2015 ANALYST AND INVESTOR DAY

Transcript

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TWO HARBORS
Investment Corp.

A Pine River Capital Managed Company

Tom Siering, *Chief Executive Officer*
Bill Roth, *Chief Investment Officer*
Brad Farrell, *Chief Financial Officer*
Margaret Field, *Investor Relations*

SAFE HARBOR STATEMENT

Hi, good afternoon, everyone. Thank you for joining us today. Before management begins its presentation, I would like to review our Safe Harbor statement. For listeners joining via webcast, I'm Margaret Field with Investor Relations at Two Harbors.

We wish to remind you that remarks made by Two Harbors' management during this event may include forward-looking statements. Forward-looking statements reflect our views regarding future events, expectations, plans and prospects and are typically associated with the use of words such as anticipate, target, expect, estimate, believe, assume, project and should or other similar words.

We caution investors not to rely unduly on forward-looking statements. They imply risks and uncertainties and actual results may differ materially from expectations. We urge you to carefully consider the risks and uncertainties described in our filings with the Securities and Exchange Commission which may be accessed on the SEC's website at www.sec.gov.

Our forward-looking statements are based on factors that are subject to change and therefore these statements speak only as of the day they are given. We do not undertake any obligation to update or correct any forward-looking statements if later events cause them to change or become inaccurate.

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

EXECUTIVE OVERVIEW - TOM SIERING

Thanks, Maggie. How many people had seen the movie or read the book *Moneyball*, can we get a raising of hands? So you are familiar with the expression that when a player had the right "look" that was known as "having a good face", right? Well, good thing for our Investors, that Bill and I certainly weren't hired because we had a good face. Today, I am going to speak for a bit and then Bill and Brad will speak and then we are going to wrap up and take some Q&A.

This is a great day for us to come together and speak about what we are seeing in the market and how we see the world going forward. With respect to the macroeconomic perspective, it's been an interesting time. We've had a lot of rate volatility especially in consideration of absolute rates. We are dealing with the end of QE, so the Fed is going to be still buying, but the participation should be less going forward. So this causes us to be cautious, frankly, and we are also going to speak to this in greater length but one of the reasons why our spread duration leverage is relatively low today.

So, with respect to our credit strategies, we look at a lot of things, obviously unemployment, the unemployment rate is really become an imperfect measure of possible wage inflation, but nonetheless, on a broad sense you've seen it down to 5.5% from 6.7% in February 2014. That's the lowest it's been, obviously, post crisis.

HPA continues to be positive, although we anticipate that it will be at a more modest pace going forward. We view all these things in respect of both our rates and credit strategies. Let me talk for a minute about FHFA, that's obviously been in the meme around the proposed rulemaking change. We submitted a response letter which can be found on our website. We understand that more than 1,200 letters were submitted. And I think that was probably far in excess of the anticipation of FHFA. We are waiting to see what comes from that, and obviously that's important to us, because we were the first REIT of any kind to gain admission to the home loan banks. Our relationship with Home Loan Des Moines is excellent, as represented by the increase in our facility that we recently announced, and Brad is going to speak more to that later.

We think REITs are very important to the mortgage market as the only private permanent capital providers in the U.S. mortgage market. And, as such, we think we are a perfect fit for Home Loan's mission to support long-term housing. Two Harbors obviously is extremely well capitalized, and we provide a parental guarantee, which represents $4 billion in capital. So, we believe that not only are we very mission based, but we meet the safety and soundness mantra of Home Loan Banks.

As I said in our opening remarks, we are more immersed in Washington than we were in our early days. There are a few things we are interested in, including conforming loan limits because conforming loan limits define Freddie, Fannie and FHAs balance eligibility. They directly affect the quantity of loans available for Private Label Securitization. A large quantity can help the Private Securitization market increase in depth and liquidity.

The government continues to have an outsized footprint, and we think there are many benefits to reducing the conforming loan limits. G-Fees are important. Fannie and Freddie have been a key focus for much of the mortgage market in respect to the G-Fees because they determine how much the GSEs will compete with the private market.

If G-Fees are set lower, a private entity would price risk the GSE crowds out creating undue credit risk for tax payers. Freddie and Fannie's regulator, the FHFA, has indicated they will be releasing G-Fees changes very soon. We submitted a comment letter in September in support of G-Fees being set at a similar level that private capital would charge for the same risk to make sure the GSEs are properly charging for credit risk.

Another thing that we are interested in is Private Label Securitization as we build our conduit business and then increase our aggregate securitizations; we have a deep interest in the return of the Private Label Securitization market. There are many conversations happening in D.C. about necessary steps to increase issuance and investment in new securities. In addition to conforming loan limits in G-Fees, we believe sensible standards are important and can help increase liquidity.

As an active issuer we believe we can contribute positively to these conversations to help drive standardization terms that make sense for the market. Such standards can complement the recently finalized risk retention rule to give issuers and investors confidence to reenter the market.

GSE reform, operating in Fannie legislation is likely to be a longer term initiative. We believe it is important to remain engaged in this dialog. We believe that GSE reform is necessary to improve the competitiveness of private capital and protect investors. An explicit government catastrophe guarantee behind private capital could provide more certainty to the market participants and borrowers and increase the opportunity for private capital to participate in the market. It is better to undertake this reform, while the housing market is recovering rather than waiting until the next crisis. Recently, it was announced that Gene Sperling has joined Pine River as an advisor. Gene was a director of the National Economic Council under Clinton and Obama.

So let's take a look at some of the data that supports our rate and credit strategies as we discuss our diversification in the commercial real estate. What we see here is that housing affordability remains quite high and commercial real estate has recovered pretty nicely. The graph on the bottom is an interesting one, overall homeownership in US peaked at 69.2% in 2004, ownership rates dropped to a low of 63.8% in 2011, but the cohort that is most affected is in the "35 and under", which has dropped to the lowest rate in 20 years at 35.3%, down from a peak of 43.6% in 2004. Affordability and home ownership rates are very impactful to mortgage and housing markets. Through the efforts of our mortgage loan conduit program, we are providing capital to segments in the US housing market that they haven't had access to the exceptionally tight credit standards.

We've come a long way. When we started out in 2009, we had a $124 million market capitalization, and today we are at $3.8 billion. When we started, we had five FTEs and today we have over 100 employees. We've been able to drive shareholder value through comprehensive rates and credit strategies and built a franchise value through operational businesses. We are externally managed by a wholly-owned subsidiary of Pine River Capital Management, a global asset management company. Our total AUM at Pine River is $15.8 billion, importantly while Pine River gives us entree, resources and imprimatur so the access to Pine River's extensive infrastructure is very important to us.

We have a mission-based strategy. Our mission is simple in nature but complex in execution. We want to be the best mortgage REIT that exists. We are the largest hybrid mortgage REIT investing in residential mortgage assets. We are a provider of permanent capital to the US mortgage market. We strive to be a thought leader throughout the industry. We utilize superior security selection and sophisticated hedging techniques to drive returns. We maintain a rigorous risk management system, strong administrative infrastructure and best practice disclosure and corporate governance.

Let's talk about the opportunity set. We have the flexibility to take advantage of opportunities across the market given our diversified portfolio. Our rate strategies include Agency RMBS, mortgage servicing rights. Our credit strategy includes legacy non-Agency RMBS and the mortgage loan conduit business. Commercial real-estate is a new initiative for us and it's focused on debt and related assets. These strategies allow us to allocate capital dynamically based upon the market opportunity. We believe the diversification of assets will help us to maximize the return profile of our business, while dampening volatility in our portfolio due to movements in interest rates and mortgage rates.

Additionally, clearly we are of the mindset that the market favors operating businesses over those that simply hold a portfolio of securities. We believe this will build franchise value which is obviously why we are here -- for our shareholders.

2014 was a heck of a year for us, and one I'm very proud of. It was really transformational with respect to our operating businesses. We are quite proud of our growth as we steadily grew our prime jumbo holdings and pipeline throughout the year. Let's just have a little recap of 2014. We did three securitizations; we increased the pipeline significantly. We built the MSR business from scratch to a very meaningful business. We increased our home loan facility from $1 billion to $2.5 billion which was subsequently increased again recently as Brad will talk about. We started a CRE initiative and we launched high LTV and non-prime products. It was really a heck of a year and a testament to the great team that we built.

You know, Bill Parcels famously said “you are who your record says that you are”. I guess it’s a day of sports talk, but since our inception, we’ve delivered a 134% total return to our shareholders versus a pure index of 57%. We’ve done this having the diversified portfolio and opportunistically deploying capital to drive shareholder return.

With that, I'm going to turn the presentation over to Bill for a strategy update.

STRATEGY UPDATE – BILL ROTH

Good afternoon, everyone. Thanks for sticking around after Billy took off, we can certainly understand if everybody wanted to see him the rest of the afternoon. He is quite inspirational.

Today I'm going to spend some time talking about what we do on a daily basis and where we are going with the new initiatives that are the future for Two Harbors.

First and foremost, we are really focused on driving shareholder value and we believe that the more options that we have to deploy capital, the better chance that we have to deliver high returns, and more importantly, a high Sharpe ratio which derives from the fact that we have multiple strategies as opposed to just one.

Some of this will be review for some, but what I'm going to review today is our rate strategy which includes anything with a return primarily determined by interest rates or prepayments. I'm going to spend some time talking about our conduit activities which we intend to also use to enhance our MSR sourcing capabilities. Then, we are going to spend some time discussing our credit strategy.

Our credit strategy includes anything with return primarily determined by the credit performance of the asset. That doesn’t mean there is no interest rate exposure, but the primary determinant of return is credit. We have a substantial credit expertise onboard. We have a full internal mortgage research team at Pine River that we draw on, and we intend also as we go forward not only to capitalize on the remaining opportunities in legacy space, but really focus on building the conduit and generating credit assets.

We are also going to spend a little bit of time talking about the commercial real estate strategy which is in its infancy and take a look at what Two Harbors might look like over the next several years.

We will take just a moment here on this slide, this is stuff that you guys probably can easily access, but it’s worth noting. In 2014, we saw dramatically lower interest rates despite the fact that everyone thought they were going to go higher, maybe that’s why they happened. There is actually a lot of reasons behind it that are too numerous to discuss today.

More interestingly, the curve was substantially flatter. So while ten-year rates fell a little over a 100 basis points, the curve between two’s and ten’s flattened by 120 and five to ten’s flattened by 70. That speaks to a number of factors and it's certainly something that we take into consideration as we manage our business.

On the right, you will see something that might be hard to make out on projector, but in the book it might be a little easier. I think the takeaway here is that over the last 12 years you will see that the OAS of the Agency market is sort of average today, but because volatility is so low and as a result of the Fed policies and the stability that we've seen, nominal spreads are really quite challenging. And if you take a look at the December 2011 part of graph you will see that not only were nominal spreads much wider, but OAS' were much wider. So, as a result of that, it's very challenging to operate an Agency strategy and extract value. And, keep in mind that this 12-year history also includes a substantial amount of time where the GSEs were big buyers. They haven't been buyers as we all know, in fact, they've been sellers, and the Fed has replaced them. But it just points to the fact that the Agency market is very challenging in terms of extracting value, and we will discuss that a little bit more in a moment.

On the left, despite the fact that we have historically low rates, we are actually in a pretty benign prepayment environment. In the last 12 years, we've seen an average CPR of the mortgage index of about 17 and more recently you will see that we were well below that, despite rates being low. So that's actually been, to a certain extent, a good thing for Agency mortgages, but it's also driven IO pricing much tighter over the past 15 months. And you will see on the bottom right, the bottom line is OAS, which has gone from about 300 OAS into somewhere around 100 or so. But something we are going to spend time talking about and one of the reasons we really like mortgage servicing is the OAS of prime new issue mortgage servicing. The middle line is the spread. While IO products have gotten richer, and MSR has gotten richer, on a spread basis we still see servicing as attractive and we are going to spend more time on that a little bit later.

So just to take a quick look at the rate strategy on the right, we usually start left to right; we are going to go to right to left on this slide. We have about 12 billion total, and you will see the bulk of it in the pie chart is 30-year fixed Ginnie Mae, HECMs, and some other buckets including servicing.

Our general strategy is to take advantage of opportunities that come about when we see dislocations, and to add MSR over time by building flow relationships through our conduit, really flow sale agreements through our conduit relationships. We are going to see in a minute what we think ROEs are on the Agency side and that will emphasize why we are playing defense, and have been for the last year or so.

Our outlook is generally that Agency spreads are relatively unattractive today. We don't see the likelihood that they are going to widen anytime soon, implied vol is still low which once again goes in that sort of okay, OAS, but not so okay nominal spreads. And generally ROEs in Agency strategies are below 10%.

If we take a high level look at our holdings, you will see that about 80%, in the red box, are in relatively short duration and short spread duration products. So, basically, higher coupons and then HECMs, HECMs are two-to three-year average life bonds, very little prepaid variability and virtually no extension risk. Basically we are "hiding out" in what we think are relatively low-volatility instruments until we see better opportunity.

The other thing that's worth noting here is that mortgage servicing, which is about 4% of the strategy, obviously helps hedge our basis risks. Not only do we have outright low spread duration, but we also have a basis hedge in the servicing component.

Let's just spend a minute looking at the MSR portfolio; I think the biggest thing to take away from this slide is the extremely high quality of it. If you look at the bottom red box you will see an average FICO in the mid-700s, low LTV, and while you never going to have no delinquencies, basically 99% of the pool is current. And so, that speaks to the very high quality and the point there is that we are trying to capture the prepayment sensitivity and not the credit sensitivity of this asset, as it helps hedge our book.

One of the things that we are very focused on, as I mentioned, is using our conduit relationships to grow flow MSR sellers. We aim this year to add between six and ten sellers on a flow basis. While bulk opportunities are very interesting and you can put a lot of money to work when they occur, the stability of having flow sellers is actually much more interesting in terms of building a business for long-term because there will always be bulk opportunities, you just have to be the best bid on any given day, as opposed to having a longstanding relationship with the seller who is also providing you other products as well. So that's really our biggest focus, and we intend to grow that not just in 2015 but also in the years following.

We took a snapshot just to give you focus on the idea of how we see the opportunity set for the rates strategy. It's no coincidence that we own high coupons because we actually think they provide highest expected ROE. You will see that we put 30-year, 3.5s in there, that's actually representative also I think of 30-year 3s and 15-years in general. You will see the expected ROEs, after hedging out the interest rate risk is very low. If you wanted to access those coupons and generate a higher return you are going to have to dial-up risk somewhere else, whether it's leverage or interest rate risk which isn't something that is particularly interesting to us.

As you will see, the higher coupons start to get more interesting and, MSR, while it is richer than it was when we spoke to you a year ago, still is a very attractive ROE especially given the extra benefits from the basis hedging. And someone might say, well, if the yield is seven, how come the ROE is higher, that comes from the fact that we have negative duration and therefore can use it to either reduce swaps or add pools that are positive duration. So, you actually get an add-on effect by having a positive yielding asset that contributes negative duration.

So hedging, that seems to always be the question that everybody wants to ask about in terms of either dialing up risk or what's your exposure or what's your exposure, in some cases people want to know what our exposure is. What we've done is taken a snapshot of a daily risk report and we've synthesized it down into buckets. This is a partial duration report that we look at every day when we are managing the portfolio.

Now, this is about 1/50th of the actual because we've tried to synthesize it down to one slide. But there are a few important things to take away from this slide, which is as of the end of the year. First of all, you will see at the bottom our total dollar duration exposure. So if you look at the bottom left, it says $1.78 million. That is our duration exposure per basis point move in rates. But that masks what's going on in different parts of the curve, which we thought we would share with you today; and you will see that we are actually modestly short at the front end of the curve, and we are long further out the curve.

Now, someone could say, well, why would you do that? Well, there are a couple of reasons and we carried a bigger flattening positioning most of last year which was beneficial as the curve flattened. It's our belief that there are a couple different potential outcomes as we look at the world today. We could either see the economy in the U.S. continue to do well, but inflation not get totally out of hand, in which case the Fed is probably going to raise rates. And the long end, given what's going on in Europe and with long-term inflation expectations in the US, the long-end might not move, might go up a little bit, but we think will likely go up less and some people think it could even come down. We think that if the Fed is moving, the curve is likely to be flatter.

The other thing that we think about is; well, what if the U.S. kind of suffers from a very strong dollar and we see weakness creep into the U.S.? It's still possible that Fed could raise rates, but the long end might come down. We did see a lot of that occur last year. We feel like we have a little bit of protection to that, as well. I think the other thing that's worth noting on this page is the negative duration that MSR provides to the long end of the curve, as well as the swaption position which also provides tremendous protection. You will see that as Agency pools have positive duration, if rates go up you are going to get more duration in that bucket. So it's very important for us to have this disaster protection in place, and we will see the impact of that on the next slide.

For some of you this is going to be your favorite slide of the day. So for those of you who fall into that bucket, welcome to Slide 21. What we've shown here is up and down a 100 and we are throwing up at 200. I know that there was a conference once where we got asked about up 300 or 400, and I apologized, we are not going to have that in this slide today. But the important takeaways here are the following: if you look at the Agency pools, the difference between up a 100 and up 200 is fairly linear. So in other words, in a parallel up a 100 we would expect the Agency pools by themselves to go down by $450 million. Up 200, if you had a lot of extension risk built into your holdings that would be a substantially higher delta. 450 is said to be 900 which would be linear or might be a $1.2 billion or $1.4 billion.

You can see that because of our holdings primarily in loan balance pools being longer to start with don't extend very much. The convexity of that position is fairly neutral and that's extremely important if you look at what happened in 2013 where we saw tremendous amount of extension risk. The other thing that's worth noting is if you look at the swaption delta between up a 100 and 200, up a 100 we make $114 million, and up 200 we make $186 million. Basically, those are positively convex.

The other hedges which are a mix of other mortgage put options, for example, are receiver swaptions to protect against a rally, you will see there is a tremendous positive convexity there; $50 million goes to $150. So what you see when you add all that up at the bottom is we have a very slight negative convexity which is normal for a mortgage portfolio, but it's not going to dramatically harm us if that occurs.

The other thing, before we leave the slide, I'd like to remind everyone, that this is your standard parallel up a 100 immediate shift which as we've said many times just has never happened and probably won't. And it's also worth noting that some of the folks that Tom introduced earlier on the investment team spent every day looking at our risk exposures and dynamically hedging. We are actually hedging as the markets move, because that's an important part of managing this part of the book.

I think the last thing which is really worth noting is the earnings component. We talked about book value. I think everyone in this room is tired of hearing us talk about total return and total comprehensive income, but that is the way we think of the world. From an income standpoint, it's actually kind of an interesting positive story to the extent rates go up, we actually make more money. So in the up a 100, while our book value would suffer slightly, as you saw on the prior slide, down about 3% or so as of the end of the year, our income goes up. That's clearly the result of the fact that we have more assets that are floating than liabilities that are funding that. The other thing that's worth noting is as commercial real estate, which are largely floating rate loans, start to work their way into the portfolio that will be an added benefit that will accrue to that as well. So it's likely that you see that number actually creep up over the next year or so.

Okay, moving onto the credit strategy. On slide 24, you'll see that over the last year or so credit had a good year, generally earned its carry, in some cases there were some…we have little price appreciation, towards the end of the year things got a little messy and we saw credit widen out, although it has tightened back here in the first quarter. The top shows IG and high yield spreads, and you can peruse those at your convenience.

I think a couple things to note on the residential side are on the bottom left. You will see that we still see subprime as one of the highest yielding sectors available. And I would note that the yields shown on this slide are loss adjusted. If you see a high yield quote that's non loss-adjusted. More recently we've seen certain parts of the credit risk sharing deals stand out as represented on the bottom right. We'll chat about that a little bit.

The credit holdings, starting on the right again, this is the last slide we will be starting on the right for those of you who are accustomed left to right. We had about $4 billion in total, $3 billion is in legacy, and $1 billion is in basically new credit if you will, about $0.5 billion of that is retained interests or purchased new issue credit, and then about $0.5 billion are loans that through the Agate Bay shelf makes its way into the credit book, but obviously in smaller amounts than the current holding. Generally, our view is that from the credit side we want to extract the value that's remaining from the legacy portfolio over the next several years. That means we are going to sell bonds that have reached full value and retain bonds where we still think there is upside and we'll take a quick look at one here shortly.

Most importantly, we are looking to generate credit assets through the conduit which we are going to talk about as well, whether it's prime jumbo, non-prime or any other products. And then last, new sectors that we are working on include GSE credit risk transfer bonds. We've built an internal model where we can look at highly detailed information from every transaction and compare them across all the other transactions, so we can determine whether a new deal comes out of those bonds and then secondary you know, a quoted yield is nice, but you actually have to dig in and run loss adjusted returns to determine whether they are worth owning or not.

Furthermore, we continue to see positive momentum in housing, although slower than what it's been, employment is clearly a tailwind for not just legacy credit but new issue credit. And so, we expect to see good borrower performance and we think it's a good time to be allocating more capital to credit.

So let's start with the legacy overview here, and there is a lot on this slide. I think there are a couple important takeaways here. First of all, I mentioned the tailwinds. The legacy book is largely sub-prime, so the fact that gas prices have come down so much, actually makes potentially a huge dent in…or not dent, but actually I don't know what the opposite of a dent in a car is. But it's a benefit or a boon to a borrower who is driving an F-150 25 miles each way to and from work. That's extra money in their pocket which hopefully they'll use to come current on their mortgage if they are delinquent.

The big thing is on the slide in the red box, the average market price of what we own is still more than 25 point discount to par, and below that you will see the average loans in the pools that we hold is over 8 years, that's the 100 months. At the bottom, if you looked at this and this is your first time looking in any of our statistics, I will say 29% of what you know, of the loans in the pools you hold are delinquent, that's actually down from numbers that are much higher than that, in the 40s over the last say three or four years ago. So the delinquencies are going down, and at the bottom you will see that the prepays, which were running around 4%, are much higher than what we have historically modeled. In terms of voluntary prepays, we typically model 1% or 2% for life, so we think there is some upside there.

I know Tom gets kind of upset when we talk about the HEAT bond that we showed because back when it was in the 60s, and he had bought a bunch of Two Harbors stock and somebody said well, you are kind of bullish why you are doing this, he said that this HEAT bond at 60 bucks, could recover at par. As it turned out, Victor sold the bond at $97.5 because it clearly was going to get par, but it wasn't there yet, and so Tom got a little miffed at that. We are going to introduce another bond here which we might not track it over several years, but highlights the bonds that we are retaining and why we like them.

This is a Carrington bond from 2006, as you see in the middle, at the end of that month last month there was a $66 price bond, it's a second pay bond so there is a bond in front of it that's going to pay off, and then this will start cash flowing in about three years plus or minus.

You will see the delinquencies were about 38% of the pool, prepays have been in that 1% to 2% range that we talked about, and severities on loans that have been liquidated but running in the low 60s. When we look at our base case, and we say 2% and we default 54% or basically everyone is delinquent plus another 16% of the pool, and we jack the severities up somewhat you'll see that this bond yields about 5.5% which that bond can be typically financed somewhere around one and three quarters today. That's actually a high single digit ROE which in itself in this rate environment isn't too bad. What gets us excited is the convexity of this bond to different outcome.

Things kind to go pear shaped on the right, we lose some yield and the bond probably gets marked down, but it's still actually a reasonably respectable yield given the financings probably staying low. But what gets us excited even more is on the left, you will see that this bond could actually be a much higher yield which would drive an ROE somewhere in the low to mid double-digits. And it doesn't take much, as you can see by the assumptions there, to actually have quite a bit of upside. These are the kind of bonds that we are retaining, the bonds will get up into the high 90s, and they don't have anything left to the kind of bonds we are selling.

Let's move on to the future. The evolution of the credit business is going to be clearly driven by our conduit activities. Our goal is basically to cultivate a network of seller partners who originate loans to our guidelines, and our pricing, and our specifications, as well as servicers who can help service those or they can provide us MSR subservicing so we can deploy capital into credit products that we've determined and we've underwritten.

As part of that, and as Tom mentioned, we have grown from only a handful of us to a little over 100 people, many, many of whom are dedicated to the operational nature of this business, which we will talk about in a few moments.

We have built and we continue to build the operational component to work with counterparties, settle transactions, monitor performance et cetera. So I'll let you can read on your own the progression over time. Just in 2015, we've closed one Agate Bay deal. If you look on Bloomberg, you might see that there is another one that hasn't closed yet. So we are not going to spend a lot of time on that. But this year, given our run rate of about $300 million a month in locks, we expect to do somewhere from six to ten deals. And obviously market conditions permitting, we anticipate growing the prime jumbo component. So last year it was about $1 billion, this year might be around $3 billion of deals and next year 2016 we expect that to grow even further.

More interestingly, as Tom mentioned, we've rolled out a high LTV product. We've got about say roughly $30 million in locks there, that's a very new, those are prime borrowers. We are excited that that we are started to see some traction. On the non-prime side, we are working on a number of products with originators designed for more average credit quality homebuyers that fall outside the GSE box.

We think that as we evolve over the next several years, we are not just going to have prime jumbo, but product that is just a near miss. We are going to have more average credit quality, and we have the FHLB line that we can use to fund these until securitization markets develop for those products. We think this is as a capital allocation as the legacy goes down with a new issue credit we expect to go up, it went up to almost 10% of capital at the end of 2014. And you can probably expect that could grow in the 3% to 5% range this year and for the next several years depending on how things go.

One thing that I think is really important as you think about Two Harbors versus other mortgage REITs is what we look like versus what some others look like. This is very important to distinguish what we are doing and it's a very key component of our business not only today but as we move forward. We spent the last several years really building the infrastructure to allow for a scalable and growing business making our own credit products and also overseeing and managing the MSR component of our business.

The important things to point on this slide is that we have over 50 people that are focused solely on processing, managing and overseeing the things that we are doing in these businesses. Without reading through the bullets, you can see that clearly this is very different than buying securities and putting them on repo. This is truly a platform that we think can drive shareholder returns for the foreseeable future.

I think it's also important that we are very, very focused on counterparty management. We have a full team and a counterparty oversight committee that looks at any counterparties that we might sign up, full due diligence, site visits, file samples et cetera. We have a mortgage compliance team that reports through Rebecca in order to comply with all of the myriad of things that we need to comply with, but not only that, but that our counterparties have to comply with. If we were to have a counterparty that's not playing by the rules it could impact us. So these are very, very important things that we are working on.

And finally, it's important to note that there is a huge overlap of efficiency between the servicing parts of the business and the conduit part, because effectively you are boarding loans whether there are loans where you have the principal and the interest or just the servicing component, these teams work together. They are all on the same floor in Minnetonka and we get a lot of efficiency from that.

Let's take a look at our Agate Bay securitizations. The big thing here, it's really sort of a simple story; this is super high credit quality, fully underwritten, low LTV, high FICO et cetera. And we are very pleased that so far these deals are performing well. There are no delinquencies that are 60-days plus. So I don't know how we are going to do better than that, but we are very happy with the performance that we've seen and this program is one of the leaders in the space.

I'm supposed to run a video now.' We're going to take a look here at some of the markets we are in. This won't be entirely surprising, but basically these are generally coastal markets, and our geographic distribution is really quite good. And I think it's important to note as you watch the video, if you look at the FICO and the LTV that you see in each of these markets and the dispersion, they are not all lumped in one little area, these are huge MSAs. We have a lot of diversification, the credit quality is extremely good, and we are confident of the performance we expect to see as we move forward. And keep in mind; this is the product that we are retaining the credit risk on, which is exactly what the conduit is intended to produce.

Moving on to the part that some of you guys might be wondering about. Well, what do these deals look like? And I actually fibbed a little bit before. We are actually going to start on the right on this slide too. So this is something you might want to spend more time a little later if you care to. What we want to do is just show sort of illustrative pricing and what this means for our business. On $1 billion of loans that we acquire from originators around 1 and 2.5, if we sell off the AAAs and the AAs and the A, you will see that that leaves market value of about $43 million. What comprises that $43 million is a servicing strip worth about $12 million, and then some IOs and some credit bonds. And the total, as I said, it's about $43 million; we actually get a little bit of leverage on the IO and the subs, so that the capital that we deploy against this is about $23 million. And you will see that the ROEs of the different components actually are pretty attractive. We are looking at roughly at 12% or so ROE, deploying about some $20 million of capital.

Moving on to some of the newer products; what you will see here is a very high level look at what we are trying to do in these other products. We actually have a new products group that thinks about the kind of loans that we'd like to put out there and what segments of the market we want to attach to. What you will see here on the right side, you will see a high LTV prime, it's basically the same caliber borrower, just somebody who wants to take out more money, somewhere in the 80% to 90% range, and you will see that if your standard or up until maybe yesterday the most produced coupon was around 4%, this person is paying a little bit more, somewhere between 4% and 5%.

The high DTI is similarly a very high credit quality borrower, who basically goes above the DTI limit. Once again, very low LTV, they are paying a modest premium as well, but that generates a more interesting asset to us and once again these are fully underwritten. So we are very comfortable with the credit.

And then non-prime, which we are still working on. We are working with originators to figure out the best product that they can market and sell. But, I think the important note is the FICO is sort of more of an average credit quality borrower. We have a whole pricing grid that adjusts as these numbers change. But it is to give you an idea of the kind of loan that we intend to be out with going forward.

These are areas that are fairly new, not only for us, but pretty much for everyone else. I think anybody who follows the space will know that the anything out of the prime bucket, especially if you get into non-QM, is just starting to develop. We think that this is a huge opportunity for us going forward, and we are set-up because of our partnerships with originators that we intend to continue to grow that we should be able to access this product if we develop the right products.

Let's take a look at our positioning in the credit book. As we saw earlier, we think that the legacy position still has some upside, last year capital was about 31%. It's interesting, we sold more bonds than we bought last year, but yet the market value stayed the same primarily because prices continue to improve. You'll see that these numbers will trend lower and we will see that on a future slide. The interesting takeaway here is that, the quality of underwriting today is so high and the information we get is so much better. If you looked at an LTV or debt to income from 2005, it wasn't really clear how good that information was.

Today, if you look at an LTV, you know that that number is really good. In other words, the quality of the inputs is much, much higher today than it was. It's not the underwriting, not only are the credit guidelines tighter, but the quality of inputs are higher. For that reason, we really like new issue credit, and you'll see if you look at everything below legacy, the remaining 13% is pretty much all new credit, which is going to be going up.

Let's take a look at the credit market opportunity set like we did on the rate side. Legacy bonds yields, as saw on the earlier slide and compared to everything else in the world, are still pretty interesting. But on an ROE standpoint, they are high single digits. As we saw on the Carrington bond we looked at, it's right in there, but we think that if we keep the right bonds with decent upside that we are going to continue to see good performance.

Risk transfer, we debated what to put here because when the market tightened up and we saw, very tight prints in the third quarter of last year, it's hard to see that there was any value in any of the tranches. Then we saw the market widen out dramatically later in the year and early in the first quarter and the numbers got really very interesting. We saw double-digit ROEs and even into the mid-teens.

My comment on that is, when it's not good, we are not going to be buying and we might be selling, and when it's good we will try and buy as many as we can. We don't control that, but we can opportunistically take advantage of it. You will see here that as I showed you on the securitization slide about 12% today expected ROE, so we think that somewhere in 10% to 15%, which we've talked about before.

And the last one non-prime, to be honest with you, we don't know for sure because we haven't gotten loans in yet, but based on the pricing we are putting out there and where we can fund them, either using in the short run FHLB or in a securitization over time, we think that metrics will be fairly similar, hopefully better than the prime. That gives you an idea of what we see as the opportunities in the credit space.

Okay, commercial real estate. My guess is there could be a lot of questions on this in terms of, what we are going to do and how we are going to do it. We haven't put a dollar to work yet, but I'm going to give you a high level of what we are thinking and where we are going. This is something we will be talking a lot more about as we move through the year and into next year. Basically, the commercial real-estate market in the U.S. is north of $3 trillion, and about half of that is going to be maturing in the next several years and need to be refinanced.

At the same time, many historical providers are dealing with capital issues, balance sheet issues, et cetera. We think that there is a tremendous opportunity for folks like us, if you have the right team in place to take advantage of the returns that are available and provide capital to this market. We see returns in the low double-digits, potentially higher. For some senior assets, if they meet certain criteria, might be able to put on the FHLB which would clearly be a substantial benefit to those ROEs, and you will see that REITs are actually really very small part of the market. We are very excited about the team we brought over, the senior guys there. The most senior guy is actually a year older than me, and I'm really excited about that. They've got 30 years in the business and are very well regarded. We are excited to have them onboard.

So what are we going to be working on? This is a debt strategy. We don't really have any intention to buy strip malls or hotels, but rather provide financing for office, multi-family et cetera. You can peruse the slide on your own, it's fairly straight forward, most of these are floating rate loans, they are typically three to ten years, and loan sizes will be $10 million to $100 million.

We thought we would give you a couple of examples of generic loans. The first one is on slide 38, an 18-story office building that's about 90% occupied. The senior part of the capital structure here on the right, now obviously we are picking a data point just to show the math. Obviously there is a range where these trade. But LIBOR+400 is sort of a mid-point. Because it's a senior loan, you can get funding at LIBOR-200, about three terms debt to equity. And you could see that your ROE there is about LIBOR plus a 1000, which is very low double-digits to spot-LIBOR and obviously higher to forward-LIBOR.

Now, just to give you an idea, if we are able to put this loan on the FHLB line which as I said it's really too early at this point, funding is closer to LIBOR plus 25. The advance rate would be slightly less but this number would go up quite a bit on the ROE side. We also thought we should give you an example of a mezzanine loan. Here is a $40 million mezzanine loan on hotel in a major U.S. City. And I have no idea where this picture came from. So if somebody knows what hotel that is, he can let me know later.

The attachment LTV is 62 to 70, so basically the senior loan goes up to 62, and the mez loan goes to 70. The math on this is shown on the right for what the kind of outcome we might expect from something like this. Just to be clear so everyone understands, this is a lending business, not a CUSIP driven business. We are in the process of hiring underwriters, originators, and getting licensing and building out the infrastructure. When we look at one of these loans it might be a 60 to 90 day process.

On slide 40, you will see our goals and our anticipated path over the remainder of this year. We expect to start putting capital to work, maybe in the late second quarter, but more likely third quarter and beyond. We expect to run somewhere from third quarter of this year through second quarter of next year. We've made an initial commitment of $500 million, and obviously that number, if things are going well and the returns are good and we like what we are seeing, could grow over time.

Okay, as I promised at the beginning, let's take a look at what Two Harbors might likely look at over the next few years. Again, I'll reiterate our goal to generate attractive risk adjusted returns. We love the fact that we have a variety of strategies that can accomplish this goal. We talked about Agencies not really being that interesting today. The nice thing about that market is, if we go back to 2011 and expected returns are 16% to 20%, it's very easy to deploy capital, but more importantly, we see better opportunities in the other sectors we discussed.

On the rate side, we expect that capital in the Agency space to come down, as you will see from the little arrows. We expect MSR capital to go up, and we see returns consistent with what we showed on the prior slide. Keep in mind, if you take a high single digit ROE on Agencies and you blend in, a high single digit return on MSR double-digit it gets you sort of a mid-point there. We are hopeful that we will be able to extract value as opportunities present themselves as we have in the past.

On the credit side, which you will see that legacy was 40%, today it's about 30%. And you see that's going to go down, as a natural progression. But, you can also see that the new issue credit and commercial will be going up. So we are very excited about what we are doing and where we are going. We are very excited to be able to create our own products and deliver the kind of returns that we would hope to for our stockholders.

And with that, I will turn it over to Brad.

CFO UPDATE – BRAD FARRELL

As an avid college basketball fan, I offer my sincere apologies at our scheduling, it looks like Notre-Dame pulled out their victory, and I don't mind getting interrupted if someone would let me know if Iowa State won. I'm starting to regret my choice as I think I have them in the final four. Thank you for being here, we appreciate your time today. I'm going to try to ad lib a bit to my comments, and as you can guess as a CFO I generally am structured, but I do respect the time and most importantly I want to get to the question and answer session.

So what am I going to talk about today? I'm going to talk about the impact on the diversification. It's been a monumental year of change, new asset classes which brings new disclosures, new matters that we face around REIT Compliance and the 1940 Act. You can see on slide 44 some of the topics I want to hit.

First of all, REIT compliance, we do spend a significant amount of time working with the traders, evaluating investments, evaluating their structures, thinking strategically about how they fit into our REIT guidelines and 1940 Act. With that said, our primary intent is to buy and hold investments. We can structure ourselves in a way that's very favorable and very flexible to take advantage of many different opportunities. We create structures that typically have sister entities, we usually have a REIT entity and a TRS entity that allows really optimal flexibility for Bill and the team to make a decision about how we want to hold the investment, how we want to hedge and really maximize the potential ROE for the trade. Examples of instruments that we hold in the TRS are some of our complex derivative trading.

We do much more than straight forward interest rate swaps, swaptions, and different short positions on treasury to hedge rates, and a lot of those activities do take place in the TRS. At the same time, we are purchasing and securitizing mortgage loans. We are conducting servicing activities at least from a P&L perspective, and obviously, we use sub-servicers to support us in that manner.

We are going to be originating and selling at different times our commercial mortgage debt. I think the key message is from the slide is the REIT requirements are important to us, but we have significant amount of flexibly to use our TRS's in a manner that really allows the front office to operate across the spectrum that they want to operate in.

Finally, I will move over to 1940 Act compliance. I can definitely say this isn't probably the flashiest of topics. But, it is absolutely critical that we maintain our focus and compliance here. There are a couple of key points I want to make because it does come up in questions every once in a while. Each of our legal entities actually have an exemption, exemptions aren't monitored at a consolidated basis or at a REIT level. So each of our entities meet their own requirements in a manner that's depicted on slide 46. The largest entity that we have which conducts RMBS trading activities use what's referred to as the whole pool test or the 3 (c), 5 (c), that's one that many people are very familiar within the industry.

We often get questions as to how we think about maintaining compliance with that as our portfolio shifts and as we shift capital to other strategies. Again, we have a great deal of flexibility, the run-off of our non-Agency book is very complementary and allows us to potentially shift our Agency positions, while still maintaining that 55% whole pool test. Addressing a question we often get is can we optimize our portfolio within the structure of a REIT, within the structure of the 1940 Act test"? And the answer is a very solidly, yes. It takes a lot of work between the front and back offices, it takes a lot of communication around our structures, but we succeed in doing that and that allows the opportunities we are taking.

The next few slides are focused really on our capitalization and financing structure. Before jumping into the detail, I would point out that we continue to expand our relationship with the FHLB Des Moines. As Tom alluded to, recently our capacity increased from $2.5 to $4.0 billion. The additional capacity serves on a number of fronts besides obviously sending a message that we have a continued healthy and strong relationship with Des Moines, really provides us the ability to consistently price in the prime jumbo market. It offers us the ability to retain AAA securities, if we feel the market opportunities don't exist to sell those, and also as a diversification mechanism for our Agency portfolio. Having that capacity and the duration of 20-year term really provides us a lot of comfort in our financing strategies, especially as we move into the conduit space and to a certain degree to commercial real estate space.

You are very familiar with our Agency strategies, how much capital and our financing flexibility and our continued focus on diversification. We have multiple counterparties including the FHLB, we ladder our profiles appropriately; MSR does not have leverage as we cash fund that on the balance sheet. You can see on slide 47 that opportunities for financing in the market are very limited, and really the terms are not that appealing to us. So, we have chosen to cash finance and that's our intended strategy going forward.

On the credit portfolio, again, you've seen much of this information, diversification again is important, laddering is even more important. The FHLB can finance non-Agencies above 'A' class, typically that's going to be the bonds that we retain in our securitizations. As I mentioned, it's an extremely useful tool to aggregate mortgage loans or private securitization at very competitive terms.

Moving onto financial management on slide 49, admittedly we work with many of you on this, we are much more complex than a standard Agency mortgage REIT, but complexity is not necessarily a bad thing. We strive to maintain disclosure around that complexity, most importantly on the accounting side we've been very focused on electing fair value options on our asset classes when that's available to us. We fair value MSR, we fair value our mortgage loans and we fair value our retained interests and our securitization. Really under the REIT method we think about economic return. The more we can make stockholders equity and our financials look like economic return that fits with investor and the analyst needs.

Commercial real estate is going to throw us into different game a little bit. We will not be fair valuing that asset. You hold that asset at amortized costs; it doesn't lend itself to a continuous fair value measurement, albeit it does require impairment testing. As we evaluate that impairment, there will be some elements marking that asset to the market to a certain degree. But again, we will have a significant communication as we grow that portfolio.

Moving to operating expense, the key messages here is we have had an upward trend in our expense ratio over the past several quarters and years, but we tied it very well and very responsibly to the ROEs we are generating in these asset classes. As Tom and Bill mentioned, we have been able to grow our human capital which is really adding value to our assets and how we manage servicing. At the same time, we also have expanded our vendor relationships, counterparties that can provide us due diligence and services that optimize value for shareholders. And, also, to think about the long-term, is our IT architecture and infrastructure. Just as with any company, IT is going to allow us economies of scale over time, and keep our expense ratio in check as we grow these businesses.

I would mention as disclosed on the slide, commercial real estate will change our depiction as we move into it in 2015. Being able to capture the higher ROEs on these assets will lead to higher expenses, so our expense ratio is expected to go up, somewhere in the 20 to 40 basis points. This will really depend on the timing and as we are in the investment ramp, but we wanted to mention that to you and look for more information as we take on that initiative.

Dividend considerations are another topic that we obviously get questions on our earnings calls and this is a slide that's fairly similar to something we talked to last year. We do focus on a variety of factors. We are focused on economic return and our ability to sustain our dividend over the long-term, and that's our primary objective. At certain times, our dividend distributions and book value growth and preservation go up. Well, as I said I don't go off the cuff very well sometimes.

As a REIT we really ultimately focus on taxable income. We have historically stayed true to that; it's something that as a REIT intend to be 90% of our distribution requirements. We understand that core earnings is obviously an industry recognized metric. But sometimes that can conflict with the preservation of book value and total economic return.

At times we would distribute more than core earnings as we generate other taxable income, such as realized gains. But an important reminder is we have unrealized gains of approximately $900 million in the portfolio. So it gives us a lot of flexibility to evaluate where we think in a long-term we can sustain our dividend, but at the same time focusing on providing that overall shareholder return.

Moving to my final slide, and allowing for Tom to come up and hit some key points, is our historical record of growing and preserving book value, while generating dividends. There is quite a bit of data on slide 52, but you can see our year-over-year comprehensive income on the upper left increased meaningfully year-over-year in 2014 to $578 million, a factor which we are extremely proud of. With this in mind, our cumulative comprehensive income performance has exceeded our cash dividend distributions by more than $600 million resulting in book value growth. Our taxable income is consistently aligned with our dividend distributions and complies with our REIT requirements. 2014 distributions did exceed taxable income due to some utilization of capital loss carry forwards.

On the bottom right, we depict our book value and dividends declared. At year end, our book value was $11.10 per share and we delivered a $1.04 in dividends per share. And investors since our inception in

2009 has received $8.27 per share in dividends. Together these four quadrants illustrate how we have achieved our objective to deliver total return.

I want to thank you for your time today. We look forward to your questions, and I'll pass it back to Tom.

2015 AND BEYOND – TOM SIERING

Thanks, Brad. I am going to have some closing remarks and then we are going to take Q&A. Unfortunately, Bill has a plane to catch, but we will do the best that we can. So as we look forward what are we trying to achieve. Obviously, we've built these relationships with originator partners and so it allows us to buy prime jumbo loans, MSR and some of the new products too, in respect to high LTV and non-prime.

As Bill said, we are getting in commercial mortgage market, and why are we doing that? Well, it meets the criteria that we require to enter into any new business. It has scalability, it has opportunity and that has a long runway and those were things that we look for when we build the business.

So what we are really trying to do, what we are really trying to achieve, is that we are not married to doing any one thing. The mortgage market is always changing; it's a very ephemeral market. What the opportunity is today is not the opportunity tomorrow. We want to have the ability to move capital to many different parts of the market to drive shareholder value. And so, everything we are doing is with that interest in mind.

We have a commitment to the mortgage loan conduit business. We talked about MSR; it's an excellent asset for us today. Why is it a great asset? Well, it's got a very attractive ROE, and that allows us to hedge interest rate risk very well. And what's the end game here? Well, if you look where Agency REITs trade today, they are at about 86% of book value, Two Harbors is about 90% of book value, credit hybrid REITs are about 91%, operating businesses trade at 115%, and commercial REITs trade at 120% of book value.

As we look forward, we are hoping to generate an attractive dividend. We are hoping to grow book value and importantly, we are trying to increase our valuation and respective book value. Historically, book value has been a kind of a ceiling on REITs, and we want to break through the ceiling. So we talked about how we want to be opportunistic in allocating capital, the operating businesses are very important to our business and obviously optimization of shareholder value over the long-term is why we are here.

As one final remark, we have our legacy businesses, we created new businesses, obviously the prime jumbo business, commercial and MSRs. As we look forward, we expect those to be meaningful parts of our business and we look with great optimism to the future beyond and driving our shareholder return.

Maggie is going to give the microphone for those who have questions, please.

QUESTION AND ANSWER

Tom Siering
Hi, Mark.

Participant
Yes, thanks. Could you just talk about which of the opportunities in the credit world, would you think could be the most meaningful opportunity over the next couple of years of putting capital to work?

Bill Roth
Sure, on the credit side, we are actually excited about all the things we are doing. If you look at the numbers, securitization is historically a 10% to 15% ROE business, and the numbers are in that range now. Now obviously it's a little ephemeral depending on where AAAs trade and loans trade. But you know, that moves around quite a bit, but from a longer term perspective those are obviously very attractive. Commercial real estate, we also see has being in that range, and that the beauty is that most of the assets are floating. So it's levered to higher LIBOR. We think we are in the sweet spot of areas that can drive returns in that range, and that's what we are working on.

Tom Siering
Yes, on commercial real estate, we have gotten a lot of questions in the past, why haven't you been in the market, because the opportunity is there and the traditional lenders to the space, banks, are reducing their footprint for all the reasons that we know. Our answer was always that the investments team's experience is in residential mortgages and we demanded that we have a world class team before we entered the commercial real estate market. So we are very excited about the intersection that we find ourselves at, a great team, good market conditions, and big opportunities. We are very excited about that.

Participant
And just one more, are those illustrative returns issued on the GSE we are sharing, is that where returns are now or is that where they were when they cheapened up and you stepped in, and to what you attribute the volatility you see in that market

Bill Roth
I don't recall the date on that slide, but unfortunately the spreads have been volatile. We started out at 700, then went into 250, then went back to…I am talking about the longer data, they went up to 500 and now they are closer to 400. Basically it's a new issue market and there was very little secondary trading. There has been lots of chatter regarding this topic and the folks in D.C. are well aware that liquidity is not good. I think it's one of those things that when the opportunity is there, we are going to access it, and we aren't going to buy them just because that's a new issue, because I mean if you bought bonds at 260 or 270, at the end of the year those bonds were 85 bucks. So that's not a great outcome. I think it's a sector we have to be opportunistic about, and hopefully liquidity will come back, but we'll have to see.

Tom Siering
Yes, it's not a super liquid market. And, as such, creates volatility, right. But as a permanent capital vehicle we are not worried about that, and it affords us the opportunity to pick and choose paths and the team has done a great job around that.

Participant
Regarding commercial real estate, I mean cap rates have fallen tremendously, since the crisis and they're at all-time lows. How do you couple the risks associated with that, when you are dealing with that 80% LTV? And do you think that's a function of just where interest rates are, and I am just trying to understand how you are thinking about that but the risk profile?

Bill Roth
One of the things we have said is that we are not planning to buy buildings. So it's interesting on the debt side of equation, but I can't speak for those who buy and sell actual buildings. What we are looking at is, underwriting a property, underwriting all the components of what goes into the debt service coverage in the LTV. It's an interesting point you raised, because cap rates are low, yes, but returns on the debt side are actually pretty interesting. The big thing that we need to keep close tabs on is that we don't get back to the underwriting that we saw during the mid-2000s. Interestingly, the team that we brought onboard was totally absent from the market at that time so, clearly, there might be a period which we don't write loans. It's really about quality control and making sure you are underwriting to reasonable standards, if the equity guy wants to pay too much that's their prerogative.

Tom Siering
There are some similarities to our legacy credit business. The team is deep dive focused, MSA driven, they care about who the equity sponsor is - all of those things are important. As you know, Mom and Pop are much more likely to default than a blue chip equity sponsor.

Participant
Just a quick question on the expense management, it sounds like with the expansion of the commercial mortgage business your expense ratio is going to continue to rise. But I wanted to get a little bit more of an explanation of when that would be stabilized, and then what type of levels we could anticipate going forward. And then subsequently, is there going to be a point where we actually realize scale and then for the expenses to go the other way?

Brad Farrell
I think I can address that. So I didn't hear it's perfectly. But I think the question was, when the scale get achieved on the expense ratio, what's driving now the timing of it, et cetera, I think would you like capture most of the question?

Bill Roth
Yes, I apologize. Actually heading to Australia and this is not a flight I can miss. So thanks for coming guys.

Tom Siering
Thank you, Bill. We don't want to cut our Q&A though. So Bill's chief lieutenants are all here, so if you have a market's question that I can't answer I'm going to call out one of Bill's lieutenants. Well, have a great trip.

Brad Farrell
Okay, so I'll take it in a couple of pieces. We estimated it would be higher 20 to 40 basis points. What's driving the majority of that is transactional expenses attached to closing and due diligence of the investment. That's the timing of it and how it scales - it's going to be distinctly tied to how we are deploying capital. I think that's an absolutely critical point to understand.

On the scale side, if we deploy $100 million of capital and apply a certain amount of leverage, let's say somewhere around $1.5 billion to $2 billion of assets, that will achieve the scale we need and how we are structuring the team. A lot of what we are using is third party resources to support us in those initiatives. So it's not going to go up immediately 20 to 40 basis points, it's going to ramp in recognition of actually buying assets and bringing people onboard to generating the ROEs that Bill disclosed.

Tom Siering
The way we look at it is very simple. I don't want to say I don't care what the expense ratio is, I do. But more important to me is what I get for those expenses. The opportunity is such that our shareholders are much better off having a commercial real-estate effort, which represents increase in costs, because the ROEs are so attractive. For a dollar I spend, what do my shareholders get - today that's a really good deal in the commercial space.

Participant
One follow-up on the commercial business. Since you are going to essentially be a new issuer or new lender in that market, do you have a particular strategy in terms of the size of loan and then do you intend to grow as you scale up or do you intend to be a flow lender and trade off or do you intend to basically originate to hold on the balance sheet?

Tom Siering
With respect to that, we haven't invested dollar one. I want to be circumspect of what I'm going to say here, but we want a diversified portfolio. It's not going to be massive and there is obviously an expense of doing diligence - so it has to be of a certain size. We are going to care about a lot of different things, including MSA concentration, but we will have more to say about this when we actually start putting money to work. I think that's a more appropriate time to give granularity around that.

Brad Farrell
The one thing I would add is that it will likely be all of the above. Whether it's a whole loan structure, senior piece or mezzanine piece, the key thing is that we have a team with significant relationships across those fronts within the industry. Our financing structure is going to be setup to handle all scenarios. Obviously a whole loan structure and the ability to finance some things with the FHLB give us lots of optionality.

Tom Siering
Historically our team has invested up and down the capital structures though, but for instance if we can do something today, but get some home loans that's pretty juicy.

Participant
How do you think about managing your liquidity as you are growing into more illiquid assets like the conduit business and commercial real estate?

Tom Siering
Great question. We run a daily liquidity report and our goal is to never be in a position where we have to sell anything. What that number is with respect to liquidity -- in other words, the excess liquidity to manage big shocks -- depends upon what's in the portfolio at any given time. We have internal risk limits set up with respect to leverage depending upon what is in the portfolio. These are calculated and

monitored on a daily basis to make sure that we are comfortable that we have ample liquidity to withstand big shocks.

Brad Farrell
I also had a couple of things. Obviously bringing on MSR makes our balance sheet very different because we have no leverage on that. We really think about that asset, it's not an easy asset to sell; it takes a significant amount of settlement period. You have to get GSE transfer and we are obviously very cautious about that asset class. On the others, it's sliding scale internal metrics that we established that are linked to the appropriate leverage on those assets. One thing we have stayed committed to since our inception is how much debt to equity we are applying on Agency strategy, which, as Bill disclosed, hasn't really changed and is running below five right now. The non-Agency side is running about 1.5. So you add that all together and then we use that excess liquidity targets that we utilize and modify as we bring on different type of liquidity assets.

Tom Siering
The Federal Home Loan line helps us an awful lot as well because we can borrow money up to 20 years. But it's, today, I would just say that, as you know, we are running quite low leveraged and we have a lot of excess liquidity.

Participant
Hi, thanks. I was just wondering, if you could share any track record of the size of the portfolio that the commercial real estate team managed at Prudential?

Tom Siering
I'm not at liberty to share that because it's the property of someone else. But I will say, it's quite good and I think if you ask people in the market Jack Taylor is well known and respected -- it's a big fish we landed. Some people have referred to him as the Dean of the commercial real estate market. His track record is very good, he is a very thoughtful guy, he brought two of his chief lieutenants with him, and they are very capable guys. And I'm a partner at Pine River Capital, and I like to joke that if I wasn't a part owner, I couldn't get a job there, because we demand that we hire really brilliant people and these guys are great.

Participant
As a follow-up, if I were to think about the 20 or 40 basis points, am I right to think that's somewhere around 1.6% to 3.0% expense ratio just on that $500 million equity investment, if I were to try to calculate the net ROEs?

Brad Farrell
Yes, but you have to think about the ramp period of that. What I was focusing on with the 20-40 basis points is the consolidated expense ratio -- in a 170, 180, 190 basis point type range. Really the most important thing, if you are modeling, is to think about the ROE we are disclosing on the overall investment and then put the expense slowdown and you are going to get to probably the rough numbers that you mentioned.

Participant
Thank you.

Participant
I had a question about the difference between the economics between buying MSRs, buying IOs and buying excess servicing strip and any accounting or other issues for the REIT, but really the underlying economics and the preferences there?

Tom Siering
You know, I'm going to ask Matt Koeppen or Bill Greenberg.

Bill Greenberg
Sure. So when we compare the relative attractiveness of CUSIP's, IOs or IOS, and servicing and there are several important differences to keep in mind. One of the main differences are the risks characteristics of servicing the interest rate characteristics not just operational risks and liquidity risk and so forth. But chief among them is the duration differences between servicing and the IO markets because of what are called floating rate components in servicing per unit of investment. Servicing has a more negative duration than IOs which, as Bill said earlier, allows us to buy more positive duration hedges against it. So it's very difficult to compare gross yields on an asset of MSR versus an IO because you also have to take into account the impacts from hedging the portfolio fully.

Another very important distinction to make is, when you are looking at IOS in comparison, it's very misleading to look at OAS differences. You can track it through time and it's indicative of something, but the embedded leverage that you have in an IOS contract is significant and it's really not available in the MSR market. All else equal, if they were the same assets and one has a better leverage and one doesn't, you expect that to trade at a much tighter yield and tighter OAS. So those aren't really directly comparable things when you are comparing them.

Brad Farrell
And the other part of the question I think was more about structuring within a REIT. I think the high level answer, and I believe we have mentioned this at different times, is we received a Private Letter Ruling from IRS that was specifically tailored to us and how we are thinking about stripping that asset. We are very comfortable that we can minimize the tax impacts on our taxable subsidiary and maximize the yield coming to the REIT for dividend distribution.

Tom Siering
So just by way of background, Bill is one of our PhDs. Thank God he doesn't like baseball so I didn't have to keep him away from Billy Beane. The other part of the answer is that historically MSR has traded at a rich value to IO because it obviously comes attached to a mortgage. Entities wanted it so they could interface with the consumer. You know, there are some other products, but because of a variety of things and including that origination spreads are pretty punk right now MSR are much cheaper than they have been historically.

Participant
How is the relationship with the Federal Home Loan Bank -- different, better or worse, what's your take now?

Tom Siering

Well, Brad manages the relationship, but I am going to brag about it. Our relationship with them is amazing, they are great people. Brad has a lieutenant, Sheila Lichty, who spends a lot of time managing that relationship as well. We get really high marks in respect of our operational capabilities and their ability to look through and understand various assets that are going on the home loan facility. So relationship has been fantastic, and Brad has done a great job managing that. The proof is in the pudding; we had a $1 billion when we began last year, today we've got $4 billion. If it wasn't great those numbers wouldn't be there.

Brad Farrell
Yes, and that's the macro comment on you, on a day to day basis. We set the limit and had a significant underwriting process to be a counterparty to the Des Moines. We continuously have ongoing disclosures and meetings where we disclose how we think about the risks in our portfolio. That hasn't changed, that was in place before the rule making and it's in place now. Being able to increase our capacity illustrates how comfortable they are with both of those two items. I think that's kind of the most telling aspect of the relationship.

Tom Siering
Furthermore, nothing around FHFA has anything to do with our relationship with Des Moines -- it's a great relationship, they are great people.

Participant
I realize non-prime is in its nascency as a new initiative, but how much balance sheet capacity would you be willing to devote to that until securitization really allows you to ditch out at a favorable price?

Tom Siering
Well, I like to joke that non-prime is like the Loch Ness monster of the mortgage market – it's talked about all the time, but really hasn't been seen. But this is not a cheeky answer; the answer is that depends because where the ROE is. We love all our children equally which is to say the various buckets of the mortgage market. Today, we don't see any ceiling on it, and I mean that's a nascent market and we'll see if it develops. Obviously, if they were to develop a securitization market around it that would help the liquidity a lot. But even the prime space has been slow to recover post crisis, but how much we'd dedicate to it depends upon is there a securitization market, what's the opportunity set et cetera. So it's very difficult for us to say. We don't want to oversell it today, because it's nascent and we want to be forthcoming about that.

Brad Farrell
It would take time to make it meaningful to the balance sheet we currently have. I think that's the most important takeaway.

Participant
Even with the stock trading at about 90% of book and the stock has done pretty well compared to your peers over the last year. We talked to a lot of investors who are little hesitant to approach the space, rightly so because of expectations of the curve over the next year.

Tom Siering
[Multiple speakers], I missed that.

Analyst

Investors are a little hesitant to approach the stock and the mortgage REIT space in general based on expectations of the curve. How would you respond to that, how you recommend that we get investors a little more comfortable with the stock over the next six months to a year? Thanks.

Tom Siering
Well, it's a great question, thank you for it. I am very excited about the opportunity that we see. We are continuing to develop these operating businesses and to the extent that we can do that we think it's going to help the valuation of stock. As I said, our goal is to get to a point where book value is a negating factor in our share price and the way forward for that is to build up these new businesses. We made a heck a lot of progress.

In respect of the curve and interest rates and so forth, whereas Bill said, we still have a bit of flattening bias in the portfolio it's less than it was, but we continue to model, the team has done an amazing job modeling different scenarios. And we think we've hedged out significant model risk, no matter what and today we are hiding out very low spread duration assets in the agency space. So we have been very cautious, our leverage is lower, our spread duration is low, our divestment there is going to be a sunnier day in the Agency space and in times like this the important thing is to have some capital such that you can take advantage of that opportunity when that presents itself.

We thank you all for attending. We are delighted to have Billy Beane, what a great speaker. We thank you all for coming and we hope to see all soon. Thank you very much.

CONTACT INFORMATION

If you have any questions, please do not hesitate to reach out to the Investor Relations.

July Hugen
Director - Investor Relations
Two Harbors Investment Corp.
612.629.2514
July.Hugen@twoharborsinvestment.com

Investor Relations
Two Harbors Investment Corp.
612.629.2500
investors@twoharborsinvestment.com