability in our financing. We finance MSR across four lenders, with \$1.7 billion of outstanding borrowings under bilateral facilities and \$296 million of outstanding 5-year term notes. We ended the quarter with a total of \$504 million unused MSR financing capacity and \$166 million unused capacity for servicing advances.

I will now turn the call over to Nick.

Nick Letica

Thank you, Mary.

Please turn to Slide 10. Over the third quarter, the correlation of higher rates, higher volatility and wider mortgage spreads remained in place. Nevertheless, the active management of our Agency coupon positioning and our exposure to MSR, coupled with disciplined re-hedging of our interest rate risk as yields rose, protected the portfolio, and resulted in less of an impact to our book value.

Let's look at Figure 1. Mortgage spreads performed well in July as rates and volatility remained stable, only to weaken during the months of August and September, as the yield of the 10-year Treasury notched its highest level in over a decade. For the current coupon, the nominal spread to Treasuries widened by 11 basis points over the quarter to 151 basis points, while the OAS increased 48 basis points, only wider by four basis points, given the concurrent increase in volatility.

At these levels, spreads remain very wide, historically, with a nominal current coupon spread well above the 90th percentile of long-term history. In a nearer-term context, spreads finished the quarter much closer to their averages since the beginning of June, a period that has mostly past the distortions of the banking crisis and raising the debt ceiling in the second quarter.

Focusing solely on the current coupon does not reveal the underperformance of lower coupons for the quarter, most of which took place during the latter half of September, as longer-end rates shot higher. What made this particularly interesting is that the FDIC successfully completed their sales of lower coupon MBS, like 2.5s, by early August, at which point the bonds had recovered almost all the widening that occurred since the banking crisis was touched off in March.

Call it guilt by association, but given the rise in rates and steepening of the yield curve, there was clearly no love for longer duration bonds and lower coupons at the longest duration RMBS.

Figure 2 shows quarter-over-quarter spread curves in nominal and option-adjusted terms. It's evident how much the lower coupons underperformed by seeing the curve flattening from one quarter to the next, particularly, when focusing on option-adjusted

spreads. As is expected, when coupons go up so do spreads, compensating the investor for a greater degree of repayment risk.

As you can see, the nominal curve, in blue, is still downward sloping, but less so than last quarter, with the higher coupons close to unchanged and the lowers moving higher. The option-adjusted curve at quarter-end was remarkably flat, especially considering the dramatic range of mortgage coupons available in the market and their inherently different risks.

Now let's turn to Slide 11 and discuss our portfolio positioning and activity in the third quarter. At September 30th, our portfolio was \$14.1 billion, including \$12 billion of settled positions. On the top right of the slide, you can see a few bullets about our risk positioning and leverage. Our quarter-end economic debt-to-equity was 6.3x.

Against the backdrop of continued elevated rate and spread volatility, we think it is prudent to maintain a neutral leverage position. Importantly, we don't need to add more leverage to generate strong returns, as you will see in a few slides when we detail our return outlook.

We kept our book value exposure to changes in rates low, but maintained a short duration bias given the propensity for MBS to widen as rates increase, particularly to long-end rates making new highs.

You can see more detail on our risk positioning by looking at slides 16, 17, 28 and 29 in the Appendix. On the bottom right of this slide, we've highlighted our portfolio activity in the quarter for both Agencies and MSR, which we will address in detail in the following slides.

Please turn to Slide 12 to review our Agency portfolio. Figure 1 shows the composition of our specified pool holdings by coupon and story, and then Figure 2, you can see the performance of TBAs and the specified pools we owned throughout the quarter. Though the entire stack underperformed, on a relative basis, we benefited from having a concentrated exposure to the "upper belly" coupons, like 4.5s and 5s.

These coupons outperformed primarily due to two factors: money manager demand that had previously been focused on lower coupons from FDIC sales and diminished supply as mortgage rates moved higher pushing them fully out of the production window.

Specified pools also outperformed TBAs. Roles generally traded below carry, making specified pools a better choice, particularly with semi-season pools that prepaid particularly well during the summer months.

We actively managed our positioning in the quarter, strategically moving our exposure within the coupon stack, as well as rotating some TBA exposure to specified pools.

Most notably, we moved close to \$2 billion of our TBA 5.0s position predominantly up in coupon to 6.0s and 6.5s. The rotation was driven by several factors, including strong performance in the quarter by the “upper belly” coupons as we already discussed, the natural need to reset our current coupon hedge against our MSR rates sold off and our belief that into a “higher-for-longer” environment, higher coupons should outperform.

Figure 3 on the bottom right shows our specified pool prepayment speeds, which were 6.7% CPR in the third quarter, increasing modestly from the second quarter. Given that our pool position is concentrated in discount bonds, faster speeds are beneficial to our performance. As you can see from the chart, on aggregate, speeds on these pools were materially faster than TBAs, hence providing more returns.

Please turn to Slide 13. Our MSR portfolio was \$3.2 billion in market value at September 30th. This was down slightly from June 30th because of the conversion of approximately 1.2 basis points of MSR to IO securities, reducing the net servicing fee on our MSR to 25.2 basis points. We did not buy any MSR through bulk purchases in the quarter but did add \$472 million through float purchases and recapture.

Speeds on our MSR holdings paid 4.9% CPR, declining 9.3% from the prior quarter. Over 60% of our MSR have a weighted average loan age of 20 to 40 months, and those had a CPR of only 4.3%. We expect prepayment rates to fall again in the fourth quarter, reflecting weaker seasonal factors and the rise in primary rates.

With the weighted average mortgage rate of our MSR close to 400 basis points lower than today's rates, prepayment speed should remain historically slow.

Finally, please turn to Slide 14, our Return Potential and Outlook slide. The top half of this table is meant to show what returns we believe are available in the market. We estimate that about 62% of our capital is allocated to hedged MSR with a market static return projection of 12% to 14%. The remaining capital is allocated to hedged RMBS with a static return estimate of 15% to 16%.

The lower section of this slide is specific to our portfolio, with a focus on common equity and estimated returns per common share. Note that with the closing of the RoundPoint acquisition, we have added an after-tax benefit of 80 to 100 basis points of return to this section of the outlook. With our portfolio allocation shown in the top half of the table, and after expenses, the static return estimate for our portfolio is between 10.4% to 12.9% before applying any capital structure leverage to the portfolio.

After giving effect to our outstanding convertible notes and preferred stock, we believe that the potential static return on common equity falls in the range of 12.3% to 16.3%, or a prospective quarterly static return per share of \$0.47 to \$0.62.

Circling back to my earlier comments, there is no need to employ more leverage with our return potential in this range. Our active management of our Agency coupon

positioning, our exposure to MSR, and our disciplined risk management benefited returns this quarter and protected the portfolio from additional downside.

While rate and spread volatility can pose near-term challenges to the RMBS sector, with our capital allocation and current spreads for RMBS and MSR, we believe this is a very attractive time to invest in our assets.

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

Q&A

Operator Thank you. Our first question is from Bose George with KBW. Please proceed with your question.

Bose George Hey, everyone. Good morning. Can I get an update on your book value, quarter-to-date?

Bill Greenberg You bet, Bose. Good morning. It's been pretty volatile in the markets with--in terms of both rates and spreads. But given all that, we estimate that as of last Friday's close, that our book value--or that our TER was down around 6%.

Bose George Okay. Great, Thanks. And then, with the acquisition of RoundPoint, do you have thoughts about how much capital you want invested in the MSR change, as you can benefit from synergies of being a larger servicer, or just how does that kind of play into your capital allocation?

Bill Greenberg Sure. Well, one thing I want to clarify, of course, is that the acquisition of RoundPoint in itself doesn't really attract more capital to the business, right, it's a servicing operational entity. The amount of servicing that we own as owners is we're pretty close to the ideal amount of what we want to own here.

Yes, we can add a little bit if there're good opportunities in that space. But we're pretty close to the capital allocation that we prefer. We do intend to grow the amount of loans on the RoundPoint platform through sub-servicing relationships as we said, but that won't change the capital allocation mix, per se. It will—if you look at Slide 14, that will just change the returns in that RoundPoint line in the bottom half of the chart.

Bose George Okay. Great. And then, just one more on the sub-servicing. How meaningful do you think that opportunity could be?

Bill Greenberg Well, I think there's a lot of opportunity there. There's lots of servicing that is for sale. There's lots of servicers that are moving around from sub-servicers from one to another. And I think that that our positioning in the market and what we are, which is a large owner of servicing, and a sub-servicer, is not that many of those guys in the market where people can put their loans next to someone who is--as I wrote, as I said in my prepared remarks, is eating their own cooking, right.

And I think we're able to provide sub-servicing clients a lot of what they're looking for that is underserved in the marketplace. So, I think we're really excited about that.

Bose George Great. Thanks. And then good job protecting your book value with all this volatility.

Bill Greenberg Thanks, Bose.

Operator Thank you. Our next question is from Trevor Cranston with JMP Securities. Please proceed with your question.

Trevor Cranston Hey, thanks. Another question on the RoundPoint acquisition. You made the points about, potentially, having the ability to explore participating in other segments of the structured finance market. I was curious if you could elaborate on a little--add a little bit and sort of what you would envision that to be in terms of investments for Two Harbors. Would that include things like, taking credit risk on these types of loans or exactly how do you see that evolving?

Bill Greenberg Sure. Well, with a large servicing portfolio and with a large operating platform, some amounts of portfolio defense and recapture is certainly going to be an important part of what we do. But the main point is that, once we have such an entity and we're involved in those activities, it opens up the opportunities to be able to do other things.

As I said in my prepared remarks, whether it's offering HELOCs or second liens or other products, that's something that we can certainly do with an operating platform rather than just being exposed to MBS spreads and MSR spreads.

In terms of taking credit risk, that's not something that we are particularly looking at. We like where we are in the conventional MSR and MBS space. And if we do participate in some of those other products, we would figure out ways to provide an outlook for those sorts of things and so forth.

It's unclear what form that will take yet because we haven't done it yet.

These are still in the in the former stages. But I think the number of different things and opportunities that we have is certainly plentiful.

Trevor Cranston Okay. Got it. And this is a question that I think has come up on a number of calls, before. But given how much mortgage rates have increased over the last couple of months, can you talk about how much rate sensitivity you see MSR asset having at this point?

Bill Greenberg Yeah, so, it's one of those things that I think is tempting sometimes, and sometimes as a shorthand, we'll even say, oh, with the mortgage rates 400 or 450 basis points out of the money that the MSR has no duration or it's a very low duration, low convexity asset. And that's true, but it doesn't have no duration, right, it has low duration.

And so, what I always like to think is that, is that an at-the-money pool of servicing will have a duration of say, minus 3, minus 4. That means that for an at the money pool of mortgages, if interest rates rise by a 100 basis points, servicing asset will change by 30% in value, right.

Our servicing 450 basis points out of the money probably has a duration of, I don't know, minus three, right? Minus three, minus four, somewhere in that zone. But we have a lot of servicing, right, and so, all that adds up to a non-negligible amount of duration, right. And you might ask, why does a servicing portfolio that's 450 basis points out-of-the-money even have any duration, right, why isn't it zero, right.

And this is something that we tried to talk about, I think in the first quarter, when we talked about what the duration, sensitivity of the float components of MSR is relative to the whole thing. Remember, as the owner of servicing, we not only receive the service fee cash flows, but we also enjoy the benefit of the float earnings on the principal and interest and on the taxes of it and insurance.

And I always like to call that the float components of servicing acts like what in the in the CMO market days of old, we used to call a super floater IO, which means that it's an interest-only cash flow; there's no principal attached to it. But when interest rates rise, especially the front-end part of the curve, the coupon, the earnings that you get also rises. So, the cash in it's typical servicing portfolio, the cash flows will extend because prepayments flow.

And the rate that you earn on those cash flows for longer also increases. Now, it's true that with the pool that's 450 basis points out of the money, the cash flows aren't really extending anymore. Prepayments fees have bottomed out. But the other effect is still present, that the earnings rate that you earn on the cash flows is going up as rates rise.

And in fact, while it might be true that the interest rate duration of the pure service fee strip of the servicing asset has switched from having negative duration to positive duration, meaning that part will go down as rates rise.

The floating rate components are still negative duration and in fact, are larger in magnitude than the positive duration of the strips so that the overall duration is still slightly negative, which gives you the overall minus 3 duration rather than the minus 30. Does that answer the question?

Trevor Cranston Okay. Yeah, a very good answer. Thank you.

Bill Greenberg Thank you.

Operator Our next question comes from Arren Cyganovich with Citi. Please proceed with your question.

Arren Cyganovich Thanks. I was wondering if you could talk a little bit about the outlook for rate volatility and maybe spread volatility. I know it's kind of crystal ball kind of question, but in this

kind of higher for longer and the Fed getting, hopefully, close to this tightening cycle. Would the natural expectation be for that volatility to subside a bit?

Nick Letica

Hey, Arren. This is Nick. Thank you for the question. It's really the question, I'd say, of the day, and it's really been a question, frankly, for the last year. I think we've talked about this almost every call that we've been on. And the markets are giving us signals that we're close to an end of this hiking cycle and maybe the Fed really is going to hold now.

We see that, if you look at the shape of the yield curve, for example, we've seen the two 10s curve, for example, go from something like wider than minus 100 basis points, not long ago, to only minus 20 now. It's that curve has become less inverted or has become steeper by about 80 basis points.

That's a signal the market is giving you that we are getting closer to the end of this cycle. But the reality is these things are famously difficult to predict and to tell. And that's the reason why in our comments, as we've said, we are being very respectful of the risk in the market. And we believe that our position is balanced and is, as we described, our leverage position is being neutral.

It gives us enough return potential, enough upside to a spread tightening event that we feel that we will capture that, yet at the same time, don't have an excessive amount of downside exposure should things continue to happen as with spreads widening. We have talked about spreads being wide historically, which they are. The problem is they keep getting a little bit wider, every quarter.

And we are respectful of that. So, we've kind of built into the portfolio the level of leverage and risk and composition between our MSR and our securities holdings that we know that generates, we think, a very, very attractive return potential. And should spreads tighten and we get a cycle change, we will definitely participate in that upside, as well.

Arren Cyganovich Thanks. And then, second question I had was, you had mentioned shifting a little bit higher in coupon, I guess, I think you said in the TBA side. How do you, or how are you hedging that and what's the risk to the extent that, I don't know the economy falters and there's a flight to quality and you start to see the 10-year fall again?

Nick Letica

There has been, I mean, good question. And there certainly has been a correlation between the performance of lower and higher coupons with the rate directionality. Now we hedge it the same way we hedge everything else. We use our models, and we have, we think as accurate representations of the risk of those securities versus the lower coupons. And we hedge it with a combination of futures and swaps.

And of course, with our, again, with our MSR, we have, as Bill has talked about it in the prior question about the sensitivity of our MSR to mortgage rates. There is still some sensitivity that impacts where--how our hedging ultimately resides, where exposure

is, ultimately, reside on the coupon stack. And one of the reasons that we did go up in coupon was the fact that the current coupon went higher.

I mean, that was part of it. And part of it was also, as I said, the rotation out of coupons we thought did really well. And also, just the fact that if you aren't in a "higher-for-longer" environment, the higher the current coupon should provide a lot of good return.

Arren Cyganovich Got it. All right. Thank you.

Bill Greenberg Yeah, I might just add that that, we do actively manage the portfolio not just in the interest rate rebalancing and so forth but, also, in coupon selection and where we are on the coupon stack. And some of that relates also to how we think--does relate also into how we hedge the portfolio and what risk we want to take in different environments.

And so, as rates move sometimes in addition to hedging, what I'll call the "theoretical interest rate exposures," we will often sometimes modify our coupon positioning which has an impact, as well. And so, as we see the lower coupons underperforming, we may choose to increase exposure there from time to time or as rates fall, we might be moving that down a coupon or up a coupon, as well. And so, it's a dynamic portfolio but the hedging strategy is the same in any environment.

Arren Cyganovich Got it. Thank you.

Operator Thank you. Our next question comes from Eric Hagen with BTIG. Please proceed with your question.

Eric Hagen Hey, thanks. Good morning, guys. Hope all are well. How do you see the bulk market for MSR developing if interest rates move even higher from here? Like, how much overall capital do you feel like you can maybe devote to the MSR in that scenario where there's bulk MSRs to buy and rates are higher at the same time?

Bill Greenberg Sure, thanks for the question, Eric. Look, there's ample supply of MSR in the bulk markets. And as we've said in the quarters passing and it continues to be true that the market is trading rationally and professionally and orderly. And the sellers, especially of large portfolios, seem to be strong hands that understand how the market works and isn't going to flood the market.

Then in no way, shape, or form, is the MSR market trading as a distressed market. It's happening in a very, very orderly way.

As I said a little bit earlier, we like our capital allocation right here. We're trying to balance the relative attractiveness of MSR with the relative attractiveness of MBS, along with making sure that we have ample liquidity in the portfolio and so forth, of which the MBS portfolio provides more so than the MSR.

So, if there's our average--if there are opportunities to acquire more MSR, we can certainly participate in that to some degree. We obviously can't double the amount of MSR portfolio that we have currently, but we can grow it a little bit. But we're happy with our capital allocation and the relative mix, given the opportunities that are in the market right now.

Eric Hagen Okay. A follow-up on the hedging. I mean, is there a way to hedge the float income component of the MSR? Is that not really a cashflow that's really worth hedging with repo also being present in the portfolio? Just how to think about that. Thank you, guys.

Bill Greenberg Yeah, thanks for the question. Not only is there a way to hedge the float components, but we do hedge the float components, right. That is to say that that when rates rose, we did not achieve a windfall from rates rising and the increased earnings benefit that we have because we hedged it. And should rates fall from here, we will not realize a degradation in our book value due to that because we will be hedging that, as well.

So, when we talk about hedging our portfolio, as we've discussed many times, and actually I think one of our conversations series that we just posted is about partial durations and hedging along the yield curve, right.

And so, the floating rate components have their own exposure along the yield curve, that's different than the pure interesting rate strip. But we put it all together when we manage the portfolio and we hedge the individual interest rate buckets, interest rate maturity buckets separately, so that we're able to hedge the floating income components, as well.

Eric Hagen Okay. Thanks for the information. Appreciate you guys. Thanks.

Operator Thank you. There are no further questions at this time. I would like to hand the floor back over to Bill Greenberg for any closing comments.

Bill Greenberg Well, I just want to thank everyone again for joining us, today. And thanks, as always, for your interest in Two Harbors.

Operator This concludes today's teleconference. Thank you for your participation. You may now disconnect your lines.

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