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Q3 2018 Two Harbors Investment Corp Earnings Call

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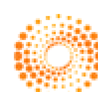

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**Stephen Albert Laws** *Raymond James & Associates, Inc., Research Division - Research Analyst*
**Trevor John Cranston** *JMP Securities LLC, Research Division - Director and Senior Research Analyst*

## PRESENTATION

**Operator**

Good morning. My name is Sonia, and I will be your conference facilitator. At this time, I would like to welcome everyone to Two Harbors Third Quarter 2018 Financial Results Conference Call. (Operator Instructions) I would now like to turn the call over to Maggie Field with Investor Relations for Two Harbors.

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**Margaret Field** ***Two Harbors Investment Corp. - Investor Relations***

Thank you, Sonia, and good morning, everyone. Thank you for joining our call to discuss Two Harbors' third quarter 2018 financial results. With me on the call this morning are Tom Siering, our President and CEO; Mary Riskey, our Acting CFO; and Bill Roth, our CIO.

After my introductory comments, Tom will provide an overview of our quarterly results, Mary will highlight key items from our financials and Bill will review our portfolio performance. 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 are based on the current beliefs and expectations of management, and actual results may be materially different because of a variety of risks and other factors. Such statements are typically associated with the words such as anticipate, expect, estimate and believe or other such words. We caution investors not to rely unduly on forward-looking statements. Two Harbors describes these risks and uncertainties in its annual report on Form 10-K for the fiscal year ended December 31, 2017, and in other filings it makes or may make with the SEC from time to time, which are available in the Investor Relations section of Two Harbors' website and on the SEC's website at sec.gov. Except as may be required by law, Two Harbors does not update forward-looking statements and expressly disclaims any obligation to do so.

I will now turn the call over to Tom.

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**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. This quarter was highlighted by strong core earnings and the tremendous progress we made in the redeployment of capital from the CYS acquisition, into both MSR and non-Agencies. Core earnings, including dollar roll income, was $0.48 per basic share in the third quarter, representing a return on average common equity of 12.4%. We are especially pleased with this result in a quarter where we were redeploying capital from the CYS transaction.



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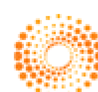

Please turn to Slide 4 for an overview of our strategy. We believe that we operate a superior business model through our diversified rates and credit strategies and our sophisticated approach to risk management. Additionally, we maintain a keen focus on optimizing our balance sheet to enhance earnings and stockholder returns. As a result, we believe that we can generate better returns with superior stability in our book value.

Please turn to Slide 5. The objective of our strategy is to make our shareholders more money while keeping an acute focus on risk management and de minimis exposure to changing rates. With this objective in mind, we thoughtfully examine opportunities for growth and innovation in the mortgage REIT space.

In July 2016, we announced that we were discontinuing our mortgage loan conduit program to reduce our operating complexity and costs and to position us to generate stronger returns for our stockholders. Then in 2017, we formed Granite Point Mortgage Trust, creating a stand-alone vehicle for our commercial business that we established in 2015.

As you can see on this slide, despite a flatter curve and higher rates, our dividend-to-book value ratio has steadily increased and now stands above that of our peer cohort. Earlier this year, we identified a unique opportunity to acquire CYS investments to further grow and expand our business. The acquisition was a milestone for our company. We grew our market capitalization and equity base. We increased the liquidity of our stock. And we expect that our expense ratio will decrease. We believe that our enhanced scale supports growth in our target assets, including MSR and non-Agencies. And we expect that these assets will deliver better long-term returns compared to an agency-only strategy.

On October 5, we announced that Brad Farrell intends to resign from his position as CFO effective January 31, 2019. I would like to take a moment to thank Brad for his dedication to Two Harbors over the past 9 years. He played a leading role in our growth, developing a first-class finance team with a keen focus on financial transparency and accuracy. I would like to congratulate Mary on her appointment as acting CFO. Mary joined us in 2011 and most recently, has held the role of Chief Accounting Officer, working closely with Brad. We believe that we have assembled a great team to take the company forward and are very excited about the opportunities ahead.

I will now turn the call over to Mary to review our financial results.

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**Mary Kathryn Riskey** ***Two Harbors Investment Corp. - MD, CAO, VP, Acting CFO & Treasurer***

Thank you, Tom. Turning to Slide 6, during the quarter, we incurred a comprehensive loss of $102.8 million or $0.46 per share, which includes the dilution from the CYS acquisition. Our book value at September 30 was $14.81 per share compared to $15.69 at June 30. After accounting for our third quarter common stock dividends amounting to $0.47 per share, we generated a return on book value of negative 2.6%.

As we indicated on our August earnings call, our book value this quarter decreased approximately 2% due to the acquisition of CYS. Additionally, book value was adversely impacted by wider agency spreads, underperformance of both higher coupon agencies and specified pools and some exposure to rates.

This quarter, our book value was also affected slightly by a non-recurring deferred tax asset write-down resulting from the deemed liquidation of a taxable REIT subsidiary.

As we turn to Slide 7, let's review our core earnings results. Core earnings, including dollar roll income, was $0.48 in the third quarter, representing a return on average common equity of 12.4%. I would note that certain expenses resulting from the acquisition of CYS are excluded from our core earnings, including the purchase premium, transaction expenses, restructuring charges and the downward adjustments to the management fee.

Our earnings power continues to align well with our dividend projections, and consistent with our guidance in early 2018, we expect to pay a common stock dividend of $0.47 in the fourth quarter, subject to the discussion and approval of our Board of Directors. We anticipate that our other operating expense ratio, excluding noncash LTIP amortization, will trend lower as a result of the CYS acquisition.



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Our expenses in the quarter ticked down slightly to 1.3% from 1.4%, primarily due to having a larger capital base. Ultimately, we expect this ratio should stabilize in the low 1s in 2019.

As we turn to Slide 8, I'd like to highlight how we are optimizing and diversifying our financing profile to benefit future earnings performance. Our economic debt-to-equity ratio, which includes the implied debt on our TBA positions, was 7.3x at September 30 compared to 6.2x at June 30. We anticipate leverage over time to drift lower as we redeploy the capital from agencies acquired in connection with the CYS transaction into lower levered assets like MSR and non-Agencies.

Consistent with our historical positioning, we expect to maintain sufficient liquidity to take advantage of market opportunities as they arise. The repo market for agencies is functioning efficiently for us, and we are focused on continuing to ladder our repo maturities and diversifying our counterparty mix. We continue to expand our counterparties, and at September 30, we had agency repo outstanding with 34 counterparties, up from 25 at June 30. Additionally, we continue to observe positive changes in the non-Agency and MSR financing spaces, which further enhances returns in both strategies.

Non-agency financing remains competitive, resulting in improvements in both haircuts and spreads. In the third quarter, non-Agency financing haircuts were generally between 20% and 30%, and we are consistently seeing spreads offered between 100 and 125 basis points over LIBOR. Spreads have come down about 20 basis points so far in 2018, and we expect this positive trend to continue into 2019.

On the MSR front, we continue to advance discussions with counterparties focused on similar features to our current facilities. This includes the two-way margining, which allows us to better manage our liquidity in a changing rate environment. Across all of our MSR financing facilities, we had $510 million outstanding with an additional available capacity of $260 million as of September 30.

Going forward, we anticipate that spreads will continue to compress for MSR financing, presenting opportunity in 2019 to further benefit MSR returns.

I will now turn the call over to Bill for a portfolio update.

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

Thank you, Mary, and good morning, everyone. The investment team made excellent progress reallocating capital from the CYS acquisition this quarter, which I will highlight in more detail shortly.

First, though, let's review our investment portfolio, quarterly performance and risk positioning.

As we turn to Slide 9, you can see that at September 30, our portfolio grew to approximately $28 billion. Our capital allocation was 76% to our rate strategy and 24% to the credit strategy. This shift towards the rate strategy was consistent with our expectations when we acquired CYS's agency portfolio.

Please turn to Slide 10. In the third quarter, interest rates rose, the curve flattened and agency mortgage spreads were mixed. Both MSR and credit performed well. MSR increased in value as rates rose and spreads widened, and residential credit continued to benefit from strong yields and stable spreads. The main driver of our performance this quarter was the addition of over $10 billion of agencies when the CYS acquisition closed on July 31. In August and September, we recycled these holdings into higher-coupon 30-years as we believed these assets offer more attractive returns.

During those 2 months, the higher coupons underperformed, as did some of our existing specified pool holdings, negatively impacting our book value. Extracting the impact of the merger and the related agency pool performance from August and September, we estimate that our book value would have been down less than 3% in the quarter.

As we continue to redeploy capital from Agencies into MSR and non-Agency securities, we expect to generate better returns, a higher net



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interest margin, lower leverage and greater book value stability.

Let's turn to Slide 11 to review the quarterly activity in our rates strategy. In addition to the growth in Agency securities, we added TBAs to our portfolio, growing our net notional TBA position to $9.3 billion, largely as a result of the overall increase in Agency holdings. We were also active participants in the MSR market, adding approximately $16 billion through both bulk and flow channels. We expect the market for MSR to continue to be quite active, largely as a result of higher interest rates, difficult origination margins and the consolidation of originators. We believe that we are well positioned to grow this asset class as a result of our larger capital base.

Turning to our market outlook, we believe that the Fed will probably move the Fed funds rates into the 2.5% to 3% range by the end of 2019 and that long rates will drift higher over time. Agency mortgage spreads have widened over 20 basis points so far this year, and specified pools have also widened. While this has impacted our book value somewhat, it provides better investment opportunities as we move forward. That being said, we believe it is possible to see spreads continue to move modestly wider in the future, given the recent market volatility and the Fed's reduced involvement in the market.

Given our outlook on rates and spreads, let's turn to Slide 12 to discuss our risk positioning in a little more detail. As you know, we aim to maintain prudent exposures to interest rates, curve and mortgage spreads through our overall positioning and active risk management. On this slide, you can see our overall book value and net income exposures are low. Also because of our MSR holdings, our exposure to Agency spreads remains moderate.

As we continue to add MSR and floating-rate non-Agencies, we anticipate we will have lower sensitivity to Agency spreads, interest rate and curve changes.

Finally, given market volatility in both Agency and mortgage credits spread widening in October, we estimate book value to be down around 4%.

Turning to Slide 13, let's discuss our credit strategy. This quarter, we took advantage of several opportunities to add to our holdings of low-dollar priced legacy non-Agencies, increasing our portfolio by approximately $500 million. Despite higher rates and slightly decreasing affordability, employment data remains strong, and we expect home prices over the next several years to be stable to higher. These tailwinds further bolster the strong, double-digit total returns that we expect to generate in this strategy, and we continue to see opportunities to add bonds that we like to our portfolio.

Moving to Slide 14, let's take a few moments to highlight the progress we've made redeploying capital from CYS's Agency portfolio into MSR and non-Agencies. Initially, we reduced interest rate exposures and moved the Agency holdings from 15 years and ARMs into higher-coupon 30-years. We also took advantage of market opportunities to add both MSR and legacy non-Agencies. As you can see in the table on this slide, capital allocated to MSR is already back to where it was at the time of the acquisition announcement, and we continue to grow this asset class.

In conclusion, we had a lot of momentum in the third quarter, reallocating capital from the CYS acquisition into our target assets. Our investment strategy, going forward, is focused on further allocating capital to MSR and non-Agencies as we believe these asset classes currently present the best investment opportunity. We expect that as we are able to increase capital to these asset classes, that we will drive better returns for our stockholders, while decreasing our overall risk sensitivities. I will now turn the call back to Sonia for Q&A.

## QUESTIONS AND ANSWERS

**Operator**

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



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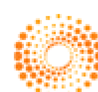

**Douglas Michael Harter** ***Crédit Suisse AG, Research Division - Director***

I guess, as you think about portfolio rotation of the CYS acquisition going forward, does the widening that you've seen since the closing of the acquisition, kind of, change your appetite there? Or do you -- and, I guess, how do you balance the risk of, kind of, rotating out of Agency, kind of, at the wides -- we've had it -- just, I guess, thoughts around that?

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

Doug, thanks for joining us. Great question. So obviously, with agencies being wider, that's a consideration. We've also seen non-Agencies, as I mentioned on the call, are also somewhat wider in October, which roughly, if you compare to widening in each, the relative attractiveness hasn't changed. So it doesn't change our appetite for non-Agencies. The other thing is, is if you look at our expected returns on the combination of MSR and Agencies, that's widened commensurate with the change in Agency spreads because that's obviously, part of that strategy. So we like the return expectancy on the combination of MSR and Agencies, plus it also is a much lower risk profile with regard to Agency spreads. So I would say that going forward, despite the widening that we've seen in Agencies, you should still expect us to see that grow the MSR and non-Agencies based on current valuation.

**Operator**

And our next question comes from Bose George of KBW.

**Bose Thomas George** ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

Actually, one on book value. When you think about the 4% decline you noted quarter-to-date, was that also somewhat higher than expected given the portfolio mix, kind of, where it stands right now relative to, kind of, where you want it when everything is, sort of, fully allocated post the transaction?

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

Yes, well, I can break that down for you pretty simply, right? Rates are up a bit, which is a small contributor. If you look at our slide, I think, it's 12 that gives you the exposures. The basis is, as you know, substantially wider, which contributes, if you look at our disclosure, somewhere in that 2% to 2.5%. And then credit also being somewhat wider, it's another roughly 1%. So what we saw, as you know, in October is, sort of, extreme volatility stocks. I think everybody on this call knows we're down to 10% at one point. So a substantial amount of volatility which fed into, sort of, all asset classes. I would note we have seen credit bounce back somewhat here in early November, which is encouraging, but that's, sort of -- everything that has occurred is consistent with our positioning and what we disclosed in the deck. I hope that answered your question.

**Bose Thomas George** ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

Actually, it did, but I guess, what I was trying to think about or ask also was the -- was whether the -- in your commentary about the decline last quarter, or in 3Q, you noted that some of it was also the positioning relative to the acquisition. So if you strip that out, that would have been, whatever, less than 3%. So the question really was the 4% decline here could we make a similar comment here where you're still transitioning, so if you adjust that, it would have been lower?

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

Yes, that's correct. I mean, as you know, we took on over $10 billion of Agencies at July 31, which, from a timing standpoint, right before the Agencies widened obviously, that's -- it is what it is. But yes, I think if you strip that out, the numbers would be less.

**Bose Thomas George** ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

Okay, great. And then, actually, you've, sort of, discussed this, but in terms of incremental opportunities, where is kind of the best place right now?

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

Yes, sure. So with the Agency widening, the expected returns are still low double digits. But they are -- I mean, if you add 100 or 200 basis points to 10% or 11%, you still get low double digits. They're not like 15% to 20%. Agencies plus MSR, though, is getting close to the



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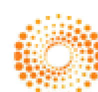

mid-double digits and that sort of reflects back on my comments to Doug's question. And then non-Agencies, the baseline, as we've discussed before, is high single digits. With those being somewhat wider, they're still high single digits, but what we're in that for, as you know, is the total return opportunity, which we think is well into the double digits.

**Operator**

Our next question comes from Trevor Cranston of JMP Securities.

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

One more question related to book value sensitivity and the capital reallocation from the acquisition. So looking at Slide 14, where we show, sort of, how things have transitioned since the deal and where they were prior to the deal, can you share your thoughts on how long you think it will take, presuming the target is to get back to the MSR allocation and the credit allocation, where they were maybe around June 30? The way things are today, how long you think it will take to get the portfolio back to that sort of balance?

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

Trevor, thanks for the question. Yes, so I guess, I may have a couple of comments on that. In terms of our run rate, as -- we bought roughly $500 million of non-Agencies for the last few quarters, and we're seeing good opportunities. So that's adding about 1.5% of capital for quarter to credit. MSR, we're seeing tremendous opportunity in MSR, and as you can expect, by adding all these agencies and not being -- redeploying the MSR, sensitivity to agency spreads is just higher. And that's something that will be mitigated as we move forward. In terms of our activity there, we view ourselves as being really actually on or ahead of plan because we're having somewhere between 0.5% to 1% of flow, but there is a substantial amount of bulk activity. We've already closed on one transaction this quarter. There are numerous, very large packages that are out for bid that we're taking a look at. So we could actually make a pretty good dent in the deployment there even this quarter or the following quarter and get back to the mid-20s very quickly. So I mean, we're very optimistic on our ability to make great headway. Like I said, we believe that we are generally ahead of plan, but I would say that our December 31 number should look like we've made great progress.

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

Great, that's helpful. And so a follow-up question on the MSR acquisition opportunity, particularly on the bulk side. Obviously, it sounds like there's a fair amount of supply and availability of assets. But can you maybe give us some more color on what you guys are seeing in terms of competition for the assets among other investors and maybe also some commentary on how you're seeing valuations trend on bulk pools over the last few months?

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

Yes, sure. Yes, so as we talked on prior calls, annual volumes typically run well north of $100 billion. I would say, for this quarter, we're already seeing north of $50 billion in numerous different packages. And I think, as I mentioned on the call, part of that is due to higher rates, we're coming into the year-end, origination margins, et cetera. So from that standpoint, there is really tremendous opportunity, and that's on top of our monthly flow volume that we're doing about $2 billion or so a month. In terms of competition evaluation, that hasn't really changed much from what we've seen the last few years. Typically, you'll have maybe 10 to 15 participants get a package and maybe, 4 or 5 or 6 will show up. And if you want to win, you need to be on the market. It is competitive. Even though it's not a lot of players, it is definitely competitive from a price standpoint. Yields haven't really changed that much. It's interesting despite some of the volatility we've seen in other areas of the capital markets, servicing valuations really haven't changed that much in the past 3 to 6 months. I'd say, bulk packages -- baseline yields are in the 6% or so, plus or minus. And flow volumes typically come in at 100 basis points or more cheaper than that. So from that standpoint, to get a positive yield on your hedge that has negative duration and hedges mortgage spread, especially when mortgage spreads are wider, the combination of that package is very compelling to us. The other thing, and Mary mentioned this, is that as we continue to see improvement in financing terms, that greatly enhances the attractiveness of the combined package.

**Operator**

Our next question comes from Stephen Laws of Raymond James.



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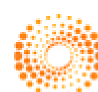

**Stephen Albert Laws** ***Raymond James & Associates, Inc., Research Division - Research Analyst***

A number of questions have been touched on, but wanted to follow up on the portfolio. Bill, could you maybe talk about how actively you're looking at that CYS portfolio? From the breakout I saw earlier this year, I think they had about $5 billion of 15-year fixed rate. I don't see that in your 9/30 portfolio. So can you maybe talk about the decisions you've made there and really what's left to do on that front? Or is it just more sourcing of non-Agency RMBS and MSRs at this point to drive the shift to the mix?

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

Yes, thanks for joining us, Stephen. Good to talk to you again. The -- so all of the exposures that we inherited from the acquisition, which are pretty much 15-years end ARMs, that's all been converted to 30-year Agency, primarily higher coupon. I kind of mentioned that on the call and that was, sort of, during the widening that occurred, which is what we talked about a little bit earlier. So there's really nothing left to do on that. The thing that we're really working on now is basically pushing down the Agencies as we redeploy the capital from that into the MSR and non-Agency. So it's really the latter of what you mentioned as opposed to the former.

**Stephen Albert Laws** ***Raymond James & Associates, Inc., Research Division - Research Analyst***

Okay. And you -- looks like you increased that non-Agency about $300 million. Looks like pricing is roughly flat versus last quarter. Are you continuing to see pretty attractive opportunities there here mid-quarter? And what's the pipeline of the new investment activity look like on the non-Agency front?

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

Yes, yes. The last quarter, I think, gross, we added close to $500 million, and we're running between $100 million and $200 million a month. Flows in that market have actually been quite good. There has been -- I mean, we're focused on -- and as you know, the low dollar price, which is -- the point there is because we're looking for the price appreciation as performance improves over time, which is what we've seen occur and we believe will continue to occur. So we've actually seen really good opportunity, and as I mentioned, somewhere between $100 million and $200 million a month has been our run rate of adding bonds.

**Stephen Albert Laws** ***Raymond James & Associates, Inc., Research Division - Research Analyst***

Fantastic. And then lastly, maybe a little bit of comment on the TBA market. Looks like a significant contribution from the dollar roll income. Can you talk to how that looks now and any specialness there and what you are seeing in that opportunity?

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

Yes, sure. So I'd say -- there's a couple things I'd say about that. First of all, I would say that the $9 billion, as a percent of total, is probably, never say never, but it's probably -- at -- definitely at the higher end of what our percentage would be. I think you should expect to see that come down. If you think about moving the CYS agencies into 30-years, the simplest way to do that was to focus on TBA. And then you figure that those would go down over time as that capital gets redeployed into MSR and non-Agencies. The second thing is in terms of specialness. Over the course of the last several quarters, we've seen some reasonable specialness in the higher coupons, 4.5s and 5s. For the most part, those rolls trade closer to carry today. So don't think you -- there's nothing -- I don't think you should expect to see any major contribution from specialness, at least currently. But as we know, that can change. But I think the bigger point is, is that you should expect to see our TBAs, as a percentage of our total, move lower as that capital gets redeployed.

**Operator**

Our next question comes from Rick Shane at JP Morgan.

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

Look, given the acquisition and the plan to transition those assets, you are in a unique situation that your duration is longer than it's been, really, for any point in several years. You also highlighted an expectation of higher rates. Obviously, spread's uncertain, but highlighted the possibility of wider spreads. You are effectively reducing that exposure into that market, which makes sense, but there is a fair amount of mark-to-market risk and realized loss potential as you sell into that. Is there a strategy available to hedge out some of that risk in the shorter term?



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

Rick, thanks for joining us. I'd say a couple of things. I mean, this is really, if you look at Slide 12 of the deck, Rick, this really is sort of the main thing I would point you to. From a rate standpoint, we attempt to be as neutral as possible. You'll see on the top left there, that our exposure to 25 basis point move in rates is only 1%, which -- it's low. It's not 0, but it's pretty low. And I don't think that's terribly inconsistent with our historical positioning, but you certainly shouldn't expect to see that increase. If anything, we would expect to keep that fairly low. In terms of the second point, it really relates to spreads, which you can see at the bottom part of that slide. I mean, the reality is we added all these agencies, and whether spreads had widened or tightened, we just have a bigger exposure until that gets recycled. There's effectively 2 ways to hedge that: either sell them all and hold cash, which isn't really the mandate of what we're in business for as a mortgage REIT; or we go out and buy a whole boatload of MSR, which, if you want to buy it at the right price, at the market price, that takes a little time. And as you can see, we've made some really good headway. Like I said, our MSR allocation is the same as it was when we announced the transaction in the spring, but we expect that to move up into the 20s and be back into the mid-20s in not-too-distant future. So I mean that.

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

(inaudible) -- well, go ahead.

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

No, I just -- look, the positioning is pretty well laid out, and I think we're making good headway on the mortgage spreads standpoint.

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

Rick, it's Tom. If you look at our interest rate exposure, it's very consistent with our historic profile. So our attitude toward rates has not changed. We want to be as rate neutral as is practical.

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

No look, I know the rate strategy hasn't changed in any way. I think what is happening here is that you have emphasized a focus on more bespoke, less liquid assets, both credit-sensitive and growing the MSR hedge book as opposed to the sort of plain-vanilla strategies of owning agency mortgage backs and hedging them in the swaps market. We know that you guys could go out and put swap position on very quickly. But you are in the sort of inflection point where that transition's going on, and I just wonder about the vulnerability as that occurs.

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

Well, I mean, let's face it. It's -- the rate contribution to performance this year has been fairly small. Mortgages have widened over 1 point since the beginning of the year, and roughly 70% of that has been in the last 2 months. So if you're a mortgage REIT, and you own mortgages, and agencies are widening, whether you have got your rates hedged or not, that's going to show up in your results. Our focus, as you know, is to have less exposure to the mortgage spread -- mortgage bases by having MSR for 2 reasons: one, it generates a higher expected return than just Agencies hedged with rate, so we think we get paid for that; plus, we have reduced spread risk. And so that's where we're headed. We are where we are right now as a result of the acquisition, and that's fine. We have much higher capital base, much more ability to take advantage of opportunities. But we firmly believe that our approach and our strategy works and has shown to work over time. And that's where we're headed.

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

And obviously too wider agency spreads suggest higher earnings going forward.

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**Operator**

And ladies and gentlemen, this does conclude our question-and-answer session. I would now like to turn the call back over to Mr. Siering for concluding remarks.

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

Thank you, Sonia, and thank you, everyone, for joining our call today. We are very excited about the opportunities ahead for our company. We look forward to speaking with you again soon. Have a wonderful day.

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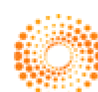

**Operator**

Ladies and gentlemen, this does conclude today's conference call. You may all disconnect.

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