



Two Harbors Investment Corp. Fourth Quarter 2019 Earnings Call Transcript

February 6, 2020



TWO HARBORS
Investment Corp.

A Pine River Capital Managed Company

PREPARED REMARKS

Two Harbors Investment Corp.

Fourth Quarter 2019 Financial Results

Moderator: Maggie Karr

February 6, 2020

9:00 AM EST/8:00 AM CST

Operator: Good morning, my name is Allison and I will be your conference facilitator.

At this time I would like to welcome everyone to Two Harbors' fourth quarter 2019 financial results conference call. All participants will be on a listen-only mode. After the speakers' remarks, there will be a question and answer period.

I would now like to turn over the call to Maggie Karr, with Investor Relations for Two Harbors.

Maggie: Thank you, Allison, and good morning everyone. Thank you for joining our call to discuss Two Harbors' fourth quarter 2019 financial results. With me on the call this morning are Tom Siering, our President and CEO; Mary Risky, our CFO; and Matt Koeppen and Bill Greenberg, our Co-CIOs.

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, 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 in the investor relations section of our website.

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 risk and other factors. We caution investors not to rely unduly on forward-looking statements. 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.

Tom Siering: Thank you, Maggie, and good morning everyone. We hope that you had a chance to review our earnings press release and presentation that we issued last night.

Please turn to slide 3 to review our results. We generated a 1.5% return on book value for the quarter, bringing our annual return on book value to 23.6%. We are quite proud of these results in 2019. Book value preservation is our primary focus and is the foundation for long-term stockholder returns.

Core Earnings was \$0.25 per share. As expected, it remains materially lower than our dividend. Echoing my comments from last quarter, in certain rate environments Core Earnings is not a good proxy for our dividend. Rather, total economic return is a much more important metric and indication of the ongoing earnings power of our company. We continue to be confident that our \$0.40 dividend is supported by both the expected underlying earnings power of our portfolio as well as by taxable income generation. As always, all future dividends remain subject to the discretion and approval of our Board of Directors.

Please turn to slide 4. In the 10 years since Two Harbors was founded we have many achievements to be proud of: we spun out two public companies; acquired a peer company; and built an impressive MSR platform, which today is a core component of our Rates strategy. Most importantly, during this time we generated a total stockholder return of 256%, as measured by the change in stock price with dividends reinvested. We also grew our book value by 10.4% during this timeframe. Both of these metrics are substantial positive outliers compared to our peers. We have defined our niche in the mortgage REIT market, not just as the largest hybrid mortgage REIT, but also through our three key differentiating factors: (1) our strategy of pairing MSR with Agency RMBS, (2) utilizing a variety of tools to hedge interest rate and spread exposure, and (3) our unique portfolio of legacy non-Agency securities. Our strategy employs thoughtful portfolio construction and security selection, as well as active hedging, as we aim to protect and grow our book value over the long-term.

Our success over the past 10 years would not have been possible without the extremely talented and driven team that we have built at Two Harbors. We are keenly focused on employee engagement and improvement as the foundation of our company. I am quite proud of the culture we have developed and believe that it is this spirit that will drive Two Harbors forward.

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

Mary Risky: Thank you, Tom.

Turning to slide 5, let's review our financial results for the fourth quarter. We generated Comprehensive Income of \$56.8 million, or \$0.21 per share. For the year, we generated Comprehensive Income of \$826.7 million, or \$3.09 per share, representing an annualized return on average common equity of 21.7%. Our book value at December 31st was \$14.54 per share, compared to \$14.72 at September 30th.

Moving to slide 6, let's discuss our Core Earnings results. Core Earnings, including dollar roll income, was \$0.25 per share in the fourth quarter. Core Earnings this quarter was favorably affected by lower LIBOR, increased servicing income as a result of MSR portfolio growth, and higher TBA dollar roll income. This was offset by Agency RMBS portfolio rotation from higher to lower coupons, as well as higher RMBS amortization due to faster prepayments. As a reminder, we calculate Core Earnings without removing the impact of higher prepayments from amortization on RMBS. In certain interest rate environments, prepayments can increase, and we will experience accelerated amortization on premium bonds. When this occurs, Core Earnings can become decoupled from the underlying financial performance of the company. Referring back to Tom's earlier comments, this is why Core Earnings is not always a good proxy for the ongoing earnings power of our company or for our dividend.

Let's turn to slide 7 to review our taxable income and dividend distributions in 2019. This year, the REIT generated taxable income of \$510.6 million, after utilizing \$11.7 million of carryover net operating losses. Our dividend declarations of \$483.6 million resulted in a distribution percentage of 94.7%. The tax characterization of the dividends distributed by Two Harbors will be treated as 90.6% ordinary income and 9.4% qualified income for our stockholders. The \$27.0 million of undistributed taxable income, or approximately \$0.10 per share, will be carried into 2020 for future distribution. All of these metrics align with our financial projections and tax planning efforts throughout 2019. For additional information regarding the distributions and the tax treatment, please reference the dividend information found in the Investor Relations section of our website.

Turning to slide 8, our portfolio yield declined in the quarter to 3.54%. The lower yield was driven primarily by purchases of lower coupon Agency RMBS in a lower interest rate environment, as well as continued increased amortization due to higher prepayment speeds. Our net yield increased to 1.19% from 1.16% due to lower cost of funds.

Let's review our financing profile as shown on slide 9. Our average economic debt-to-equity, which includes the implied debt on our TBA positions, was consistent quarter-over-quarter at 7.2x. We are comfortable with our leverage and do not expect it to change materially from here.

Our diverse financing profile includes a mix of traditional repo, convertible debt, revolving credit facilities and MSR secured term notes. At December 31st we had 23 active Agency repo counterparties with a weighted average maturity of 74 days. We continue to focus on laddering our repo maturities to minimize exposure to changes in spreads and rates. I'd like to make a brief comment on the repo markets. We have started to see some normalization of repo rates recently. We expect to begin to see a benefit from this in the first half of 2020, as our existing repurchase agreements come to maturity and we restrike them. With respect to the FHLB, we have been modest in our use of our facility due to the fact that we continue to be able to access more attractive terms in the repo market, even in the current conditions. However, we do have the ability to make greater use of that facility in the future. As a reminder, our FHLB facility expires in 2021.

Across all of our MSR bilateral facilities, we had \$562.6 million outstanding, with a total capacity of \$750 million, as of December 31. We also had \$400 million outstanding MSR term notes, and an additional \$1 billion capacity available under a variable funding note related to the securitization. As a reminder, these facilities and notes are multi-year in term and, therefore, have been unaffected by the volatility in the overnight and short-term repo markets. For more information on our financing profile, please see Appendix slide 27. With that, I will now turn the call over to Bill and Matt for a markets overview and portfolio update.

Bill Greenberg: Thanks, Mary. Please turn to slide 10. The fourth quarter in many ways saw a reversal of 2019 performance trends, as long end interest rates rose, higher coupon MBS widened, and lower coupon MBS tightened. In the left-hand chart on slide 10, you can see the changes in interest rates and in current coupon z-spreads for the quarter and for the year. Short end rates were largely unchanged in the quarter, while longer term interest rates rose. Notably, current coupon z-spreads tightened, as the steepening yield curve, amongst other factors, reduced prepayment fears, undoing virtually all of the widening experienced earlier in the year. Hedged mortgage performance by coupon is shown in the right-hand chart, illustrating the recovery in 3% and 3.5% in the quarter. At the same time, higher coupon MBS underperformed lower coupons, and were essentially flat on the quarter, leaving the large year-to-date

outperformance intact. While last quarter we had thought that the lower coupon MBS were at multi-year wides, the substantial spread tightening experienced this quarter has dampened our enthusiasm somewhat. While we still find lower coupon MBS attractive, today we would say they are on the cheap side of fair.

On the funding side, the repo markets continued to make headlines in the fourth quarter. While rates remained elevated during the quarter, the Fed's open market operations and balance sheet build out clearly stabilized the market. This was on display on the final day of the year, when overnight repo rates cleared below the Fed's target, which is highly unusual. In the first quarter so far, as Mary said, we have been encouraged by ongoing improvements in funding levels.

Please turn to slide 11. In mortgage credit, our portfolio continues to perform well in this lower rate refi environment, with higher prepayment speeds and lower LIBOR rates driving increased cash flow. As seen in the chart on the lower left, although HPA growth is below that of the previous five years, it has remained solid with around 4% growth year-over-year, and expectations are for continued slow but increasing home prices. Additionally, the housing market is still showing strength with the supply of existing single family homes as low as it has been in 15 years, as seen in the chart on the lower right. Even the supply of new homes, while above that of existing homes from a "month's supply" point of view, is still low on an absolute basis and not that far off from the post-crisis lows observed in 2012. Notwithstanding the foregoing, spreads widened slightly this quarter, and our credit portfolio contributed negligibly to performance. However, our outlook for the sector is very constructive, and we continue to believe that we will be rewarded from our holdings in the sector. I will now turn it over to Matt.

Matt Koeppen: Thank you, Bill and good morning everyone.

Moving to slide 12, let's review our portfolio and positioning. At December 31st our portfolio was comprised of \$41.0 billion of at-risk assets, which included \$33.4 billion of MSR and securities and \$7.7 billion of bond equivalent value of TBA positions. From a capital allocation perspective, 78% of capital was allocated to our Rates strategy and 22% to Credit, which was roughly unchanged from the prior quarter. While we continue to find pockets of opportunity in legacy credit, we still believe the "new credit" sectors to be unattractive. As such, we continue to expect our capital allocation over time to shift slowly away from Credit and towards Rates.

Our portfolio activity is summarized at the top of this slide. During the fourth quarter, we rotated approximately \$7 billion of exposure out of higher coupons and into lower coupons, so that by the end of the year we had acquired around \$11 billion of 3.0 percent coupons, including both pools and TBAs, up from a flat exposure at the beginning of year. This activity maintains prospective returns but with much lower mortgage spread risk, since the current coupon aligns better with our MSR holdings. As a result, in the fourth quarter, as 3's tightened and higher coupons widened, we were still able to generate a positive total return.

Activity in the MSR market showed signs of picking up in the quarter. We acquired \$11.1 billion UPB through bulk purchases and another \$11.2 billion UPB through flow origination. We have been active in growing our flow seller network and we added another flow seller in the fourth quarter. We expect to add several more flow sellers to our network in the first quarter of 2020, which should increase our quarterly flow volumes.

In our Credit strategy, we were opportunistic in adding lower-dollar priced bonds. Specifically, we added around \$200 million of discounted legacy subprime securities. At an average price of \$66, we believe these securities have attractive upside potential. While we did not sell any non-Agencies this quarter, as time goes on, we expect more of these legacy assets to reach their upside potential, at which point we will sell them and recycle that capital into the best available opportunities.

Bill Greenberg: Moving to slide 13, we would like to take a moment to highlight some additional information about our specified pool position, which was an important contributor to our positive results in both the fourth quarter and in 2019. In the upper left pie chart, we break out the specified stories that currently make up our portfolio. As you can see, across all coupons, most of our exposure falls into 3 categories: Loan Balance, LTV and Geography. Within the Geography bucket, most of our holdings are New York pools, which have reduced refinancing behavior because of the mortgage recording tax. As a reminder, Loan Balance pools have lower refinancing behavior because of the fixed costs of the refinancing activity compared to smaller loan sizes, and borrowers with higher LTV's have a harder time refinancing because of the relative scarcity of refinancing opportunities. We have also included a comparison of 3-month prepayment speeds on our specified pools versus generic TBA collateral. As you can see, our specified pools are prepaying at rates much slower than their generic cohorts. It is this differential that causes market premiums for these securities. Slower prepayments are obviously good, but the attractiveness of these securities depends on the price paid for those slower speeds. Payups on Geography pools are generally in the same ballpark as certain Loan Balance pools, while LTV pools typically trade at lower payups.

Finally, at the bottom of the slide, we have included a breakdown of our effective coupon positioning. In the left most part of the chart, we show our holdings in cash securities and TBA's, in bond equivalent value. We have spoken in previous quarters about how our MSR position acts like a short position in the current coupon – increasing in price from mortgage spread widening and higher rates and declining in price from mortgage spread tightening and lower rates. From a risk perspective, therefore, it is useful to think of our MSR position as an effective short position in the current coupon, and that is shown in the middle part of the bottom chart, where the current coupon this quarter was a mixture of 2.5 and 3 percent coupons. Finally, the right hand part of the chart shows the net position of these two effects. As you can see, although we have a significant long position in the 3 percent coupon in pools and TBA's, our MSR exposure largely offsets this, and results in a fairly uniform exposure across the coupon stack.

Matt Koeppen: Please turn to slide 14 for a discussion of our risk profile. Our exposure to changes in interest rates and mortgage spreads remain small. In the top right chart, you can see our low exposure to instantaneous changes in mortgage spreads; as of December 31st, a 25 basis point spread widening would negatively impact book value by 2.7%. Our MSR position is helpful in reducing this exposure, as Agency RMBS would have a negative impact of 5.1%, but the MSR would have an offsetting positive impact of 2.4%. The chart on the bottom of the page shows our book value exposure to instantaneous parallel changes in all interest rates. You can see that as of December 31st an instantaneous parallel shift in interest rates upward of 50 basis points would negatively impact book value by only 2.4%. These are very low numbers as we are quite comfortable with this profile. Going into a little more detail, you can see how MSR affects our hedging profile. Our RMBS assets would have a negative impact of 12.9% in such a rate move, and the MSR would have a positive impact of 6.3%. All of the rest of our interest rate hedges, including options, would have a positive impact of 4.2%. To be clear, the presence of MSR in our portfolio means that we have fewer financial hedges such as swaps and options. Our MSR holdings currently hedge approximately half of our interest rate risk in the portfolio, and half of our mortgage spread risk. To the extent that we acquire more MSR, these proportions will increase.

Lastly, I'd like to make some comments on the GSE front. During the quarter, the US Treasury and the FHFA announced that the GSEs will be permitted to retain earnings. This is a modification of the so-called "net worth sweep", and means that no dividends were payable to Treasury for Q3 or Q4; the result being that the companies have begun to build net worth. Under this new plan, Fannie Mae will be allowed to retain earnings up to \$25 billion, and Freddie Mac \$20 billion. With current profitability, we expect that the GSE's will reach those targets in 2 to 3 years. And just a few weeks ago, the CFPB announced that they were exploring revising the definition of the Qualified Mortgage to remove the 43 DTI limit and replacing it with a more market-based threshold. The CFPB director also suggested that she would extend the QM patch "for a short period" while these details are worked out. While the Treasury and FHFA are beginning to execute their plan for the GSEs, we believe that any outcome will be highly dependent on the result of the 2020 elections this year. If the current administration remains, it seems likely that some sort of plan will continue to move forward. As we have commented in the past, we believe that the effect on our business will be small, and likely focused on the potential for increased non-GSE issuance in the future.

Bill Greenberg: Please turn to slide 15. In summary, we're quite proud of our 2019 results, headlined by our book value growth and total economic return. The actions we took in the third and fourth quarters were intended to preserve or increase book value, preserve or increase return expectancy, and to reduce risk. Heading into 2020, we still view our best investment opportunity to be in pairing Agency RMBS with MSR. In that strategy, we expect returns to be in the low-to-mid double digits. In our Credit strategy, current prospective returns are in the high single digits, but with the possibility for greater total returns in the future.

I will now turn the call back to the operator for Q&A.

QUESTION & ANSWER

Operator: Thank you, Mr. Greenberg. Ladies and gentlemen, if you'd like to ask a question, please signal by pressing star 1 on your telephone keypad. If you're using a speakerphone, please make you're your mute function is turned off to allow your signal to reach our equipment. Again, star 1 to ask a question. We'll pause for just a moment to allow everyone an opportunity to signal. The first question comes from Bose George. Please go ahead. Your line is now open.

Eric Hagen: Good morning. It's Eric on for Bose. Can you just maybe walk through some of the book value decline since agency spreads did tighten and MSRs, they were flat, generally flat. Just any clarity on actually what drove the book value decline would be great. Thanks.

Bill Greenberg: Hi Eric, this is Bill. First, I'll remind you that the presence of MSR in the portfolio is really meant to reduce volatility to mortgage spreads in both directions. And so in the earlier part of the year when more spreads widening, the presence of MSR benefited the outperformance. And in the fourth quarter when current coupon spread tightened, that had an effect of reducing potential returns that we would have had.

So there's no doubt that, that portfolios that had only mortgages types of swaps would have outperformed a portfolio that had MSR in it. So, to a very large degree, the portfolio performed as it was designed and constructed to do by reducing the volatility.

And I'd say, where we did still have a little bit of exposure up in coupon as you see in the charts on Page 13, right and as we showed in the chart also on that page, lower coupon MBS outperform higher coupon MBS, so that hurt us a little bit. And as we also mentioned, on the credit side of our portfolio, which contribute negatively to our performance, that also contributed to the total return of 1.5% being slightly below what I would call, the natural run rate of the portfolio of some 12% per annum kind of number.

Tom Siering: Yes, and this is Tom. And also, I would just add that we don't construct the portfolio with any one quarter in mind, we constructed for the long haul, for long-term shareholder benefit, and obviously you can see the results really display themselves through the entire year. So, you know, the fourth quarter because of spread tightening, MSR had the effect that Bill described, but we really believe that is a much better construct for the long-term.

Eric Hagen: Okay, great. Thanks for that explanation. You guys also note that the average cost basis on your specified pools are in the agency portfolio overall just shy of 1.04. I'm just curious what the price of spec pools are right now? And just any commentary on lightening up your footprint in specified pools in exchange for either generic pool or TBAs would be great, just how you think about that relative value? Thanks.

Matt Koeppen: I'm sorry, I'm not sure I quite followed the question. Could you repeat and clarify for us?

Eric Hagen: Sure. In your press release you guys note that this -- the average cost basis of your specified pools is 1.04. I'm just curious how your new acquisitions and specified pools compares to that 1.04? And just your overall commentary on acquiring new specified pools in exchange for either generic pools or TBAs -- in a portfolio with specified pools?

Matt Koeppen: Right. I think so, we really look at, it's not really that absolute price of them, we look at the spread relative to TBAs generally, when we're talking about the valuation of specified pools and the overall attractiveness is the function of slight and sort of the expected prepayment speeds that you would expect, which we put in a chart on Page 13 and Bill mentioned that the factor that rates comes from the call protection embedded in them and we constantly look at that from the relative value standpoint and we can shift our focus between TBAs and specified pools accordingly.

Bill Greenberg: Also, as we mentioned it in the call, you know, we've been rotating our portfolio exposure down from higher coupons into 3s, as we started to move around \$7 billion down into that coupon in the quarter, and much of that exposure has been rotated into specified pools, of course, it's not the absolute dollar price itself that matters here, it's about as Matt said, the relative call protection and the amount of prepayment protection that you buy for these prices.

Eric Hagen: Yes, understood. But just to get a sense for what the dollar prices actually are on specified pools as they find the maximum portfolio right now.

Bill Greenberg: I mean, at the end of the quarter, 93 were mid 101 the average payoffs of the range depending on the story that we talk about from, you know, 0.5 point to 2 or 3 points potentially. So and we have to look for holdings in detail to find exactly what it is, but it's going to be 1.02 to 1.04 or 1.05.

Tom Siering: Yes. Importantly half the price you pay is what you get for the price. That's the important thing.

Eric Hagen: So I -- now I totally understand. I just wanted to get a sense for the pricing in the market relative to your cost basis curve. And thanks for the comments guys. Appreciate it.

Tom Siering: You bet, thanks for the questions.

Operator: We'll now take the next question from Mr. Doug Harter. Please go ahead. Your line is open.

Doug Harter: Thanks. Looking at Slide 8, can you talk about what were the factors that kind of driving the increased portfolio yield as of December 31st compared to the 4Q average?

Mary Risky: Sure. Good morning, Doug. Are you talking about the figures in the net yield?

Doug Harter: Yes, if I'm looking at the annualized portfolio yield, the 3.74% that you're selling as of December 31st, compared to the realized yield of 3.54%. I guess just what's behind that 20 basis point improvement? And I guess how should we think about that as we kind of -- is that 3.74% the right number to kind of be starting to think about what the first quarter level can be?

Mary Risky: Yes, that asset yield does represent what we believe the go forward yield will be.

Doug Harter: Great. And then a couple of the -- sorry, go ahead.

Mary Risky: I was going to say there's an (inaudible) in the portfolio and that's what our current book reflects as of 12/31.

Doug Harter: Great. And then a couple of times you guys mentioned repo normalizing in the (inaudible) repo is kind of rolling over. Can you just quantify what that type of magnitude could be kind of as the full portfolio -- as repo reprices fully to kind of where levels are today?

Matt Koeppen: Yes, I can take that one, Doug. So relative to -- to put some numbers on are relative to the sort of high rates that we saw, which we experienced in that September-October period, where we saw term repo rates, call it for one to three months, in the OIS Plus 50 range. Subsequent to year end, after all the actions that the Fed took in open market operations and building out their balance sheet, things have really dramatically normalized. We're seeing -- for comparison in January, we saw rates somewhere more in the OIS plus 20 range. So call it, you know, 25 to 30 lower than what we saw at the highs. So it's been encouraging.

Doug Harter: Okay, got it.

Bill Greenberg: And that's specifically with (inaudible). I'm sorry, Doug. I was just going to say that that's consistent with the levels that we've seen maybe like at the end of 2018.

Doug Harter: Got it. That makes sense. I appreciate that color. Thank you.

Operator: The next question comes from Trevor Cranston.

Trevor Cranston: Right, thanks and congratulations on a good 2019. First question. The faster realized prepay speeds the last couple of quarters have obviously had an impact on core EPS. Can you give a sense

of kind of where you're expecting speeds to come in for the first quarter? And also maybe talk about you know, how much impact the recent rallying rates is likely to have on speeds you know, given that we've already had lower rates than this in the relatively recent past? Thanks.

Bill Greenberg: Hi. Thanks very much for the question, that's a good one. You know, I think we are still experiencing some amount of slower speeds from the tick up in rates that we had towards the end of the year as well as winter seasonal. So I think next month of these will be a little bit slower than what we've seen. But this recent rally that we've had will have an effect. And, you know, another one of the things that we've seen in January so far in this recent push to lower rates was that current coupon spreads, primary, secondary spreads have really -- have tightened into that rally.

And so primary mortgage rates are currently at the same level or maybe even a little bit lower than what we saw in the fall. And so after a temporary respite in speeds in the next month or two, I think we'll see speed increase again, maybe back to the highs that we saw or thereabouts in the fall. I'd say in that area. I think with current rate levels and where the refi index has been. I don't know that they'll exceed that, but it can certainly easily be at those levels. And obviously, the direction speed beyond that as we kick into spring and summer seasonals, where speeds are naturally faster. It will depend on the level of rates going forward.

Trevor Cranston: Okay, got you, that's helpful. And then second question, I'm just wondering if you could provide any sort of commentary color on kind of roughly how book values fared since the end of the year you know, given the movement we've seen in rates and spreads?

Bill Greenberg: Yes, sure. Before I hand it over to Matt to take that question, I wanted to reiterate one point. That while the increased speeds or fast speeds will affect core earnings, as we've talked about before, it does not affect our return expectancy in the portfolio. The mortgages are priced to expect those kinds of speeds in the future and it highlights the difference that we talked about in the past between short-term carry and longer-term economic return. And with that, I'll let Matt talk about the book value.

Matt Koeppen: Good morning, Trevor. So in January, obviously we had a bit of a flight to quality rally in that we saw mortgage spreads modestly wider. And then offsetting that, our credit book actually showed some positive performance that, net of those things, amounts to roughly a scratch. So we called book value roughly unchanged through January.

Trevor Cranston: Okay, perfect. Thank you.

Matt Koeppen: Thanks a lot, Trevor.

Operator: The next question is from Rick Shane.

Rick Shane: Hi, guys. Thanks for taking my questions this morning. I just wanted to take a look at Slide 23 and your positioning on TBAs. It's interesting. It's sort of a barbell strategy, long on the 3%^s, long on the 5^s, and in the middle, you're short. Just curious what that suggests to us? Is that just netting out the longer position at the long end of the curve or is there something else going on?

Bill Greenberg: Thanks Rick for the question. This is Bill. I wouldn't focus too much on the TBA part of the table. I would focus on the top table, which really shows the exposure across the coupon stack. And so it's really a mixture of the TBAs and specified pools that we spend a lot of time looking at.

Now, it's true, right, the difference between those tables shows the difference in specified pools, which has call protection in -- embedded in those securities. But of course, to the extent we own TBAs, it's a statement that even though the speeds will likely be faster, there's no pay for them and so we attribute good valuations and return potential to those at lower prices, even though the speeds will be faster.

And so for instance, in phase five, where we're showing the position of \$3.8 billion, it's not -- there aren't that many specified pools being produced with those coupons and rates. And so they're hard to find nevertheless. And in the past, we liked the valuations of the TBAs even with the speeds that are being priced in. So that's what you're seeing there is just a mixture of where there are specified pools and where the value is in the relative coupons.

Matt Koeppen: And Rick, I'd add --

Rick Shane: Got it, and then --

Matt Koeppen: I just wanted to add quickly on Slide 23, we've added some -- the new chart that we added on Slide 13 really is the one that I would point you to. That really gives you the best sense of what our effective coupon position is, where our force (ph) is really lying net of all the servicing exposures. That picture really is meant to lay out where our exposures in their entirety are.

Rick Shane: Got it. And I would -- I think that slide is a really good enhancement. It's helpful. Back to the previous comment though. Should the way we look at Slide 23 and particular when we look at the 4s on those RMBS side versus the TBA position, should we think about this that the premium -- 40% of the premium in your book in the 4s and so are you trying to sort of net that risk out through the short TBA position?

Matt Koeppen: Yes, those things do net and those TBA positions sometimes may be created by just tactical decisions that we're making as we rotate the portfolio out of one coupon or into another. That's a snapshot in time. It happens to be that we had a short TBA position, but the net 4 position is what we were really pointing to focus on in terms of the risk that we're taking.

Rick Shane: Got it. Okay, great. Thank you so much guys.

Tom Siering: Thanks a lot, Rick, for the question.

Operator: The next question comes from Mr. Kenneth Lee.

Kenneth Lee: Hi, thanks for taking my question. Just one in terms of the economic leverage. You touched upon it in the prepared remarks that you don't expect leverage to change too much from current levels. Just wondering what the key drivers were for the slight uptick in the quarter? Just wondering whether it's mainly due to mixed shift a little bit more toward agencies or whether there was anything else driving that? Thanks.

Mary Risky: Sure, this is Mary. So the average for the quarter was consistent, both in debt-to-equity and economic debt-to-equity. I will say the slight uptick at the end of the quarter was just based on production related to slight net increase to our capital allocation to rates.

Bill Greenberg: Yes, it was just a snapshot in time and what grades happen to be going through the time. The metric that we look at is more the average, but I stress more importantly than that, that the leverage is, but one measure of risk that we look at, right and as -- and I think we talked about in the past before that, our portfolio with the presence of MSR equally best from variations in mortgage spreads.

And so lots of times when people talk about what leverages that really asking a question about how much money you can lose or what is your book -- what's your book value volatility going to be or questions of that nature.

And so I'd like to just point out that, again, the MSR and portfolio is meant to reduce that and so while one has to be respectful of the nominal core leverage, we actually look at more of a measure of drawdown risk in general, and the ones that we can lose money and for our portfolio, that -- that's a different number than what the state of nominal leverage is.

Kenneth Lee: Okay, very helpful. And just one follow-up on an earlier question. Just in terms of the market trends and hedging, given that a lot of the trends reversed in the fourth quarter versus the rest of the year in 2019 and given your earlier remarks that you know, when you look at the hedging it's for the longer-term should we assume that there weren't too many changes to the hedging in the quarter? And that in terms of the macro assumptions you're pretty much embedding the similar trends I saw for the first three quarters of 2019 to continue going forward? Thanks.

Matt Koeppen: Hi Ken. It's Matt. I would point you to Slide 14 that shows our risk profile, both from a spread perspective and from an interest rate perspective. And if you look back at previous quarters, I think you've seen similar exposures and they're reasonably small. So the short answer to your question is that I don't think we've really changed our hedging and risk profile dramatically in the recent quarters.

Kenneth Lee: Okay, very helpful. Thank you very much.

Tom Siering: Thanks a lot, Ken.

Operator: Our next question comes from Matthew Howlett.

Matthew Howlett: Hey, guys thanks for taking my question. You know, there's been a request for comment out on pooling arrangements with the GSEs, you know, particularly impacting the TBA and specified pool market. Do you guys have a strong history of finding value -- relative value between, I mean how could that impact you know, the pool you know if you do change the price -- the price between TBAs and specified pools?

Bill Greenberg: You know that's a very timely question, and obviously we're paying attention to those comments and those proposals. They are proposals at this point, you know, I think there's a lot of moving pieces as you know, some industry participants who have expressed opinions that those proposals will definitely impact specified pool buyers and originators and really, almost everyone in the chain. I prefer to see how that plays out a little bit more before figuring out what the impact will be. Honestly, we are price takers in that space and not price makers, so we'll react to whatever it is and we'll find value where it can be found.

Matthew Howlett: You mean to say an opportunity, is it good limit you know what I'm hearing is, you know the TBA -- it's that people say this could improve -- the TBA markets going to limit some high speeds servicers, but it could diminish the quality of specified pool, I mean given do you guys own MSRs and you head with TBAs and you buy specified pool, I mean you said opportunities is going to create more price discrepancy or does it potentially limit your arbitrage opportunities or portfolio management opportunities?

Bill Greenberg: I think our preference is that the more different flavors of specified pools there are, the better it is for us. We're able to pick our spots more and it's around the value in ways that we may have different opinions than the prices that might be in the market.

So to my mind, anything that homogenizes that is not preferable, but if that's what they want to do and what it is, you know, there are, as you say, it'll make TBA a little bit better and it might improve convexity in certain ways and so forth. So it's not clearly all one way, I'd say, in terms of the impact. But my preference would be to maintain it the way it is.

Matthew Howlett: Got it, okay. Moving on the servicing side, you added I think you said one slow seller. I'd love to hear, you know, in terms of is that bank or non-bank and, you know, what's the outlook, I mean what you're seeing in terms of adding bank or non-bank sellers. And then there was talk of some of the J.P. Morgan getting back in the FHA. I mean, are there going to be -- do you foresee a change in the bank appetite to grow servicing? Just a little bit of comments on the outlook on the servicing landscape?

Bill Greenberg: Sure. So the flow sales we've been adding are all non-bank. They're the small mortgage originators that obviously are interested in flow arrangements, because they don't have either the capital or the internal capacity in other ways to hedge their servicing, which requires lots of infrastructure and expertise and so forth. And they want to focus on just originating work, right. So we have a bunch more in the pipeline as well for the first quarter of 2020. And so we're pretty optimistic about our flow volumes being higher in the future.

In the servicing market, in the fourth quarter, it was pretty near, I would say. We only saw about 25 billion bulk packages come to market in conventional product, which is pretty low. And even of that, a fair amount of that did not trade. I'd say, again, a story that we've told in the past. Due to a volatility in interest rates, lots of mortgage servicing sellers prefer to have stable rates. Someone makes a decision to sell a servicing portfolio on Monday and it's not until the next week, the following Monday, or Wednesday, or even later that people will collect bids.

And in that time, as you've seen, with interest rates being as volatile as they are, rates can fall 25, or 30, or 40 basis points and all of a sudden, the prices aren't what they expect anymore. And so we really need about some rate stability in order to see more bulk sellers come up in the volumes.

Matthew Howlett: Got it, okay. Thanks guys.

Operator: It appears there are no further questions. I'll now turn the call back to Ms. Karr for concluding comments.

Maggie Karr: Thank you and thank you for joining our conference call today. We plan to participate in the Credit Suisse 21st Annual Financial Services Forum on February 27th. Our presentation, which is scheduled

for 3:20 PM Eastern Time, will be webcast live on our website under the Events and Presentations link. We look forward to speaking with you then and have a wonderful day.

Operator: Ladies and gentlemen, this concludes today's call. Thank you for your participation. You may now disconnect.

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