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EDITED TRANSCRIPT

TWO - Q2 2015 Two Harbors Investment Corp Earnings Call

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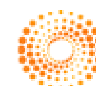

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Two Harbors Investment Corporation Second Quarter 2015 Financial Results Conference Call. (Operator Instructions).

As a reminder, this conference call is being recorded. I would now like to introduce your host for today's conference Margaret Field with Investor Relations. Please begin.

Margaret Field - *Two Harbors Investment Corp - IR*

Thank you, [Janeane], and good morning. Welcome to our second quarter 2015 financial results conference call. With me this morning are Tom Siering, President and Chief Executive Officer; Brad Farrell, Chief Financial Officer; and Bill Roth, Chief Investment Officer. After my introductory comments, Tom will provide a recap of our second quarter 2015 results, Brad will highlight some key items from our financials, and Bill will review our portfolio performance and operational businesses.

The press release and financial tables associated with today's conference call were filed yesterday with the SEC. If you do not have a copy, you may find them on our website and the SECs website.

This call is being broadcast live over the Internet and may be accessed on our website in the Investor Relations section under the Events and Presentations link. We encourage you to reference the accompanying presentation to this call, which can also be found on our website in the same location. Reconciliation of non-GAAP financial measures to GAAP can also be found in the appendix of the accompanying presentation.

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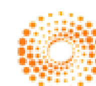

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We wish to remind you that remarks made by management during this conference call and the supporting slide presentation may include forward-looking statements. Forward-looking statements reflect our views regarding future events and are typically associated with the use of words such as anticipate, 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 described in our filings with the SEC, which may be obtained on the SECs website at www.sec.gov. We do not undertake any obligation to update or correct any forward-looking statements if later events prove them to be inaccurate.

I will now turn the call over to Tom.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Thank you, Margaret. Good morning, everyone, and thank you for joining our second quarter 2015 earnings call. For those of you with an earnings presentation please turn to slide 3 for an overview of our financial results and strategic initiatives.

Our book value at June 30th was $10.81 per share. Through the first six month of the year we have delivered a total return on book value of 2.1% comparing favorably to the sector. Additionally in the second quarter we delivered comprehensive income of $2.7 million or $0.01 per weighted average share. Core and GAAP earnings were $0.22 and $0.60 per weighted average share respectively.

From a strategic perspective we remain on course to shift capital from the legacy Agency and non-Agency RMBS portfolios to the operational businesses, which includes the mortgage loan conduit, MSR and commercial real estate. Our mortgage loan conduit continues to gain momentum as we have competed four securitizations thus far in 2015. With these securitizations we are creating new subordinate and interest only credit assets for our portfolios at attractive returns.

MSR is an excellent asset for our portfolio as it provides yield, negative duration, hedges basis risk and is a natural complement to our Agency RMBS portfolio. We are focused on building MSR flow-sale relationships especially where we can leverage relationships with existing conduit originator partners. Subsequent to quarter end, we closed a $4.7 billion bulk purchase of Fannie Mae MSR.

The marriage between the MSR and conduit businesses allow for many operating efficiencies and infrastructure overlap. From a product development perspective we continue to evaluate avenues that are rooted in our core competencies of prepayment and credit risk analysis for the benefit of our stockholders. This is also helpful for U.S. home owners.

With respect to the commercial real estate initiative, the personnel and the infrastructure requirements are substantially complete to support the strategy and we are on track to deploy capital in the second half of 2015 and into 2016. As we have articulated in the past there is a large amount of refinancing that is required within the next several years and many of the traditional lenders in the commercial space are retreating. Moreover, many of these commercial loans are floating rate in nature, which is desirous in a rising interest rate environment.

We have made tremendous progress and believe we are poised for growth in our operational businesses over the next several quarters. Each of these initiatives has the potential to offer attractive returns, build franchise value, increase valuation and most importantly drive stockholder returns.

Turning to slide 4, let's talk briefly about market and policy matters related to our business. Interest rate volatility remains elevated with the general expectation the Fed will raise rates later this year. As noted in our strategy section, MSR helps mitigate this risk and we continue to remain conservatively positioned with respect to interest rate exposure, which Bill will discuss in more detail.

Unemployment metrics improved year-over-year as of June 2015 falling to 5.3%. However, recent wage data remains tepid. National home prices increased to 6.5% on a rolling 12-month basis according to CoreLogic.

From a policy standpoint we are in active dialogue with parties in Washington on a number of industry topics, including private label securitization, servicing standards and capital requirements, GSE risk sharing and housing finance reform. With respect to the FHFA proposed rulemaking regarding

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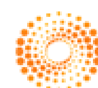

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Federal Home Loan Bank membership, we have not heard anything further after submitting our response letter. It is our belief that this issue is still under review.

I will now turn the call to Brad for a review of our financial results.

Brad Farrell - *Two Harbors Investment Corp - CFO*

Thank you, Tom, and good morning, everyone. Our primary objective is to deliver total return for our stockholders over the long-term. We accomplish that through dividend distributions and book value growth and preservation during times of volatility.

In addition to a review of our comprehensive income and book value performance in the quarter, I'm going to expand my discussion to include taxable income and its impact on our dividend declarations in 2015. In addition I will provide color on how our trading decisions to preserve book value impacted our core earnings relative to the first quarter of 2015.

Please turn to slide 5. Book value is $10.81 per share at June 30th versus $11.08 as of March 31st. Comprehensive income was $2.7 million or $0.01 per weighted share in the second quarter. This is primarily driven by the net carry on our interest earning investments as well as unrealized gains on our hedging instruments, principally MSR, swaps and swaptions. These were largely offset by unrealized losses on our available-for-sale securities. We believe comprehensive income represents the truest reflection of our portfolio performance and long-term dividend power.

Moving to slide 6. The Company declared dividends of $95.5 million or $0.26 per share in the second quarter. The chart on this slide compares our taxable income against our dividend distributions for the first and second quarters of 2015 as well as year-to-date. As a REIT we are required to distribute 90% of our REIT taxable income. Through the first six months of 2015 we have distributed 76% due to sizable realized gains of $167 million.

Please turn to slide 7 for a summary of our financial results. Core earnings were $0.22 per weighted share, representing an annualized return on average equity of 7.9%. This represented a $0.04 per share quarter-over-quarter decrease but was in line with our expectations. On the left hand side we have provided a quarter-over-quarter variance analysis of core earnings. The fluctuation was impacted by three principal factors: lower interest and servicing income net of MSR amortization along with the extension of our swap position.

Interest income decreased approximately 6% quarter-over-quarter as the amortized cost of our available for sale holdings decreased from $13.5 billion to $12.2 billion due primarily to the sale of certain Agency securities. We also lowered the leverage on our Agency portfolio from 6.0 times to 5.5 times.

During the quarter we extended a number of our swap maturities to improve our hedge exposure across the curve. It is important to highlight that while our Agency portfolio decreased meaningfully during the quarter, our swap expense declined only modestly due to higher net spread associated with this protection. Somewhat faster prepayments on our MSR in the second quarter coupled with higher notional UPB in the first quarter were the primary drivers of a 10% decrease in servicing income net of MSR amortization. Future MSR performance will be heavily influenced by prepayment trends.

As we have noted in past earning calls, core earnings is not a driver of our dividend as we make investment and portfolio decisions based on expected total return, much like we did this quarter, which can often reduce core earnings for a period of time. We do not intend to increase leverage, rate exposure or other portfolio risks to improve core earnings if we believe this increases the risk of book value deterioration.

Please turn to slide 8 for an overview of our financing profile. I would like to highlight a couple of things on this page which includes our typical financing disclosure. Our FHLB advances totaled $3.0 billion at quarter end. The FHLB facility is a valuable financing tool that, among other things, affords our conduit business a stable and dynamic funding source. The repo market for RMBS continues to function normally with meaningful shifts in financing haircuts or rates. For more information on our repurchase agreements and FHLB financing please see slide 23 in the appendix.

With that, I will turn the call over to Bill.

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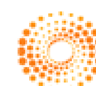

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William Roth - *Two Harbors Investment Corp - CIO*

Thanks, Brad, and good morning, everyone. Turning to slide 9, I'll walk through the composition of the portfolio and our capital allocation.

As of June 30th the portfolio was $14.9 billion in assets with roughly 55% of capital allocated to the rates strategy and 45% to credit. Our commercial strategy is in the nascent stages of capital deployment, but we anticipate meaningful growth in this strategy throughout the second half of 2015 and into 2016.

As Tom mentioned earlier, the allocation of capital across our portfolio has been shifting towards our operational businesses with over 20% dedicated to retained interest from our securitizations, our loan pipeline, MSR and commercial real estate at quarter end. We have made significant progress on this transition, although roughly 44% of our capital is still allocated to Agency RMBS. While we have been reducing this over time, the widening of Agency spreads during the second quarter and underperformance of specified pools did put negative pressure on book value. We reduced our Agency portfolio in the second quarter, selling approximately $1.4 billion of specified pools.

With respect to Agencies we believe it is prudent to play defense in this environment and we are positioned for the most part in higher coupon shorter duration assets that minimize our basis and prepayment risk exposure while also carrying low leverage. Please see slide 19 in the appendix for additional detail on our Agency portfolio.

Credit spreads were relatively stable throughout the quarter, however we continued to sell certain legacy non-Agency bonds we believed to be fully valued. With regards to new issue credit, we are focused on the growth of our conduit, retaining subordinate and IO bonds from our two Agate Bay securitizations. I will discuss our conduit and securitizations in more depth momentarily.

Please turn to slide 10 for review of our portfolio performance and yields. As you can see on the bottom right, our annualized net interest spread was 2.79%, down 28 basis points quarter-over-quarter. Net interest spread was negatively impacted by a decrease in our Agency yield from 3.5% to 3.1%, as well as a decline in MSR yield from 9.8% to 8.7%. These were partially offset by solid performance across our credit portfolio. Agency yield declined primarily due to the aforementioned sale of certain specified pools and modestly higher prepayments driven by the low rate environment earlier in the year, which primarily impacted our IO and MSR holdings. For more details on our rates and credit strategies please refer to the appendix slides 18 through 22.

As Brad eluded to earlier, we extended many of our swap maturities to improve our positioning and exposure across the curve. This helped us protect book value during the rate rise in the quarter. Generally speaking, we are positioned for the Fed to move interest rates higher on a measured basis while maintaining optional protection should a dramatic change in rates occur.

The chart on the bottom left illustrates that our net interest income would increase in a rising rate environment while our book value would be relatively protected. The increase in income is largely driven by the majority of our legacy non-Agency portfolio being tied to LIBOR and the substantial floating rate sensitivity on the "receive" side of our swap positions. I would also note that our exposure to Agency mortgage spread duration remains low. In the current environment our main focus is to protect book value especially as we focus on moving more capital in to the conduit, MSR and commercial real estate opportunities. See slides 24 and 25 in the appendix for more information on our hedges.

Now let's spend a few minutes on the conduit starting on slide 11. During the second quarter we sponsored two Agate Bay securitization totaling $493 million in UPB, retaining approximately $32 million of subordinate and IO bonds for our portfolio at ROEs in the low double digits. We are very pleased with the pricing execution on both deals and the breadth of investor interest and participation. According to mortgage research from Credit Suisse our Agate Bay brand accounted for roughly 19% of the total new prime jumbo issuance through this first six months of the year. We are proud of this strong market share.

Our pipeline which includes loans and interest rate lock commitments was approximately $1.3 billion at June 30th, which provides a solid foundation to be a reliable and consistent issuer. We remain on track to complete six to ten securitizations in 2015.

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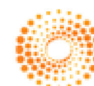

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We are pleased to announce that subsequent to quarter end we launched an expanded credit program that will target a more average borrower profile than our prime jumbo program. It initially allows for among other things borrowers with FICOs down to 660 and LTV over 80%. These will be fully underwritten mortgages meaning the Ability-to-Repay requirements. As usual, we will provide updates as meaningful milestones are achieved.

Please turn to slide 12. On the MSR side during the second quarter we were focused on expanding flow sale arrangements. We have made good progress and anticipate adding 5 to 10 of these relationships by year end. On the bulk side, as Tom mentioned, we recently closed on a purchase, investing approximately $46 million, and we continue to evaluate deals as they become available.

With respect to commercial real estate, we are beginning to develop a healthy pipeline and are excited about the deal flow that we are seeing in the marketplace today. While we are in the early stages of deploying capital, we look forward to updating you as this initiative grows.

In closing, we are pleased with the continued growth of our operational businesses as they have the potential to drive stockholder returns and the creation of franchise value over the long-term. I will now turn the call back to Janeane to take any questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). And the first question is from Doug Harter with Credit Suisse. Please go ahead.

Doug Harter - *Credit Suisse - Analyst*

Thanks. Bill, I was hoping you could talk about how you see the Agency opportunities today and sort of what types of environment you would be looking for to potentially add more risk there, or should we think about re-risking the portfolio happening as the operating businesses need more capital?

William Roth - *Two Harbors Investment Corp - CIO*

Hi, Doug, good morning. Thanks for joining us. Our general view is that the Fed is very intent to the extent the data is appropriate to do so to raise rates. And we think as they start to raise rates, that implies that you would see more volatility potentially and that you could see more pressure on the mortgage basis some of which we saw this quarter. So we see expected returns on a hedged basis without using too much leverage or taking duration risks still well below 10%. So it is challenging to us to see how adding to the Agency side of the equation makes sense where we are today especially given that the businesses we are focusing on, to us we see expected ROEs in the low double digits and generally that doesn't require a lot of leverage. I mean commercial real estate low leverage MSR is unlevered and the conduit, obviously, is a securitization where you are retaining credit. So we would have to see some substantial widening in Agency spreads to even start thinking about changing the direction of the capital allocation. But as you see on page 9, the red arrow pointing down, given where things are today you can expect to see that direction continue.

Doug Harter - *Credit Suisse - Analyst*

Great, thank you.

William Roth - *Two Harbors Investment Corp - CIO*

Thanks, Doug.

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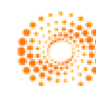

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Operator

Your next question is from Trevor Cranston with JMP Securities. Please go ahead.

Trevor Cranston - *JMP Securities - Analyst*

Hi, thanks. First question relates to slide six in the presentation on the taxable income. I was just curious looking at the delta between 1Q and 2Q taxable, it looks like part of that is driven maybe by realized gains. I'm sure there is a lot of moving parts in there. But can you help us understood the main drivers of the difference between 1Q and 2Q there?

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Yes, thanks, Trevor. Brad will take that one.

Brad Farrell - *Two Harbors Investment Corp - CFO*

Hi, Trevor. I think you kind of answered the question already, which makes my job easier. It is realized gains that are going to be the two that are going to create that spread. We did harvest more gains in Q1. And as you can see here, about $100 million, and in Q2 $65 million. In Q1 we focused more on selling off some non-Agency securities and harvesting value there. In Q1 it was a little bit more on the Agency side, but -- I'm sorry. Q2 was more on the Agency side. So really that delta is going to be the realized gains. The underlying kind of quote run rate taxable income has remained fairly consistent across those quarters.

Trevor Cranston - *JMP Securities - Analyst*

Okay, got it. That's helpful. And then on the MSR opportunity, Bill, I was wondering if you could maybe give us some additional color on the bulk markets specifically in terms of what you're seeing on valuations and competition for pools versus where it has been for the last few quarters?

William Roth - *Two Harbors Investment Corp - CIO*

We haven't seen any real substantial shifts. Obviously, I think everybody knows Ocwen had announced a substantial program that was going through to flow throughout the year. That well is still involved in bulk transactions. Typically we're looking for new prime high credit quality, which isn't generally quite the same as some of the other pools. But on that front we still see a steady flow of opportunities. Pricing is fairly similar as it has been early this year, so we still see that as a good opportunity. As we mentioned, we did close this one deal after quarter end. But we're also very focused on adding flow sellers. We believe that having a stable of partners that can provide us monthly volume actually is a lot easier for us not only to process but to count on continued adding to the position as opposed to bidding when bulk pools come up. So I would say generally not much change.

Trevor Cranston - *JMP Securities - Analyst*

Got it. And have you guys seen any increase in the availability of financing available for MSR positions? Is that something you guys would look to bring on as the portfolio grows over the next couple of years?

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Brad Farrell - *Two Harbors Investment Corp - CFO*

We're always looking in to the marketplace and having discussions with counter parties, but really right now the spread on the financing of that asset just doesn't really appeal to us relative to our cost of capital. So in the foreseeable future we don't anticipate applying leverage to that asset, but we're always in active discussions with many of our counter parties understanding their capabilities.

Since I'm speaking, I actually want to go back and do a little bit better job of that realized gain question, because I did miss one important component in Q2. So I did note that we captured realized gains on the portfolio, but we actually terminated, as we mentioned, a series of swaps to reset the duration of the tenor. So that largely offset the realized gains Q2. So that is going to be kind of why -- so in Q1 we harvested RMBS gains, had relatively minimal swap terminations. But in Q2 we again harvested a decent amount of realized gains in the portfolio, but a lot of that was offset by terminations of swaps as we extended against the curve. So hopefully that is a little bit better answer to your question and maybe resolved the confusion.

Trevor Cranston - *JMP Securities - Analyst*

Yes, that makes sense. Thanks for the additional color. Thank you.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Thanks, Trevor.

Operator

And the next question is from Rick Shane with JPMorgan. Please proceed.

Rick Shane - *JPMorgan - Analyst*

Thanks for taking my question. I want to get a little bit sort of philosophical here. There are a continuum of strategies ranging from sort of single focused to hybrid. And you guys at this point are really the most diverse of the hybrid strategies out there. I would describe to you that I think the implications of the ends of the continuum are that a single focused strategy is basically a relative return strategy and that a hybrid strategy really focuses on managing absolute returns over time. And I think that is really what you guys are trying to do. What I would love to hear from you is what you think that absolute return opportunity is over the long-term for Two Harbors, but also importantly given the competitive environment and the rate environment where you think we are right now and what that looks like over the next six months?

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Sure. I mean clearly we're trying to get away from a single strategy profile. The Agency market today is challenged as we've openly said. And to generate attractive returns in that space implies doing two things that we don't want to do, which is employing a lot of leverage and taking interest rate exposure, which we are covetous of neither of those. And so what we're really trying to do is allocate capital across the mortgage sector broadly in a way that is the most prudent. And in many respects we run the business in a way like many people within the asset management business do, which is that we're trying to dampen volatility, we're trying to have the highest return for the risk associated with it. So the mortgage market is -- the management team today is sitting in the lovely state of Minnesota. And the mortgage market is sort of like the weather in Minnesota; if you don't like it, stick around it will change.

And we are trying to allocate capital across various sectors as prudently as we can and we want to afford ourselves and our shareholders every opportunity to employ money wisely. So today the best sectors frankly are removed from our legacy Agency and non-Agency portfolios. Agency spreads are challenged. Non-Agencies are still attractive but arguably that opportunity is seen as sunset as portfolio naturally runs off in the next

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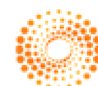

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three or four or five years. So today MSR, the conduit business and commercial real estate full stop are the most attractive things we see in respect of all the things that I've talked about. And that's our focus. That's what we think will make our shareholders money.

Rick Shane - *JPMorgan - Analyst*

Okay. So in -- a couple of follow-ups to that. Do you think that in the current environment those opportunities continue to represent double digits ROEs? And one thing I think we've observed over time is there are some switching costs and some transitional cost as you do that. Do you think that at any given point you can actually fully realize that opportunity or is there a little bit of latency as you rotate the portfolio?

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

In respect to cost our infrastructure is pretty fully built out. Obviously the gating factor for us in respect to capital deployment is the whole pool test, which largely can only be achieved through the Agency portfolio with some caveats to that. But that is a gating factor. But in respect to switching costs that is not a substantial issue for us.

Rick Shane - *JPMorgan - Analyst*

Okay, that's helpful. Thank you.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Thank you.

Operator

And the next question is from Brock Vandervliet with Nomura Securities. Please go ahead.

Brock Vandervliet - *Nomura Securities - Analyst*

Thank you. Just to follow-up on Rick's question regarding the whole pool test, is there a hard stop in your mind in terms of the Agency MBS exposure that you can work down to?

William Roth - *Two Harbors Investment Corp - CIO*

Hi, Brock. This is Bill speaking. So, yes, the thing is it is on total assets, right, so it somewhat depends on the composition of our book in terms of what the total is. But I think rough numbers you can assume that the range of capital allocation is somewhere from either like in the 20% to 35% range. And I know that is large range, but it depends on the composition of the remainder. Tom mentioned there is some other caveats. So as the commercial loan book grows to the extent those are whole loans that may provide some benefit. To the extent that we hold loans on our books that we make through the conduit that provides some benefit. But generally speaking the range from Agency capital is going to be in that 20% to 35%. So given that we're at 44% at quarter end we still have a decent amount that we can reduce that going forward.

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Brad Farrell - *Two Harbors Investment Corp - CFO*

Yes, the biggest driver is really going to be the relative portfolio size between the Agency and non-Agency securities. That's really going to dictate that range over the long-term. And we have structured ourselves through our legal entities with quite a bit of flexibility as we invest in commercial real estate and other whole loan assets.

Brock Vandervliet - *Nomura Securities - Analyst*

Okay. That is great, very helpful. Separately on the new underwriting template you mentioned it seems to be consistent with what we're seeing with the credit just gradually opening up. Is that purely focused on jumbo or non jumbo as well, and do you have any sort of volume pro forma that you could share with us?

William Roth - *Two Harbors Investment Corp - CIO*

This is Bill again. That's a great question. Thanks for asking about that. So the answer to the first part is, it does not necessarily have to be jumbo. Clearly the guidelines we have put out certainly allow it to be. But we do have the ability in our posting rates for conforming. Volumes is, you know that is the great question. We feel like we've put a product out there that should be very well accepted. We have gotten a lot of very high level excitement from the folks that we've rolled this out to. We believe that the rates and the guidelines are going to be well accepted by the market. But that being said, it is really hard when you roll a new product out to get an idea on what the volumes will be. It is not just the borrower community, but it is also the competitive environment. So I think it is really too early to give you any view on that. I think we'll have a lot better idea in the next quarter or two.

Brad Farrell - *Two Harbors Investment Corp - CFO*

One other aspect that we think about and I think we've mentioned before is we face sellers that have multiple needs, and we're trying to provide capital solutions to them across many platforms whether that is MSR, whether that is prime jumbo or moving in to expanded credit. So we're just expanding our suite of products so we can be a robust solution provider to those sellers.

Brock Vandervliet - *Nomura Securities - Analyst*

That's great, exciting development. Thank you.

Operator

And the next question is from Dan Altscher with FBR Capital Markets. Please proceed.

Daniel Altscher - *FBR Capital Markets - Analyst*

Thanks, and good morning, everybody. I wanted to follow-up a little bit on Trevor's question around the taxable income and, Brad, you provided some good explanations there. But I guess the right way -- or the way I'm trying to think about it now is taxable income maybe running a little bit lower on a quote, unquote run rate basis now with some of the portfolio allocations or changes taken intra quarter from reducing the Agency exposure?

Brad Farrell - *Two Harbors Investment Corp - CFO*

I'm sorry. Can you repeat that question there? Sorry, I didn't hear the last part of it.

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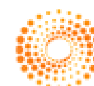

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Daniel Altscher - *FBR Capital Markets - Analyst*

Sure. Sorry. I was just wondering if run rate taxable income is running lower perhaps excluding all the realized gains and so forth on the swap losses or the realization of swap losses. If taxable income is running lower on a run rate basis now because of the portfolio allocation decisions that were made in the Agency book?

Brad Farrell - *Two Harbors Investment Corp - CFO*

Yes, I think core earnings is the metric that many use and it is going to somewhat mirror the underlying basis of taxable income. So as depicted in Q2 because of our smaller portfolio, lower leverage that quote underlying run rate is going to be lower. The purpose of this slide is to kind of show the bigger relationship to our taxable income and really what's going to drive the dividend in 2015. As you can see if you look at year-to-date, we have $249 million of taxable income. If you think about our obligations to distribute, you are looking at around $224 million. So we were just trying to show year-to-date the delta that we'll have to evaluate heading in to the back half of the year, and then kind of obviously contemplate that relative to our run rate. So the point of this slide is to look at the bigger picture, disclose the bigger picture and how we're thinking about our dividend heading in to the back half of the year.

Daniel Altscher - *FBR Capital Markets - Analyst*

Okay.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

This is Tom. People sometimes want to use core EPS as a proxy for dividend distribution, and the fact of the matter is that really a doesn't matter in respect to dividend. Our obligation is in respect to taxable income and that's what this slide addresses.

Daniel Altscher - *FBR Capital Markets - Analyst*

No, that's clear. And I think what I was trying to get at was more so was wondering since there is obviously still some pretty big buffer there between what has been distributed versus what's been earned if there was potentially a need for a special dividend at the end of the year given you haven't paid out everything yet in terms of taxable. But I guess what the point is, there is some room to backfill maybe lower taxable income going forward with outsized taxable income that has been generated in the first half of the year.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Well, obviously we have never and we are loathe to give dividend guidance going forward, but this slide is simply what it is, which is to show where we are in respect to taxable income for the year in respect to dividend distribution.

Daniel Altscher - *FBR Capital Markets - Analyst*

Got it. Okay, no, that's helpful. And then maybe just another topic quickly, credit risk transfers. I think maybe in the past quarter you maybe started a little bit of a small allocation to credit risk transfers. Anything you are seeing on that front now that maybe is perhaps interesting, whether it is old CAS or STACR bonds or maybe some of these new ones that are more of the REMIC structure?

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William Roth - *Two Harbors Investment Corp - CIO*

Yes, sure, Dan. Thanks for asking about that. The CRT market has fluctuated quite a bit in terms of being attractive and being unattractive. As of the end of the quarter, we frankly didn't have enough of these to warrant breaking them out. We did add some during the quarter when they cheapened out and we saw ROEs using a little bit of leverage get out in to the low double digits, and we do have capacity. But as you point out, they are -- first of all I would say that's not a core strategy. Our core strategy is really to drive the conduit to provide credit assets for us. But from time to time they are attractive for sure. You mentioned this new deal with the different structure and that was pretty interesting as a REMIC. And so some of the bonds in that deal are more REIT friendly, so that was kind of interesting to take a look at. But as you can imagine, we're more interested in assets that are attractive on a risk reward basis and provide high expected ROE. So just being REIT friendly isn't enough. So we actually looked at that deal and did not actually find the pricing that interesting, but the structure itself was actually pretty interesting. And to the extent that that becomes an ongoing program and we see valuations as attractive that would be worth our spending some time on. But I reiterate the best thing we can do is keep driving the conduit process because then we're creating our own assets fully underwritten, our guidelines. And we think that that's not only good economics but it's also franchise value for our stockholders.

Daniel Altscher - *FBR Capital Markets - Analyst*

Got it. Okay. Thanks, Bill.

William Roth - *Two Harbors Investment Corp - CIO*

Thank you.

Operator

And the next question is from Mike Widner with KBW. Please go ahead.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Good morning, guys. Just wondering if we could talk a little bit about how you think of the equity retained in the securitization whether it is jumbos or the new the program that you're talking about? And once you have those subordinates, do you plan on or do you currently implement any sort of leverage on top of those?

William Roth - *Two Harbors Investment Corp - CIO*

Yes, sure. This is Bill again. So the credit pieces comprise market value roughly 5% or so of the stack and then there is IOs depending on what coupons we're selling you either retain none or retain some. The IOs on an unlevered basis expected yields are in the mid teens. You can get some leverage on those. The subordinate bonds because they are a discount have a PO components to them, i.e., faster prepays help. So that is a nice package to combine would the IOs. The yields on the entire credit stack in that 5% to 6% range, but clearly the top bonds there are richer and the bottom bonds are reasonably cheaper. There is financing available certainly for the top bonds and even a little bit for the bottom bonds. So when you look at the combined expected returns from what is retained, it puts you in the low double digits currently. Now there have been times where that number is much higher. Obviously there could be times when it is lower but that would be when AAAs are much, much wider. And at that time as we did before we might retain some AAAs because we can use FHLB funding for that and there is no reason to sell AAAs at levels that are just too cheap. So I would say generally you can think about low double digits. We do think that if the market opens up and AAAs improve in their pricing that those numbers have upside from there.

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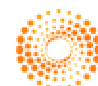

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Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Got you. And so that I'm understanding clearly how you're doing it and how you're thinking about it, if I very simply take the securitization loans on the balance sheet minus the securitization financing you have $750 million and just for simplicity and rounding, does that represent the equity -- you just said you have the credit pieces that the bottom and you have some IO and different pieces. So does that $750 million represent the combination of all those and is there any financing against those as well. I'm just trying to think about the equity in those securitizations if that makes sense.

Brad Farrell - *Two Harbors Investment Corp - CFO*

Yes, you're thinking about it the correct way. So that net equity of the balance sheet so the grossed up balance sheet that does reflect the investments in AAAs as well as the subs and IOs and then you would reduce that equity exposure based off an assumed amount of financing. So on the AAAs assume that those are being financed largely by the FHLB potentially repo and then as Bill disclosed there is some financing applied to some of the lower credit bonds.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Got you. So when I look at like page nine with the capital, the $750 million is part of that 33% in non-Agency; is that correct, that 33%? I'm just thinking about where you put it when you show it on these tables.

Brad Farrell - *Two Harbors Investment Corp - CFO*

Yes, so we disclosed that in the conduit. So anything we are either holding in whole loan form or effectively consolidating because we have retained interest that is all being represented as conduit because it represents our own product. If we're buying AAAs of other deals in the marketplace, those would be showing up as non-Agency if that's clear.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Yes, no, I think that's clear.

William Roth - *Two Harbors Investment Corp - CIO*

Let me just add something to that. So that 12%, 4% of the 12%, 4% is for the retained credit and IO bond, 3% is for the retained AAAs, and then as I mentioned, we have pipeline in excess of a billion between loans and locks, so 5% goes to support that. Now as those get securitized, right, that will move -- that 5% will move from capital allocated to the pipeline to capital allocated to the retained interest. So currently the retained interest capital is 7% of the 12%.

Mike Widner - *Keefe, Bruyette & Woods - Analyst*

Got you, that's perfect. That's exactly what I was trying to back in to, so that helps quite a bit. Thank you, guys.

William Roth - *Two Harbors Investment Corp - CIO*

Thanks, Mike.

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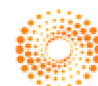

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Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Thanks, Mike.

Operator

And the next questioner is Joel Houck with Wells Fargo. Please proceed.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Thank you, and good morning, everyone. My question is I guess somewhat conceptual but I guess I'm looking more for a practical answer, and that is, a lot of the legacy non-Agency bonds are floating rate and while I don't think any one believes the Fed is going to get out of control with raising rates, there are some, I'm not one of them, that believe that once the Fed starts raising rates it is going to be a classic tightening cycle. I'm wondering if like on slide ten you show a 100 basis point increase in rates you're obviously because of the floating nature of the assets that benefits net interest income. How do you think about the tolerance on credit if rates actually did rise 100 basis points? In other words. If the Fed for whatever reason raised 100, would those subprime bonds really hold their value as the payments would go up for these borrowers in a stressed situation. There are all kinds of obviously, other things to consider which not to say the least if the Fed raised 100 basis points we might be in a recession, but I'm just kind of wondering how you guys think about it. Or what the breaking point you would say, hey, at a certain point we wouldn't be comfortable owning these non-Agency portfolio at current prices? Is it 50, a 100, a 150? I mean how do you handicap it?

William Roth - *Two Harbors Investment Corp - CIO*

Hi, Joel.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Hi, Bill.

William Roth - *Two Harbors Investment Corp - CIO*

I will try to give you -- good morning. I will try to give you a practical answer.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Okay.

William Roth - *Two Harbors Investment Corp - CIO*

If I can. So first of all, it's a good question. Clearly the Fed moves interest rates, right, according to activity in the economy. When they see the economy is going well and they want to sort of put the breaks on or slow it down a little, they raise rates. And then when it goes the other way, the lower rates. So presumably and they have been very careful about this that they want to make sure there is high level of employment and incomes are strong before they raise rates. So I think the first thing we would say or I would say any way is that it is highly doubtful they are going to raise rates a lot unless the economy can support that, both the job market and the income. So that's the first thing. So it is not clear that we're in that position at this point.

Secondly to the extent they raise rates 25, 50 or 100 first of all they will still be extremely low, right? I mean Fed funds at 1% call is not, that's not a high number. But you do make a good point about these deals. So there is offsetting factors that I'm going to just cover at a high level because it

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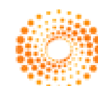

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is fairly complicated. But the gist of it is that while we would be getting a higher interest rate on our bonds, right, the excess spread in the deal would probably go down. So there would be less available to cover potential losses. So those kind of offset, right, you have a little bit of excess spread so you might have more losses but you're getting higher coupon. Furthermore, many of these borrowers have been modified, so they have been modified in to fixed rate payments as opposed to floating. So I think that dampens the effect of the losses. So I would say overall to the extent we see rates up a modest amount, you know, 25, 50, 100 basis points I don't really see much performance change in the assets. To the extent rates are up a lot, say 300, then I think you could see some change but clearly that would be in an environment where we saw rising wages, home prices, very strong employment. So it is unclear to really know what would happen there.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

It is important to know that 100 basis points rise in rates does not translate into 100 basis points in increased mortgage payment to the borrower by the nature of the securities. So that is important to know. As Bill said, a lot of these have been mod in to fixed rate payments for the home owner. So that's important to know. I would also reiterate what Bill said, if you look at current economic data it is pretty difficult to envision a real jail break today in rates given how muted employment data is. Wage inflation does not seem to be particularly present which is sort of a super metric to Chairperson Yellen.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

I agree it doesn't appear -- I mean if anything the data suggests that now they may not raise in September certainly greater than 100 I think is hard to see unless things really, really change. So I appreciate the answer and the color around more of the borrowers moving in to fixed rate through modifications. Just to kind of close here on a final note back to the taxable income discussion. I just want to make sure because I've always understood that Two Harbors runs the Company for total economic return and I think you guys look at it the right way with the comprehensive income included. But the taxable earnings it is what it is, you have to pay it out. But that is not really something that investors -- you would encourage investors necessarily to look at to value the Company; is that the correct way of thinking?

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

It's Tom. I think it is very important, we are not harvesting non-Agency gains to manage taxable income. We are selling non-Agency bonds when we think they have hit -- you know, they've maximized their upside potential and so we're not trying to manage in any way taxable income via non-Agency sales. This slide simply shows where we are in respect of our obligation to pay out taxable income. But we continue to manage the portfolio as we always have, which is to maximize total return to the shareholders, and we are not in any way trying to manage taxable income through non-Agency sales to be abundantly clear.

William Roth - *Two Harbors Investment Corp - CIO*

Joel, let me just add something to that. You have been with us for a number of years, you may recall that heat bond that we had in that example.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Yes.

William Roth - *Two Harbors Investment Corp - CIO*

We bought at an extreme discount, and I don't remember the exact price now but it was in the 50s or something like that. And that was a bond that we sold last year at 97.5 so this is a subprime bond that paid LIBOR plus a quarter I think that was almost par, okay. So forget gains, forget

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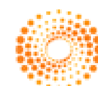

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losses that's just not an asset that we want to own. We're not driving good shareholders value by retaining that bond. As Tom said, when we have non-Agency bonds that don't make sense for us to own anymore, we're selling them.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

No, I just wanted to clarify. I thought that was the case, and I appreciate the color. Thanks, guys.

William Roth - *Two Harbors Investment Corp - CIO*

You bet.

Operator

And the next question is from Chris Gamaitoni with Autonomous Research. Please proceed.

Chris Gamaitoni - *Autonomous Research - Analyst*

Good morning, guys. Most of my questions have been asked. I guess I will follow-up just on the increase flow strategy with MSR. Do you still expect the MSR returns to be in that 8% to 10% range that you mentioned at the Investor Day.

William Roth - *Two Harbors Investment Corp - CIO*

Hi, Chris. It is Bill. Yes, so on an unlevered basis and unhedged, in other words with taking on the negative duration we see the yield, expected yields in the high single digits so in that range. When we hedge the duration, right, in other words we have to get back to neutral by either carrying up swaps or adding pools or adding swaps we see those hedge returns in to the low double digits.

Chris Gamaitoni - *Autonomous Research - Analyst*

And how would that change if you did add leverage? Especially -- let's assume rates go higher, you're adding more a bigger book. If you add leverage the MSR potential volatility can get pretty extreme if rates were to drop in that scenario assuming that you start at a higher coupon as you build a book.

William Roth - *Two Harbors Investment Corp - CIO*

Yes, I think there are a couple of points to your question. I think your cost of leverage is less than your expected return, adding leverage to any assets will increase your return. So obviously if we levered MSR at a yield lower than we were getting, it would increase our expected return and it would increase the volatility. As you know that's true with Agency, it is true with any asset. With regard to valuation change, look, if rates go down, MSR is going to go down in value just like any IO product, like any swap that you have there or any hedge that has negative duration. Not only is valuation go down but you expect it to go down because the asset you're hedging you expect to go up. So the reason we run a pretty close to match book is because we're trying to extract the relative value of the assets that we're holding and not make bets on rates one way or the other. But clearly if you want to do that people do that. That's just not the way we run the business.

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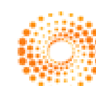

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Chris Gamaitoni - *Autonomous Research - Analyst*

Sure. I guess finally, if you could talk about what your competitive strengths are in the flow market, and how you see winning share from competitors. It seems to me, looking at the data leaders in that market are Pingora, who now is in a relationship with Hatteras, and RoundPoint with a pretty significant piggybacker, so it doesn't seem like there's a lot of free money out there, but just how you get share versus other large players, and maybe a sense of how much flow maybe monthly you think you could get to.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Yes, I'd be really reluctant to give you any sort of volume numbers, but really what we're trying to do is be a capital solutions partner to originators. So if you look at the businesses that exist today, MSR and the prime jumbo conduit business, that's providing capital solutions. Additionally, obviously we're rolling out this expanded credit program, so we want to be their preferred capital solution in respect of consistent pricing and just the ease of the relationship and the respect, the service that we provide to them. We think that by doing those two things, we will win market share. We are winning share, and I think we're on a great path.

Chris Gamaitoni - *Autonomous Research - Analyst*

Perfect. Thank you so much.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Thank you.

Operator

The next questioner is Ken Bruce with Bank of America Merrill Lynch. Please go ahead.

Ken Bruce - *Bank of America Merrill Lynch - Analyst*

Thank you, good morning. I hate to belabor a point, but I want to make sure that I am crystal clear on what you're trying to say in relation to slide six on taxable income. Brad, I think you pointed out that you saw the run rate taxable income quarter to quarter to be relatively stable, and I'm hoping you might be willing to provide that number. Obviously there is some moving pieces here that are impacting the actual realized taxable income, and we fully understand the obligation to pay; but understanding your run rate earnings power on the taxable basis, I think is still a very important variable for many of us. So if you could provide some clarity around that, that would be extremely helpful.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Yes, it's Tom, and then I'm going to hand it over to Brad. I would just say that we really don't know what our taxable income is going to be going forward, and we'd be reluctant to provide run rate data around that. Obviously it depends upon what happens in the portfolio. If non-Agencies richen to an extreme level, obviously taxable income would go up because you could expect us to sell them if they had no further upside.

Brad Farrell - *Two Harbors Investment Corp - CFO*

Yes, unfortunately the detail within that is not something that I think we can really share at this time. I think if you think about our run rate, the industry benchmark is core earnings, and obviously that is going to be a reflection of yield, leverage, spread on hedges, and I think that's a fair way to look at what's driving the underlying taxable income. But then when you drop in a numerous number of items that are either ad hoc or associated with shifting the portfolio, you get into a lot of detail, and it's one of the reasons we've been hesitant to disclose taxable income historically because

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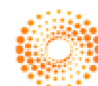

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it does lead to more questions than really answers. Really what we're trying to do, and I'd reiterate a couple themes here - one, comprehensive income continues to be our super metric. It's how we manage the portfolio, it's how we focus on economic return, and it's how we think about the long term dividend sustainability. The purpose of this slide is to really also reflect how we're looking at 2015 specifically and the benefits of the shifts in the portfolio we're seeing on taxable income. We just want to make sure people understand when questions come up of why our dividend has been higher than, quote, our core earnings, these are some of the factors that we're weighing in, and we want to be very transparent about that. But getting into more granular analysis within the taxable income components, I think are challenging to disclose without getting into a lot of complexity. So hopefully that helps. It's the best that we can do to answer that question.

Ken Bruce - *Bank of America Merrill Lynch - Analyst*

Yes, I tried. We do appreciate the extra disclosure, at least as it relates to the gains. It does allow us to understand a little bit of the moving pieces. Maybe one follow-up to an answer to Mike Widner's discussion around the returns on the conduit securities. You had mentioned low double digits, and I wasn't sure if you were making that comment with respect to anticipated leverage on any of those securities, or if that is purely an unlevered return that you're expecting in that particular book.

William Roth - *Two Harbors Investment Corp - CIO*

Hi, Ken, it's Bill. No, as I mentioned, we get typically a half to one turn on the sub bonds, and I think at least one turn is available on the IO, although you have to be careful about that. So if you just assume sort of generally one turn of leverage on that package, it definitely gets you into the double digits.

Ken Bruce - *Bank of America Merrill Lynch - Analyst*

Okay, great. Thank you for all your comments this morning. I appreciate it.

William Roth - *Two Harbors Investment Corp - CIO*

Thanks for joining us.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Thank you.

Operator

This does conclude our Q&A session. I would like to turn the conference back to Mr. Siering for any further remarks.

Thomas Siering - *Two Harbors Investment Corp - President, CEO*

Thanks, Janeane, and thank you all for joining our earnings call today. We will be participating in the JMP 2015 Financial Services and Realty Conference on September 21 in New York City. We look forward to the opportunity to speak with you then. Thank you for your interest in Two Harbors. Have a wonderful day.

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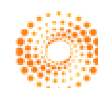

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Operator

Ladies and gentlemen, thank you for joining us today. This does conclude the program, and you may all disconnect. Everyone have a great day.

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