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FINAL TRANSCRIPT

Q4 2017 Two Harbors Investment Corp Earnings Call

EVENT DATE/TIME: 02/07/2018 09:00 AM GMT



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PRESENTATION

Operator

Good morning. My name is Shannon, and I'll be your conference facilitator. At this time, I would like to welcome everyone to Two Harbors' Fourth Quarter 2017 Financial Results Conference Call. (Operator Instructions) I would now like to turn the call over to Maggie Field with Investor Relations for Two Harbors.

Margaret Field

Thank you, Shannon, and good morning, everyone. Thank you for joining our call to discuss Two Harbors' Fourth Quarter 2017 Financial Results. With me on the call this morning are Tom Siering, our President and CEO; Brad Farrell, our CFO; and Bill Roth, our CIO. After my introductory comments, Tom will provide an overview of our quarterly and annual results, Brad will highlight key items from our financials, and Bill will review our portfolio performance and positioning.

The press release and financial tables associated with today's call were filed yesterday with the SEC. If you do not have a copy, you may find them on our website or on the SEC's website at sec.gov. In our earnings release and slides, which are now posted in the Investor Relations section of our website, we have provided a reconciliation of GAAP to non-GAAP financial measures. We urge you to review this information in conjunction with today's call. I would also like to mention that this call is being webcast and may be accessed on our website in the same location.

Before I turn the call over to Tom, I would like to remind you that remarks made by management during this conference call and the supporting slides may include forward-looking statements. Forward-looking statements reflect our views regarding future events and are typically associated with the use of words such as anticipate, expect, estimate and believe or other such words. We caution investors not to rely unduly on forward-looking statements. They imply risks and uncertainties, and actual results may differ materially from expectation. We urge you to carefully consider the risks described in our filings with the SEC, which may be obtained on the SEC's website at sec.gov. We do not undertake any obligation to update or correct any forward-looking statements if later events prove them to be inaccurate. I will now turn the call over to Tom.

Thomas Edwin Siering *Two Harbors Investment Corp. - President, CEO & Director*

Thank you, Maggie, and good morning, everyone. We hope that you had a chance to review our earnings press release and presentation that we issued last night. Please turn to Slide 3 to review our quarterly and annual results.

In the fourth quarter, we generated comprehensive income of \$65.7 million, core earnings of \$81.3 million, or \$0.47 per share. Our book value at December 31 was \$16.31 per share. These results were consistent with our expectation when we declared our fourth quarter dividend of \$0.47. As we announced in December, we anticipate this dividend to be sustainable into 2018, subject to market conditions and the approval of our Board of Directors. For the year, we generated comprehensive income of \$459 million, representing a return on average common equity of 13.6%. We also grew our core earnings return on average common equity to 11.3% from 10% a year ago.

Please turn to Slide 4. 2017 was a year of progress and transformation for Two Harbors, as we executed on our plan to maximize stockholder



returns through running a more efficient and focused business model. In 2016, we completed a thorough analysis of our business, reviewing the performance and growth potential of each area. As a result of this review, we discontinued our mortgage loan conduit, which allowed us in 2017 to reduce operating complexity and cost and most importantly, to make more money. Furthermore, in mid-2017, we formed Granite Point Mortgage Trust, a commercial real estate REIT and in the fourth quarter, completed the distribution of approximately 33.1 million shares of Granite Point common stock that we held as a result of the contribution of our commercial real estate platform to the new REIT. Additionally, we took advantage of opportunities to enhance our balance sheet and capital structure, completing a convertible debt offering and three preferred stock offerings, which resulted in a lower cost of capital that we believe will be accretive to our common stockholders. The execution of our plan resulted in annual core earnings growth, as you can see on the bottom of the slide, and three dividend increases, which reflected our stronger earnings power. Importantly, we achieved these strong results while maintaining an acute focus on book value protection and risk management.

Turning to Slide 5. Going forward, our straightforward business model will be focused on our residential rates and credit strategies, which are rooted in our core competencies of understanding and managing interest rate, mortgage prepayment and credit risks. There are three key factors that differentiate Two Harbors from our competitive cohort. Firstly, our strategy of pairing MSR with Agency RMBS helps protect our portfolio from changes in mortgage spreads and generates strong returns. Secondly, we use a suite of instruments to hedge our interest rate exposure, including swaps, swaptions, mortgage options and MSR. Bill will discuss this more thoroughly in a moment. Finally, our unique portfolio of deeply discounted legacy non-Agency RMBS is one that can't be easily replicated. This portfolio has benefitted from, and we believe will continue to benefit from, strong residential housing tailwinds and falling LTVs, which positively affect both default probabilities and prepayment speeds. In addition, positive changes in the MSR and non-Agency financing spaces creates the potential for greater returns in both our rates and credit strategies. Our ambition is to be the industry-leading hybrid mortgage REIT, and we intend to accomplish this by driving earnings power and delivering book value stability. This is the foundation for our areas of focus for 2018. In our rates and credit strategies, we will leverage our competitive advantage in MSR and our unique portfolio of legacy non-Agency RMBS to generate strong returns. We will continue to focus on diversifying our financing profile and managing our capital structure for the benefit of our shareholders, including adding additional MSR financing facilities, which is a strategic imperative for us. Furthermore, by emphasizing the development of additional technology solutions, we believe we can drive further efficiencies across our business, particularly as it relates to growing our MSR platform. Finally, we will maintain our sophisticated approach to risk management to protect book value and mute volatility. Heading into 2018, there are many positive considerations for Two Harbors. The recently passed tax reform legislation, which includes a 20% deduction benefit on ordinary REIT dividends, may increase the after-tax attractiveness of investing in REITs for certain types of investors. Additionally, as the Fed reduces their reinvestments in RMBS, we believe there could be a tremendous opportunity to add Agencies at attractive spreads. We will continue to grow our MSR platform through both flow sale and bulk purchases. In our credit strategy, we believe that returns on our legacy non-Agency portfolio will continue to positively benefit book value. All said, in 2018, we believe that we have the ability to generate strong earnings while maintaining book value stability through a variety of interest rate environments. I will now turn the call over to Brad for a review of our financial results.

Brad Farrell *Two Harbors Investment Corp. - CFO and Treasurer*

Thank you, Tom. Please turn to Slide 6. Comprehensive income was \$65.7 million for the quarter or \$0.38 per basic share, which represented a return on average common equity of 8.5%. Our book value at December 31 was \$16.31 per share, as compared to \$19.56 at the beginning of 2017 after adjusting for the reverse stock split.

Combined with our common stock cash dividends of \$2.01 and the Granite Point stock distribution amounting to \$3.67 per common share, our annual return on book value was 12.4%. As I've noted on past earnings calls, due to our prior controlling ownership interest in Granite Point, we consolidated Granite Point on our GAAP financial statements until the distribution of the Granite Point shares on November 1. Granite Point is now classified as discontinued operations. We have disclosed financial metrics throughout our earnings materials, which focus on our continuing operations to assist stockholders in better understanding our financial performance.

As we turn to Slide 7, let's review our core earnings results. Fourth quarter core earnings were \$0.47 per basic share compared to \$0.51 per basic share in the third quarter. As we noted on our third quarter earnings call, we expected to have numerically lower core earnings due to our lower capital base following the distribution of Granite Point stock. As expected, our core earnings return as a percentage of average equity increased to 11.3% in the fourth quarter from 10.2% in the third quarter. We are pleased with this growth in our core earnings return on average common equity, as the completion of various strategic initiatives over the past 18 months has resulted in higher earnings without

compromising our goal of prudently protecting book value. Looking at this slide, you will see that core earnings from continuing operations this quarter benefited from the addition of RMBS in our portfolio as well as MSR portfolio growth from approximately \$9 billion UPB bulk purchase, as we deployed capital from our Series C preferred stock offering. Our other operating expense ratio from continuing operations was 1.1%, down from 1.4% in the third quarter. This reduction is largely related to a favorable quarter-over-quarter variance and our LTIP amortization of \$3.9 million due to decline in our share price following the Granite Point distribution and resulted in fair value of the unvested restricted shares.

Going forward, we expect our continuing operations expense ratio to be in the range of 1.1 to 1.4%, excluding noncash LTIP amortization. But this will remain largely dependent on the volume of MSR transactional activities.

Please turn to Slide 8, as we briefly discuss our taxable income and dividend distributions in 2017. As previously stated, it was our goal to distribute 100% of our taxable income through our cash dividends in 2017. Excluding the Granite Point dividend, we distributed \$347.9 million, which achieved this goal. As such, 36% of our cash and Granite Point distributions will be treated as dividend income, with the remaining 64% treated as a return of capital to Two Harbors' stockholders. We will not be carrying forward any taxable income into 2018. More information on the tax treatment of dividends in 2017 can be found on our website under Investor Relations and Dividend History.

As we turn to Slide 9, I'd like to highlight how we've optimized our financing profile and capital structure in 2017 and our areas of focus for 2018. Our debt-to-equity ratio was 5.9x at December 31. This is consistent with our expectations, following the deconsolidation of Granite Point. As you will recall, on our third quarter earnings call, we stated that pro forma debt-to-equity at September 30, would have been 5.8x. We are comfortable with our current level of debt-to-equity and maintain plenty of liquidity to take advantage of market opportunities. We successfully executed 3 preferred stock offerings this year and preferred equity now accounts for \$726 million or approximately 20% of our capital base. With a weighted average coupon of 7.6%, we believe that the preferred offerings will be accretive to our common stockholders over time, as the proceeds from these offerings have been invested into RMBS and MSR, where we see attractive return opportunities, as Bill will expand on shortly. We believe that our diversified financing profile and, more specifically, recent positive changes in the MSR and non-Agency financing space can be a positive to our future earnings performance. We have begun to see new counterparties entering the repurchase market and larger counterparties favoring pool spreads versus treasuries. Additionally, it is important to highlight that the repo market for non-Agencies has recently become much more competitive, and we've seen improvements in both advance rates and spreads in the latter half of 2017. We expect this positive trend to continue into 2018. We continue to thoughtfully manage our FHLB capacity, which stood at \$1.2 billion outstanding at December 31. The FHLB is a valuable financing alternative for us and offers financing capacity should the repo markets become strained. After several months of discussions, we closed a \$300 million financing facility for Fannie Mae MSR collateral. This exciting development offers three competitive advantages: first, the ability to generate incremental MSR returns on a levered basis; second, a multi-year financing term at a favorable spread to LIBOR of 225 basis points; and third, two-way margining. In particular, we believe that the two-way margining feature will allow us to better manage our liquidity when rates go up and we experience increases in the value of MSR collateral. As of December 31, 2017, we had \$112.5 million outstanding under this financing facility with an additional available capacity of \$187.5 million. We continue to advance other MSR financing discussions, focused on similar terms and two-way margining.

Heading into 2018, it is a strategic imperative for us to add additional MSR financing facilities, while also maintaining a keen focus on liquidity management. I will now turn the call over to Bill for portfolio update.

William Meyer Roth *Two Harbors Investment Corp.* - CIO & Director

Thank you, Brad, and good morning, everyone. Please turn to Slide 10. As of December 31, our overall investment portfolio was \$22.4 billion, with 68% of capital allocated to our rates strategy and 32% to credit. We completed a preferred stock offering in the fourth quarter and deployed that capital into our rates and credit strategies in roughly the same proportion as our current capital allocation.

As we will discuss shortly, we believe that returns in our rate strategy are in the low to mid-double digits, and expect similarly strong total returns in our credit strategy.

Moving to Slide 11. I'd like to discuss some of the drivers of our portfolio performance in the quarter. Our net interest spread was 1.97%, which was relatively unchanged quarter-over-quarter. In our rate strategy, specified pools gave back some of their price outperformance that



occurred in the third quarter, somewhat negatively impacting book value. Residential credit continued to perform well, as we realized attractive yields and a strong overall return driven by slightly better valuations across our portfolio.

As we move to Slide 12, let's discuss the opportunities in our rate strategy and how our portfolio of MSR paired with Agency RMBS is a distinguishing factor of our business. In conjunction with our preferred offering in November, we increased our Agency holdings and grew our MSR portfolio through flow sale arrangements and a \$9 billion bulk purchase. In addition, late in the quarter, we opportunistically added another \$8.7 billion of MSR through a bulk purchase that closed on February 1. Over the past several months, our MSR has been hedging about 30% of our Agency holdings, and we intend to increase that percentage over time depending on market conditions. Moreover, as Brad noted, the addition of financing for MSR in the fourth quarter allows us to continue growing our portfolio going forward to further benefit our rates strategy. Our portfolio of MSR is a distinguishing factor for Two Harbors and key component of our hedging strategy because it allows us to generate better returns with lower risk. Furthermore, there are high barriers to entry to be able to own MSR. We believe that MSR is very valuable in this market environment, as it hedges both interest rate and spread risk in our rates strategy.

Please turn to Slide 13. Higher interest rates and a flatter yield curve are historically the bane of mortgage REITs. However, we believe that the combination of our hedging strategy and floating-rate non-Agency holdings leads to our book value and net interest income exposure to be relatively insensitive to moves in interest rates and curve shape. Let's examine this in more detail, starting on the right-hand side of this slide. As we move into an environment of potentially higher rates and with the Fed reducing their reinvestments in RMBS, there is the possibility for wider mortgage spreads. In this situation, MSR benefits our portfolio because it increases in value when mortgage spreads widen. Combined with the use of swaps, swaptions and mortgage options, we feel that we can protect book value through a variety of rate and spread environments. On the bottom right of this slide, you can see that as of December 31, our expected book value change with rates up 25 basis points is a decline of 0.7%. Additionally, as the Fed increases interest rates, there will likely be the effect of continued curve flattening, which has the potential to compress net interest margins. Moving to the left-hand side of this slide, you can see that as short-term rates increase, repo rates go up, which has a negative effect on net interest income. However, we are well positioned should this market scenario occur. As short-term rates go up, we expect to benefit from higher income from receiving LIBOR on swaps, non-Agency floating rate coupon increases and increased float income on our MSR. On the bottom left, you can see that our expected change in net interest income in an up 25 basis points scenario is a positive 2.4%.

By actively managing our exposures on a daily basis, we believe that we can deliver shareholder value through book value stability and income generation in a variety of rate and curve environments. To further highlight this, despite the dramatic move up in rates in January, our book value is relatively unchanged from December 31. This is a testament to our approach to risk management and hedging.

Moving to Slide 14. Let's discuss our credit strategy. Our unique portfolio of deeply discounted, legacy non-Agency RMBS is a distinguishing feature of our strategy because of the total return opportunities that exist. 2017 was an excellent example of this as yields were strong and bond prices improved. Residential credit assets benefited from increasing home prices supported by affordability, low housing supply and strong demand. Street research reports note that total returns for the non-Agency sector on an unlevered basis ended the year at about 9.6%, which includes yield and price gains. As a result of this, our non-Agency portfolio contributed nicely to our strong performance for the year and benefited our book value.

In addition to the strong returns we've already realized, we believe our credit portfolio has the potential for even greater price improvement and total returns. While many credit assets today trade at or near par, our portfolio, with a weighted average market price of \$76, has a tremendous amount of upside price potential over the coming years. Residential credit tailwinds remain strong and continued re-equification by borrowers can result in increased prepayments, lower LTVs, delinquencies, defaults and severities. Taken together, we believe these factors can positively impact our credit strategy, driving bond prices higher and generating strong total returns, which benefit our book value going forward. In closing, we are excited about our portfolio positioning across our rates and credit strategies and the potential opportunities that could arise from the Fed's tapering of their RMBS reinvestments. We are focused on taking advantage of the key factors that differentiate us from our peers, growing our MSR position, maintaining our sophisticated approach to hedging and extracting total returns from our non-Agency portfolio. By doing this, we believe that we can deliver value for our shareholders through book value and income stability and earnings growth. I will now turn the call back to Shannon for Q&A.

QUESTIONS AND ANSWERS



Operator

(Operator Instructions) Our first question comes from Doug Harter with Crédit Suisse.

Douglas Michael Harter *Crédit Suisse AG, Research Division - Director*

I was hoping you could talk a little bit about the pipeline to continue to grow the MSR portfolio and, sort of, how the returns on that piece of the rates strategy has changed, given moves in rates?

William Meyer Roth *Two Harbors Investment Corp. - CIO & Director*

This is Bill. Yes, so as we've said in the -- in past quarters, we have this flow sale program with small and mid-sized originators. And that's been generating, and we expect it to continue to generate \$2 billion to \$3 billion a month, call it \$2.5 billion, over the course of the year, of monthly flow volume. In addition, I mentioned that we just recently, just last week, closed on \$8.7 billion of a bulk deal that was agreed to in the fourth quarter, and we just closed on February 1. We do remain active in the bulk market, and we would expect to take advantage of opportunities that may come up throughout the year. In terms of returns, returns on Agency today, agencies just hedge with interest rate products are in the single digits as we see it. Maybe, you can get to 10%, but agencies paired with MSR, we still see that in the low to mid-double digits in terms of returns. And so, as we've talked about in the past, adding MSR financing, which we've just completed one, and as Brad mentioned, we're working on others, is a key strategic focus to enable us to continue to grow the MSR part of our book.

Douglas Michael Harter *Crédit Suisse AG, Research Division - Director*

Got it. And then I think you mentioned that about 30% of your Agency book is hedged with MSRs. Can you just talk, what that might mean in -- if we do see 10, 15 basis points of widening in the Agency basis, what that means in terms of your book value risk?

William Meyer Roth *Two Harbors Investment Corp. - CIO & Director*

Yes, sure. We have put numbers out on that in the past, and as there is an update to that. As of the end of the year, if we had a 15 basis point widening in Agency mortgage spreads, we would expect our book value to drop by about 1.3%. And then if it was 25 basis points, it would be sort of in the 2.5% to 3% range. So, obviously, MSR is doing a tremendous job there in protecting book value if we saw wider mortgage spreads.

Operator

Our next question comes from Bose George with KBW.

Eric J. Hagen Keefe, Bruyette, & Woods, Inc., *Research Division - Analyst*

It's Eric on for Bose. Bill, I'm hoping that, maybe, you can just tease apart for us the improved ROE that you guys are expecting on MSRs, just given the added leverage that you're -- that seems to be you're using on the -- in that segment of the portfolio?

William Meyer Roth *Two Harbors Investment Corp. - CIO & Director*

Yes, sure. I think we've talked about this, maybe not last quarter, the quarter before that adding leverage to the MSR boosts the overall returns that I just mentioned by about 100 to 200 basis points. And so, in addition, it just help us with liquidity management as well as margin management. In other words, the facilities we're putting into place now have 2-way margining. So when rates go up, we actually get margin call on the agencies, but then we get margin benefit on the MSR side.

Eric J. Hagen Keefe, Bruyette, & Woods, Inc., *Research Division - Analyst*

Right, that's good to know. And then in 2016, you guys were pretty active in repurchasing shares when they sold below book value. Do you believe valuation is at a level now where you could -- or we could see some buybacks?

Thomas Edwin Siering *Two Harbors Investment Corp. - President, CEO & Director*

Eric, it's Tom. In respect to that, it's always been our policy inter-quarter, not to talk about share repurchases, we just don't think it serves our shareholders, because it basically signals to the market where we might be repurchasing shares. And so we don't think that's a winner for our shareholders. But we've been quite aggressive, as you know, in the past when we felt the valuation was at a level that trumped investment alternatives. And if we get into that territory and when we get into that territory, we certainly won't be shy about repurchasing our shares. We



consider our balance sheet management to be one of the strategic imperatives for the company. So in the past, we've taken advantage of share repurchases, preferred stock offerings, convertible bonds, convertible bond offerings, so we have a suite of options on how to improve shareholder return and that shareholder return, obviously, is our #1 mission.

Eric J. Hagen Keefe, Bruyette, & Woods, Inc., Research Division - Analyst

Tom, then just given the way you guys hedged the portfolio, I don't imagine book value has corrected meaningfully since the start of the year, but if you can just give us a general sense for the change in book value since January 1, that'd be really helpful.

Thomas Edwin Siering Two Harbors Investment Corp. - President, CEO & Director

Sure.

William Meyer Roth Two Harbors Investment Corp. - CIO & Director

Yes, so Eric, I think we did mention on the call that our book value is roughly unchanged since the end of the year. And I would also point out, importantly, that this takes into account the dividend accrual. So in other words, taking into account the fact that we've earned money over the dividend, our book value is roughly unchanged through the end of January. And you know as you could see from Slide 13, in my comments about mortgage spreads and the sensitivity to our book value, we believe our book value is relatively insensitive to mortgage spreads as well as interest rate. I would also point out on the bottom right of Slide 13, we showed an instantaneous book value of potential exposure to a change in rate, up 25 and 50 being down slightly. I would point out that as of the end of January, those numbers, both those numbers, are very close to 0.

Thomas Edwin Siering Two Harbors Investment Corp. - President, CEO & Director

Yes. So Eric, it's Tom. So I need to process this with a big caveat, a month does not a quarter may. But the slight decline in our share price, we actually had a pretty good January. So that sometimes markets think what they think, but it's just a testimony that MSR is doing its thing. Credit continues to perform well, et cetera. So we're happy with our January. Again, I must say, that doesn't guarantee that continues for 2 more quarters -- or 2 more months in the quarter, but we are pleased with January.

Operator

Our next question comes from Trevor Cranston with JMP Securities.

Trevor John Cranston JMP Securities LLC, Research Division - Director and Senior Research Analyst

Question just on the interest rate environment. Obviously, there's been a fairly substantial move in rates since the end of the year and a bit of a pick-up in volatility. I was just curious if you guys could share your view, specifically, on volatility, and if you think that going forward, it's going to maybe pick up to a more elevated level versus where it's been the last couple of years? Or if you believe that it's going to remain relatively muted? And also maybe comment on how that impacts how you guys are hedging the combination of agencies and MSRs?

Thomas Edwin Siering Two Harbors Investment Corp. - President, CEO & Director

Yes, Trevor. As you know, I don't run the investment book, so I am going to -- so I can toot the horn of people who do. The team has done a really great job in this interest rate volatility, managing our convexity within the portfolio. So we're really pleased with where we are at this point in that respect. And with that, I'll hand it over to Bill for further comments.

William Meyer Roth Two Harbors Investment Corp. - CIO & Director

Yes, Tom. Trevor, yes, a couple of things. I think, we talk about how we hedge across the curve, and we use a variety of different tools. I think that's really important. When you get a chance, you can look in the Appendix on Slides 27 and 28, and you'll see we have a substantial amount of swaps and swaptions, both long and short which in combination with our MSR neutralizes a lot of our exposure as well as our volatility and convexity risk. And so, active management of that is really key. In terms of -- and we plan to continue to do the same thing we've done for years to protect our book value and earn our income. In terms of our outlook, our outlook is, as the Fed will continue to raise rates as the economy -- our expectation is the economy is doing just fine. We've talked about the tailwinds to housing as a result of that, and we think that the Fed will continue to push up the front end, the Fed funds rate. The long end will most likely be tied to inflation metrics, so if we do see wage pressures and increased -- we started to see a little bit of that. You would -- we would expect to see the long end move up somewhat. As a result of both of those, I think our expectation is this volatility will be higher than it has for the past several years, primarily

because we've been in such a low level of implied and realized volatility as a result of central bank of the -- what the Fed has done. So I think higher volatility is here to stay. I don't think it will return to the levels that we saw during the crisis anytime soon, but in terms of our managing the book, our tactics and our philosophy is not going to be changed as a result of that.

Operator

Our next question comes from Rick Shane with JPMorgan.

Richard Barry Shane *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

A quick question, then I want to delve into 1 other topic. There's comment in the beginning of the slide deck about investment in technology for the MSR portfolio. Is that primarily analytics? Because I am assuming that this business, given the nature of the investment, really is fully scaled. So I just want to make sure, I understand the technology investment.

Thomas Edwin Siering *Two Harbors Investment Corp. - President, CEO & Director*

Yes, I'm going to hand-- this is Tom, I'm going to hand that question over to Brad.

Brad Farrell *Two Harbors Investment Corp. - CFO and Treasurer*

Yes, I think you've actually got 2 parts of it, [and what we are trying to say there, one, moving MSR from where we were a year ago to where we're continuing to grow the platform, surpassing \$1.1 billion and growing, there is always efforts to do both. One, to continue to refine and improve our quantitative analysis around that portfolio. Obviously, making sure we understand any risk of delinquencies, prepayment behaviors. And so that's, obviously, critical. And then second, we always have opportunities to scale better. We feel that we've scaled already quite well on growing the portfolio from \$0.5 billion to \$1.1 billion. But there is still further opportunity to get more scale on, as we add the next \$0.5 billion or whatever we potentially add in the future. So the comment there is that, if we're growing this platform, we have to think about how technology can add value to us and not only manage the portfolio but also manage the compliance and regulatory risk that go along with the asset. So the comment is kind of broader and just, kind of, commenting that we -- we'll -- we do see technology as important to that platform.

Richard Barry Shane *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Okay, got it. Second topic I'd like to delve into is selling off of the retains of subs from the previous securitizations. Just like to understand what drove that strategically, and also make sure that we understand any accounting implications going forward in terms of potential mark-to-market.

William Meyer Roth *Two Harbors Investment Corp. - CIO & Director*

Rick, it's Bill. I will take the first part and then turn it over to Brad for the accounting implication. So when we had an ongoing conduit business, and we're continuing to produce credit pieces and IO pieces for the portfolio, maintaining our positions and continuing to have that part of the -- our portfolio made a lot of sense. What happened, obviously, as we exited the conduit business, those effectively, we looked that as any regular investment security. And so we saw a tremendous tightening in spreads for new issue credit pieces in the second half of 2016. And the -- to be perfectly honest, the spreads at which those were trading relative to the returns that we could earn at those spreads just didn't make it justified to continue to hold. Frankly, it had nothing to do whether they were retained or not retained. Had we bought them a year earlier in the secondary market, we would have sold as well. So it really just had to come down to where the spreads were, and they were too rich for us to hold, and we had better uses of the capital elsewhere. So let me turn that over to Brad in terms of any accounting implications.

Brad Farrell *Two Harbors Investment Corp. - CFO and Treasurer*

Yes, on the accounting side. It's also just a much cleaner balance sheet and story there as well. So the trust, we de-consolidated any accounting noise from that occurred in the fourth quarter. Any of the -- any small retain bonds, largely IOs that we do hold now are just classified as available-for-sale securities in our accounting for fair values like any the other non-Agency security. So no, you would not expect any noise in any meaningful manner going forward from these.

William Meyer Roth *Two Harbors Investment Corp. - CIO & Director*

Rick, let me just -- going to just clarify. I think, I said tightening of spreads in 2016. I meant the second half of 2017, my bad, my apologies.

Richard Barry Shane *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Don't worry, I've done this long enough times, starts to blur for me a little bit as well, so I am with you. I guess, the follow-up to that for Brad is, with the de-consolidation, it sounds like there will now be mark-to-market with the securities, because they are held like anything else on balance sheet. Do -- will you -- and again, this is, sort of, a noneconomic, it's more of an accounting-driven issue, but do you have to hedge those securities in a different way? Presumably, it's already on there, but I want to make sure that we understand the economic flow through if your hedging them in a way that you weren't before.

Brad Farrell *Two Harbors Investment Corp. - CFO and Treasurer*

A couple of things there. One, it's largely immaterial noise on our balance sheet of what we do hold now. Economically, they're no different than what we had before. So the loans and the debt that we consolidated, we had left it a fair value option for. So we were already fair valuing, if you will, what we held. So really -- there's really no -- there's no meaningful change from the accounting in how we manage the portfolio. If there is any residual rate risk in the retained bonds we hold, there would be hedging that in the entire portfolio just like any other security. So really, it truly is just negligible noise as we go forward.

Operator

Our next question comes from Jessica Levi-Ribner with B. Riley FBR.

Timothy Paul Hayes *FBR Capital Markets & Co., Research Division - Former Associate*

This is Tim for Jessica. My first question is just, kind of, what's your overall leverage target on the MSR portfolio? And then, can you give us an idea of timing around securing additional facilities?

William Meyer Roth *Two Harbors Investment Corp. - CIO & Director*

Yes, this is Bill. I'll take the first half and then turn over for Brad -- to Brad for the timing. So in terms of leverage, I have 2 answers to 1 question. Just on the MSR part, we're anticipating advance rates somewhere in the 50% to 60%, plus or minus range. So that'll give you, sort of, an idea. And then, given that it's paired with Agency pools, then we would have, sort of, an effective leverage for the rates strategy, which we -- over the last several years, has ranged in the 6 to 8x. One thing that's worth noting is that if we carry the same leverage in the rates strategy as an Agency-only REIT but with MSR, obviously, as we've talked about before, we have -- overall, we have less risk in terms of rates and spread moves. But anyway, hopefully, that answers the leverage side, and then I'll turn it over to Brad.

Brad Farrell *Two Harbors Investment Corp. - CFO and Treasurer*

Yes, I think, from a timing perspective, these things do take quite a bit of time. Most importantly, they involve the approvals of the GSEs. So it's really difficult to estimate exactly how quick that would occur. We hope to have another facility in place in Q2. I think it would be a reasonable approach to how we're trying to approach our negotiation. But again, that's going to be very much subject to approval from Freddie and Fannie. Really, what we're focused on here and we've, kind of, touched upon it, but the facility is that allow for multiyear as well as 2-way margining, we can't say enough about how much value that is not only the ability to apply leverage and also to manage cash and margin when rates do change. So we're really most focused on getting the right facilities in place, and we do hope to get a second facility in place in Q2 and having other discussion as well to have more in the back half of the year. Hopefully that gives you enough color.

Timothy Paul Hayes *FBR Capital Markets & Co., Research Division - Former Associate*

Yes, absolutely. And then just a, follow-up, given your favorable comments around non-Agencies, where could we see your capital allocation next heading, and, overall, are you just comfortable, kind of, with how the portfolio's division today?

William Meyer Roth *Two Harbors Investment Corp. - CIO & Director*

Yes, sure. I'll take that one. This is Bill. Yes, our credit strategy has been running roughly around 30% of capital. We are particularly focused on the deep discount legacy assets, because as we've talked about for the past however many quarters, that's where we see the most value and the most opportunity to drive book value. If you think about most new issue credit pieces are trading around par, you don't really have that upside, so our ability to grow that is really just constrained by the availability of assets that we like, and so I don't think that you should expect -- since that isn't as big a part of the market as it was in the past, I don't think you should expect that number to increase dramatically but we're certainly happy to keep it where it is or grow it as opportunities exist to do so.



Operator

This concludes the Q&A session. I will turn the call back to Mr. Siering for concluding comments.

Thomas Edwin Siering *Two Harbors Investment Corp. - President, CEO & Director*

Thank you, Shannon, and thank you, everyone, for joining our fourth quarter conference call today. We're quite pleased with the execution of our plan in 2017, and we're very excited about the opportunities we see for our business in 2018. We will be participating in the Crédit Suisse Financial Services Forum in Miami, Florida on February 13. We hope to see you there. Have a great day.

Operator

Ladies and gentlemen, this concludes today's conference. Thank you for your participation. Have a wonderful day.

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