TWO Third Quarter 2024 Financial Results Call

Tuesday, October 29, 2024

9:00am ET

Operator

Please stand by. Good morning. My name is Cynthia, and I will be your conference facilitator. At this time, I would like to welcome everyone to TWO's Third Quarter 2024 Financial Results Conference Call. All participants will be in a listen-only mode. After the speakers remarks, there will be a question and answer period. I would now like to turn the call over to Maggie Karr.

Maggie Karr

Good morning, everyone, and welcome to our call to discuss TWO's Third Quarter 2024 Financial Results. With me on the call this morning are Bill Greenberg, our President and Chief Executive Officer, Nick Letica, our Chief Investment Officer, and William Dellal, our Interim Chief Financial Officer. The earnings press release and presentation associated with today's call have been filed with the SEC and are available on the SEC's website, as well as the Investor Relations page of our website at twoinv.com.

In our earnings release and presentation, we have provided reconciliations of GAAP to non-GAAP financial measures and we urge you to review this information in conjunction with today's call. As a reminder, our comments today will include forward-looking statements, which are subject to risks and uncertainties that may cause our results to differ materially from expectations.

These are described on page 2 of the presentation and in our form 10-K and subsequent reports filed with the SEC. Except as may be required by law, TWO does not update forward-looking statements and disclaims any obligation to do so. I will now turn the call over to Bill.

Bill Greenberg

Thank you, Maggie. Good morning, everyone, and welcome to our third quarter earnings call.

Today I'll start by providing an overview of our performance and strategy, followed by a discussion on the markets, and finish with an update on RoundPoint operations. William will cover our financial results in detail and Nick will discuss our investment portfolio and return outlook.

As you may have noticed in our earnings presentation and on our website, we have recently launched a new brand, referring to ourselves simply as "TWO" going forward in all of our investor relations and marketing communications, reflective of our evolution as a company into an MSR-focused REIT.

While our core competencies have always been the understanding and managing of interest rate and prepayment risks, this new branding marks, in a very visible way, our commitment to MSR as a core part of our investment strategy.

Although we intend to grow our origination and operational capabilities within our RoundPoint subsidiary over time, we are intently focused on providing high-quality investment returns, and our combined strategy is designed to extract the most value that we can from our MSR asset for the benefit of our shareholders. I will tell you about some of those things in a few moments.

Please turn to slide 3. Our book value at September 30th was $14.93 per common share, and which, including the third quarter common stock dividend of $0.45 per share, represented a 1.3% quarterly economic return on book value. For the first nine months of 2024, we generated a 7.0% total economic return on book value, which demonstrates that our strategy is designed to produce strong returns across market environments. Please turn to slide 4. Figure 1 shows market expectations over the past year for the Fed funds rate. As you can see by looking at the green line at the end of the second quarter, market expectations were for a total of 50 basis points in cuts in 2024. However, forecasts rapidly changed for the short-end of the yield curve following the Fed's 50 basis point cut in September, such that by the end of the quarter, the market was pricing in almost 200 basis points of cuts over the next 15 months, bottoming out at around 3%, referenced by the blue line. Recent data, including inflation, jobs, and retail sales, have all come in hotter than expected, and ambiguous statements from several Fed governors have resulted in the market tempering its enthusiasm, so that as of October 21st, two cuts have been taken out of the market and the terminal rate is projected to be around 3.4%, which you can see in the purple line on this chart. Moving to figure 2, ultimately, the 10-year Treasury yield finished the quarter 62 basis points lower at 3.78%, while the 2-year Treasury yield fell by 111 basis points to 3.64%, which you can see on the blue line. The curve steepened by 50 basis points, resulting in the first positively-sloped yield curve between 2 and 10-year Treasury notes since 2022. However, the change in Fed expectations took their toll on the long-end of the curve, and rates increased in the month of October. As of October 21st, which is the purple line in this chart, 10-year rates had given back approximately two-thirds of the third quarter's rate declines, rising 42 basis points to 4.20%, while the 2-year rate rose 39 basis points to 4.03% during the same period, steepening the curve by 3 basis points.

Please turn to slide 5. The acquisition of RoundPoint was almost exactly one year ago, and we are on track to achieve the cost savings that we initially set out, and improving the economics for our investments in the MSR asset. Additionally, the direct-to-consumer loan origination channel that we started from scratch in December is starting to bear fruit. Once at scale, we imagine this effort to provide significant hedge benefits to our MSR portfolio and to protect our asset from significantly faster-than-expected prepayment speeds, should interest rates drop precipitously.

In our first full quarter of DTC originations, we closed and funded $22.4 million UPB of first mortgages and have approximately another $35 million of UPB in the pipeline. While not a large number, keep in mind that only about 1% of our MSR portfolio is considered “in-the-money,” meaning that the customer has 50 basis points or more of rate incentive to refinance. We also kicked off a partnership with a large originator of second liens, and we acted as a broker on $7.5 million UPB in a combination of both open-ended and closed-ended loans. We continue to observe a great deal of interest in this product, with mortgage rates hovering in the low 6's. Although these numbers are small, these results show the proof of concept. It also must be noted that these numbers that I just quoted were achieved by a very small team of only three to five loan officers during the quarter, and by year-end, we expect to have about 30 loan officers. As a reminder, we built our DTC originations from scratch, with no legacy risk. We spent a de minimis amount of money getting it to this stage, and it is now essentially break even. We are confident that we are building a strong platform and brand for our customers to turn to for their mortgage and home equity needs.

We are thoughtfully augmenting our investment portfolio with additional revenue and hedging opportunities in order to further enhance the strategy that we expect will deliver attractive returns for our shareholders through a variety of market environments. With MSR at our core, we have built an investment portfolio with RMBS that has less exposure to changes in mortgage spreads than portfolios without MSR, while still preserving upside to decreasing volatility and spread tightening. By investing in TWO, our shareholders are able to take part in the mortgage market and benefit from our team's deep expertise in investing in and managing MSR and Agency RMBS. With that, I'd like to hand the call over to William to discuss our financial results.

William Dellal

Thank you, Bill.

Please turn to slide 6. Our book value was $14.93 per share at September 30th, compared to $15.19 on June 30th. Including the $0.45 common stock dividend, this resulted in a 1.3% quarterly economic return, as Bill has already mentioned.

Please turn to slide 7. The company generated Comprehensive Income of $19.3 million, or $0.18 per weighted average common share, in the third quarter.

Net interest expense of $42 million was higher in the third quarter on higher average borrowing balances that were partially offset by higher RMBS interest income.

Net servicing income was $172 million, minus $4 million of third-party subservicing fees and other MSR-related servicing costs. Net servicing income was unfavorable to the second quarter by $4 million due to lower servicing fee collections, offset by higher float income and lower third-party servicing costs from servicing our MSR on the RoundPoint platform.

Investment securities gain and change in OCI was favorable to the third quarter by about $337 million due to a rally in rates and spread tightening, versus a selloff in rates and slight spread widening in the second quarter.

Servicing asset losses were $133 million in the quarter, unfavorable to the second quarter due to declining rates that drove a larger decrease in the servicing asset.

Net swap and other derivative gains were lower in the third quarter by $225 million due to hedging losses from the rally in rates.

Please turn to slide 8. RMBS funding markets remained stable and liquid throughout the quarter, with ample balance sheet available. At quarter-end, our weighted average days to maturity for our Agency RMBS repo was 78 days.

Spreads for repurchase agreements widened with financing for RMBS between SOFR plus 24 to 28 basis points. The widening was primarily due to uncertainty of the Fed's actions in September. At quarter-end, bank balance sheets were temporarily tight, owing to a number of factors that included settlements of auctioned Treasury securities, as well as banks managing quarter-end reporting metrics. Post-quarter end, liquidity and balance sheet room quickly returned to easing financial conditions. Similar effects may occur at year-end, and as has been the case in past years, we will seek to minimize our exposure to year-end funding pressures.

We finance our MSR activities across four lenders with $1.6 billion of outstanding borrowings under bilateral facilities. We ended the quarter with a total of $610 million in unused MSR asset financing capacity and $91 million of unused capacity for servicing advances.

I will now turn the call over to Nick.

Nick Letica

Thank you, William.

Please turn to slide 9. Our portfolio at September 30th was $16.4 billion, including $11.4 billion in settled positions and $4.9 billion in TBAs. Overall, our portfolio benefited from the net performance of mortgages over the quarter, but performance across coupons was uneven. Lower coupons outperformed, as investors added duration in the bond rally, while production in higher coupons lagged as the negative convexity kicked in and prepayment concerns emerged. We entered the quarter with an up-in-coupon bias, but as interest rates declined, we shifted our TBA exposure lower, mainly tracking the change in current coupon exposure coming from our MSR and also selling some higher coupon TBAs to mitigate prepayment risk.

I'll review spread performance shortly, but given the performance of spreads over the quarter, we steered the portfolio to have less spread exposure by quarter-end, even as the economic debt-to-equity rose slightly to 7.0 times. The increase in leverage naturally results from MSR requiring more current coupon hedging as rates rally. The amount of spread duration is a function of how many and which TBAs or pools we are long, after taking into account the effect of the MSR. We continue to manage our exposure to rates across the curve very closely, as you can see in figure 2 and can be seen in more detail on Appendix slide 17.

Please turn to slide 10 to discuss the market for investing in Agency RMBS. Over the third quarter, against the backdrop of the Fed continuing to have success in guiding the economy to a soft-landing, risk assets performed well. The S&P 500 was higher by about 5.5%, and with interest rates falling in the yield curve, steepening demand remained high for fixed-income assets. Figure 1, which we have shown over the past several quarters, shows spreads versus volatility from 2019 through present. Our preferred implied volatility gauge, 2-year options on 10-year rates, decreased from 104 to 94 basis points on an annualized basis, close to its lowest level for 2024. The nominal spread on current coupon RMBS finished 20 basis points tighter at 107 over the Treasury curve, while option-adjusted spreads finished 6 basis points tighter at +18 basis points. While nominal spreads remained wider than longer-term averages, by quarter-end, option-adjusted spreads moved tighter than the long-term non-QE average of 29 basis points. With OAS' at these tight levels, future spread tightening will likely need to be driven by an increased demand from depository institutions and/or further declines in volatility.

The nominal spread curve flattened a little, but remained steep, with peak spreads around the 5.5 coupon at quarter-end, as you can see in figure 2. On an OAS basis, the belly coupons of 4.5's and 5.0's were the richest part of the coupon stack, with the higher and lower coupons somewhat cheaper. The move in rates focused a lot of demand on these coupons from convexity hedgers, such as originators and servicers.

Please turn to slide 11 to review our Agency RMBS portfolio. Figure 1 shows the performance of TBAs compared to the specified pools we owned throughout this quarter. As I mentioned earlier, hedged mortgage performance varied across the coupon stack, which is evident in this chart. Overall, specified pools outperformed TBAs, with better performance from higher coupons as prepayment risks increased. We shifted about $3.8 billion in TBA exposure 5.5's through 6.5's into 4.5's and 5.0's, predominantly to re-hedge the MSR exposure as rates rallied. Overall, we continue to like the relative value of specified pools to TBAs, particularly some of the seasoned pools we own, and we added about $300 million in loan balance 6.5 pools in the third quarter.

Figure 2 on the bottom-right shows our specified pool prepayment speeds by coupon. On aggregate, speeds increased to 7.6% from 7.2% CPR in the quarter. Primary mortgage rates dropped about 75 basis points to just above 6%, which triggered some mild "media effect" for high coupon originations from the past two years, and led to material increases in prepayment speeds for 6.5% coupons and above. Overall, prepayment rates for 30-year Agency RMBS increased 8% quarter-over-quarter to 6.5% CPR in the October report, which reflected September activity.

Please turn to slide 12 as we discuss the market for investing in MSR. MSR performed well in the third quarter with strong demand for bulk packages. The volume of MSR sales continued to normalize from the record levels of the past few years. This quarter brought approximately $40 billion UPB of supply, bringing the year-to-date total to $305 billion, about 70% of the pace of 2023. Traded prices have held steady with the supply being easily absorbed by a deep pool of buyers, including both banks and non-banks. The number of banks offering MSR financing has broadened, and the increased competition has led to a compression in financing spreads. Additionally, we saw the first securitization of MSR financing of the past two years, as spreads for the securities returned to sub-300 basis points to SOFR.

Let's look at figure 1. As mortgage rates have dropped, prepayments have begun to display a bifurcated pattern: they are speeding up for newer, higher coupon mortgages, but they continue to be very slow for the locked-in, low coupon COVID-era borrowers. This chart compares actual 1-month speeds for 30-year 6.5s versus our MSR population for the past 12 months and then shows projections, the dotted lines, for the next several months. As is evident, while the 6.5a have picked up in speed, our MSR portfolio has not noticeably responded to the rally in mortgage rates. The quarterly prepayment speed was unchanged at 5.3% CPR. Figure 2 shows the composition of our MSR portfolio and where mortgage rates were at quarter-end. Assuming a 6.25% mortgage rate, on a UPB basis, only 1% of our MSR has a rate refinance incentive of 50 basis points or more. Even if 30-year mortgage rates were to drop to 5%, the number increases to only 7%. Suffice it to say that we have a substantial buffer to further declines in mortgage rates before triggering a large-scale refi wave for our MSR.

Please turn to slide 13, where we will discuss our MSR portfolio. With mortgage rates declining, the price multiple of our MSR decreased slightly to 5.6 times from 5.8 times, and 60+ day delinquencies remained low at under 1%. The portfolio was $203 billion UPB at September 30th, reflecting the net effects of the settlement of the sale of $6.2 billion of higher coupon MSR that we announced last quarter, offset by settled purchases of $3.3 billion UPB from bulk and flow channels. Post quarter-end, we committed to purchase $2.1 billion UPB through another bulk acquisition.

Finally, please turn to slide 14, our Return Potential and Outlook slide. The top half of this table is meant to show what returns we believe are available on the assets in our portfolio. We estimate that about 65% of our capital is allocated to Servicing with a static return projection of 12 to 16%. The remaining capital is allocated to Securities with a static return estimate of 12 to 14%.

With our portfolio allocation shown in the top half of the table, and after expenses, the static return estimate for our portfolio is between 9.5% to 12.7% before applying any capital structure leverage to the portfolio. After giving effect to our outstanding convertible notes and preferred stock, we believe that the potential static return on common equity falls in the range of 10.5 to 15.6%, or a prospective quarterly static return per share of $0.39 to $0.58.

As Bill discussed earlier, since quarter-end we have witnessed a large reversal in rates and have been reminded once again how quickly market sentiment can shift and that bouts of high interest rate volatility are not over. Mortgage spreads have widened, erasing much of the spread performance of the third quarter. In response, we have moved some of our TBA exposure higher, and concurrently increase our spread exposure. As noted earlier, we also added $2.1 billion UPB of MSR through a bulk purchase.

While periods of high market volatility remain a challenge, we are confident in our strategy, as evidenced by the attractiveness of our return potential. We continue to favor the long-run return and stability of having a majority of our capital invested in low mortgage rate MSR, while still preserving some upside to tighter mortgage spreads and a decline in volatility. Mortgage spread volatility has declined as the Fed has moved to an accommodative stance, and the market feels generally balanced with regard to supply and demand. Though demand is strong in the MSR market, we have nevertheless continued to find good opportunities to add at attractive levels, leveraging our deep expertise coupled with the benefits of our own in-house servicing and recapture operations.

Thank you very much for joining us today, and now we will be happy to take any questions you might have.

Operator

If you would like to ask a question, please signal by pressing star 1 on your telephone keypad. If you are using a speakerphone, please make sure your mute function is turned off to allow the signal to reach our equipment. Again, press star 1 to ask a question. We'll pause for a moment to assemble the queue.

The first question comes from Doug Harter with UBS.

Doug Harter

Hey, thanks. I was hoping you could talk about the move lower in the static return for the securities portfolio. How much of that was a result of the move lower in coupon that you talked about?

Nick Letica

Hey, Doug, this is Nick. Thank you for the question. Mostly related to the fact that spreads just got tighter over the quarter. Also, you have to remember that on our return estimate, that fully reflects the composition of our portfolio. As you can see, the amount of servicing we have as a percentage of capital has gone up a little bit and it's leverage as a total of the portfolio has gone up. On the other side, the securities side leverage goes down a little bit so that impacts the return potential as well.

Doug Harter

Got it. Obviously, this number moves around, but then, how would you think about how the quarter-to-date spreads have impacted book value and, two, how that translates to incremental returns today?

Bill Greenberg

Yeah. Good morning, Doug. Thanks for the question. I can take the book value part. As we said in our prepared remarks and as Nick mentioned a moment ago, the market in October has been pretty volatile. Fed expectations have changed, rates have risen, curve is steepened, all of that. And so through October 18th, we think that our book value was down between 1.5 and 3.0%. Over the last week, mortgages continued to widen a little bit more, so we're down a couple more on top of that.

Nick Letica

I can address the other question. As everyone knows, we've had a major reversal since the lower in rates. That was just prior to the Fed meeting in September and in fact, since quarter-end, we're up about, I don't know, 50 basis points or so, and mortgage spreads have really widened out. Many of the things that happened throughout the third quarter have now been reversed in the short period of time in the fourth quarter.

If you would look at our return potential now, it would surely be shifting back to somewhat of a higher leverage. Since quarter-end, as I mentioned in my comments, we have slid our coupon, our BV exposure back up a little bit, and our spread exposure up a little bit. You would definitely see an uptick in the return potential on the security side compared to what you saw at quarter-end.

Doug Harter

Great. Thank you both.

Bill Greenberg

Thank you, Doug.

Operator

The next question comes from Bose George with KBW.

Bose George

Yes, good morning. Just a follow-up to Doug's question, in terms of the new target range, I was curious what drove the much wider range this quarter?

Nick Letica

On the return potential?

Bose George

Yes, exactly, on the return potential. It's a quite a wide range, and maybe just discuss factors that would take it to the high end versus the low end?

Nick Letica

I know you've asked this question before and it's a good question. What really drives those variants and those returns are prepay expectations as well as funding rates. Based on the assumptions that we use for the highs and lows and how they affect those numbers, that is what really drives it. To the extent that we use a wider funding rate spread on the security side for repo, that will affect what those ranges are.

As we mentioned, there has been a little bit more volatility on the funding rates and the repo side for pools. Our funding for MSRs is predetermined. That's all longer-term, kind of locked-in sort of spreads, but it's really just variations in prepays as well as funding rates.

Bose George

Okay, great. Thanks. Then just based on your earlier comment, it sounds like the return profile this quarter-end with the move-in rates should be somewhat closer to what it was last quarter. Is that a good way to think about that?

Nick Letica

Yeah, that's correct. I think it would even be wider than that because mortgage spreads, where they sit right now, they really have widened out to the highest levels of the year. Depending, there are lots of ways to look at spreads, as everybody knows. But almost to a one, they are at the highest levels of the year in fact, where we sit today mortgage spreads are starting to look very attractive.

Bose George

Okay, great. Thanks a lot.

Operator

The next question comes from Jason Stewart with Janney.

Jason Stewart

Hey, good morning. Thanks. Could you talk a little bit about your outlook intermediate-term, maybe near-term/intermediate-term, for prepays and how servicing capacity looks for the industry given where current mortgage rates sit?

Nick Letica

Sure. Prepays for this month – we have seen an uptick in. Some of it has to do with day count, some of it just has to do with lags of where mortgage rates went in the third quarter. Those lags are a little bit hard to gauge these days for various reasons and without getting too deep into that topic, we do expect prepays to pick up in this next report. Then it will start reflecting the fact that, rates really have reversed and we estimated that mortgage rates were down about 75 basis points in the third quarter, and we're up at least that much now in the fourth quarter. We'll also be entering the winter months as we get here. Overall, I think we'll see prepays really start to come back down across the board, reflecting slower turnover rates for the lower coupons and then just much less sensitivity for the highers that we saw. The little bit of, as people were saying, we had around a two-week refi environment for the higher coupons, which is now kind of turned around. I'll let Bill talk about the MSR side.

Bill Greenberg

Yeah. In terms of MSR supply, I think we've said, and other people have commented, that MSR supply has really reverted back to more historical norms, that the amount of MSR which has changed hands in 2021 and in 2023 were record levels. Now the amount is really back to historical levels, which is in the $200 billion kind of range for a year. So we're continuing to see some certain amounts of pools trade and we're participating in those markets. As Nick said, we participate in that market, we bought some at attractive levels. We're finding opportunities to be situational and we sold a little bit in the previous quarter. We bought some here so I'd say the market is returning to historical norms, but it remains healthy and well-supported.

Jason Stewart

Got it. Okay, thank you. Then just in terms of transaction activity on the MSR valuation, do you think that has an impact on multiples? Maybe if you could just parse out the delta in the move, in the multiple, maybe 3Q to where it's going in 4Q in terms of earnings on float income versus prepays and how those two factors are driving MSR transaction multiples? Thanks.

Bill Greenberg

Sure. The transaction multiples and the prices of MSR depends on all of those factors. Forward short-term rates to the extent that the Fed has cut rates will decrease float earnings some, which should drive multiples lower, all else being equal. As Nick said, long-term prepayments are probably back to where they were a quarter ago, so that's going to be sort of a wash. Where people are pricing recapture, of course, has become a very hot topic of interest for MSR participants. Generally, we have seen what I will call the MSR mult curve, that is the prices, the mults of MSR packages ranging from very low WAC, like we have of 3.5% up to higher WAC packages, 5.0, 5.5, and 6.0s to be as flat as it's been in history. That's really attributable to the value that people are putting on recapture. That said, putting all that together, I think the movements in the short rates are small comparatively to where we are. The forward curve has steepened out, so that means forward projections of float income are higher than it was when the curve is flat. I think these will translate to pretty small changes in MSR mults.

Nick Letica

Yeah. I'll just add on to that. Your question about float income versus prepays. We've talked in previous calls about the fact that a lot of our price sensitivity on our MSR is really related to float income, given how far out-of-the-money our MSR is given its low gross WAC. Although there is always some prepay response, as we've gone to some lengths to demonstrate, it's still pretty small. Most of the price sensitivity that our MSR displays is about float rather than prepays. I don't think that's changed dramatically in this move. Of course, if you had higher gross WAC MSR alone, then prepays and current coupon exposure would have a much bigger impact on the pricing. But most of it is really just interest rate movement related.

Jason Stewart

Right. So net neutral on market multiples and biased higher on TWO's MSR multiple. Then just a quick question, is the MSR in your estimate of book value quarter-to-date? Is there any change to the MSR valuation embedded in that?

Bill Greenberg

Yeah. Well, when we said we were down between 1.5 and 3% as of October 18th, that incorporates the entire portfolio.

Jason Stewart

Okay.

Bill Greenberg

It's a hedged portfolio on both sides. All positive- and negative-duration assets are moving around in that, and that's the estimate that we think.

Jason Stewart

Great. Thank you.

Operator

The next question comes from Rick Shane with J.P. Morgan.

Richard Shane

Thanks, everybody, for taking my question. I'd like to follow up on Jason's questions related to the MSR. When we look at the sales and bulk purchases, they almost net out. When we look at the gross coupon rate, it ticked down slightly. Can you help us understand a little bit about the characteristics of the purchases you're making? I'm assuming that some of this is, or a lot of this, is seasoned MSR. You're not buying new production, but if you could help us understand what's going on here and what the strategy is?

Nick Letica

Hey, Rick, this is Nick. Thank you for that question. As you know MSR is a nuanced asset. There's all kinds of things that go into its valuation and you know that old adage in the bond market: "there's no bad bonds, just bad prices." We really look across the WAC range of MSRs. Each package is unique and it's hard to generalize. As you know we've sold some high-gross WAC stuff, we've been engaged in buying some from time to time. We bought sort of intermediate WAC kind of things that are in the 4 to 5% gross WAC range through time. It really varies and it depends on where the value is. We have bought some high-gross WAC stuff too, just because it's high-gross WAC doesn't mean that it doesn't have good value. As I said, it's a nuanced asset, the deep variables really do matter. We also have some flow and the flow MSR is by definition pretty much current coupon and we have that coming into our portfolio too. So it's a mix of things.

Richard Shane

Got it. Okay. Again, it's interesting, I'm looking at your slides, looking at the new logo, looking at the new branding, and realizing that this is indicative of the strategic shift that you guys are pointing to. When we think about how you're approaching the MSR market at this point, we've historically thought of it as a pure hedge against the Agency book. I think what's really happening here is that you're trying to play both sides of the coin, that you really want to be in the recapture business. You're competing there as much as you are, sort of creating the traditional, I'll call it "Two Harbors book versus the TWO book."

Bill Greenberg

Yeah, I think that's mostly right. What we saw in the last couple of years as rates rose was that the traditional, what I like to call hedge capacity of the MSR asset declined. The MBS part of the portfolio and the MSR portfolio bifurcated because they didn't really hedge one another necessarily, but we like the attributes and return opportunities of both. Our MSR portfolio today, at 3.5 gross WAC as we showed on some of the earlier slides, is prepaying slowly, it's cash flowing well. It's very far out-of-the-money and so forth, and so the MBS part and the MSR part don't hedge one another exactly, but they complement one another. When we think about the ways to add or augment potential returns to our MSR assets and to improve returns for the company and for shareholders, there's things we can do on the MSR side that we can't do on the security side. One of the things that we can do is we can buy a servicer. Because we did that, as I said in my prepared remarks, we're on track to achieve the cost savings that we said just through economies of scale, and control our own destiny and being able to be more efficient than we were rather than owning subservicing. The recapture effort is a part of that also. I think I've talked publicly about being able to hedge faster-than expected prepayment speeds. When rates move, when rates fall or rise, we have expectations of what we think prepayments will do. Therefore, we have expectations for what MSR prices will do and we can hedge those with financial instruments. But what we can't do is we can't hedge speeds that are faster than we expect. The origination channel, the direct-to-consumer channel, will help us do that and so that's really the genesis of wanting to embark on that. Then once we're here, we can do some of these other things, like I mentioned in my prepared remarks, in terms of originating or brokering second liens to other people and other such things. It is a recognition that we're creating this ecosystem around the MSR asset, but it's designed to support and augment the investment portfolio.

Richard Shane

Got it. Hey, Nick, thank you very much and Bill, that's very helpful. It's good to get strategic insight and we appreciate it. Thank you.

Bill Greenberg

Yes. Thanks, Rick.

Operator

The next question comes from Trevor Cranston with citizens JMP.

Trevor Cranston

Hey, thanks. Can you talk a little bit about your thoughts on swap spreads relative to Treasuries? If there's a limit to how low you think those can go and how all that plays into your choice of hedging instruments for the portfolio? Thanks.

Nick Letica

Hey, Trevor, thanks for that question. It's a great question and I will hesitate to state a limit on where I think swap spreads can go. We'll say that we use a combination of swaps and Treasury futures to hedge our book overall. It does appear to us as though a lot of the supply concerns about the market are priced into swap spreads. Right now we are at extremely tight levels on swaps relative to Treasuries. But as we've seen this quarter, that gap continues to grow. A lot of it has to do with market directionality, a lot of it has to do with the expectation for budget responsibility of the next and future administrations. But overall, we do think that swap spreads here present a good hedging opportunity and have shifted a little bit so we remain reasonably heavily hedged with swaps. Just thinking that they do offer better carry from a hedge perspective and that there are reasons to also believe that swap spreads could widen. One of them really would be if the Fed were to really stop the QT side. There are debates about that in the market, arguments on both sides, but there's a reasonable chance that happens as well, which would change the dynamic of that market greatly. But it's a very good question. It's one in which it will just depend on what happens from a budgetary perspective for the U.S. and what supply looks like. But as I said, on balance, we think that there is a lot of the bad news, about the budget and Treasury supply priced into spreads right now.

Trevor Cranston

Yeah. Okay, that's helpful. Thank you.

Operator

The next question comes from Eric Hagen with BTIG.

Eric Hagen

Hey, thanks. Good morning. When you say that you raised your spread exposure into October, is that a function of taking your financial leverage higher, or is your spread exposure also a function of how much TBA you have relative to pools and such?

Nick Letica

Yeah. Hey, Eric. It's a function of a few things. It's not leverage and that's one thing that we pointed out on the prepared remarks. Leverage is but one measure of risk that we look at. Some of our spread exposure has to do with how we allow our spread exposure to change with regard to the MSR. When rates go down, the MSR it requires, as I mentioned, more mortgages to hedge when rates go back up less.

If you know you hold essentially the same amount of mortgages, you're going to have mortgage spread exposure as rates go up and less as rates go down. Some of it just has to do with letting that exposure grow as spreads have widened so it's really more of a function of that than a leverage. We have really not taken our leverage up.

Eric Hagen

Okay. Got you. I think there is a follow-up question here on leverage, though. What is the right way to benchmark your leverage relative to the spread environment? Does your leverage account for the fact that the Fed is expected to cut rates versus last year when spreads were even wider than they are right now? But the benefit from the borrowing cost wasn't really reflected in the spread environment. How do you benchmark your leverage against that?

Nick Letica

Honestly, I'm not sure I really understand your question. We look at our portfolio composition, look at the spreads in the market, and what kind of returns we think we could generate. As we've said on prior calls, we've given a range of what our overall economic leverage is. I think that still holds. But it has to do really with where we see spreads are now. Essentially, I think you're asking, are we predicting mortgage performance based on the way the Fed is going to act? But I'm not quite sure what you're asking to be perfectly honest.

Eric Hagen

Okay. And you guys have the convertible debt coming up on a current liability in a couple of months? Do you have a sense for how you're thinking about potentially refinancing that piece of your capital structure?

Bill Greenberg

Convertible debt is coming due in early ‘26, and so that's on our radar and then we'll be addressing it before that. One other point, if I could just make about your question about leverage and so forth and Nick's answer, I might just elaborate a little bit. That leverage is one measure of our risk that we look at, of course. But we have other measures in terms of that. We put in the deck, also, about our mortgage spread exposure and the amount of liquidity we have and so forth. Because the MSR is as out-of-the-money as it is, it does still contribute to offsetting some mortgage spread exposure. We think that's important to include in our overall risks as well, and so, we don't just look at leverage as one measure, although we obviously pay attention to it and respect it. But it's a whole suite of metrics that we look at when we're managing the portfolio exposures.

Eric Hagen

Got you. All right, that's really helpful. Thank you guys.

Operator

The next question comes from Harsh Hemnani with Green Street.

Harsh Hemnani

Good morning. Hey, thanks for taking my question. Now that RoundPoint is scaled up and operating, could you remind us the recapture rate on a long-term basis that you're projecting on the MSR there?

Bill Greenberg

Yeah. As I said, we just finished our first quarter of DTC operations. As I mentioned, we only had a number of loan officers that can be counted on one hand. And so, we're not up to scale yet. As I said, I think what we've done here is a proof of concept, and we're bringing the thing to scale. I think it's too soon to talk about what the recapture rates are on our portfolio. But we do expect that we'll be able to achieve industry-level recapture rates on an Agency portfolio once we're fully at scale. We are in this weird environment where 1%, or less than 1%, especially with the recent move in rates of our portfolio, are in-the-money. And so these are very small numbers of our portfolio that are actually in-the-money. It's not a great moment to talk about what the recapture rate is, but we'll have more to say about that in future quarters.

Harsh Hemnani

Okay. That's fair. Then you touched on this a little bit in the prepared remarks and on a few prior questions, but perhaps in the near-term, call it the next couple of quarters. How are you looking at the relative value across the two strategies right now, where you're seeing the opportunity to invest better in the securities portfolio or MSRs?

Nick Letica

Hey, Harsh. Thank you for that question. Mortgage spreads having done what they have done thus far this quarter, the mortgage side at the moment looks quite attractive. How long that lasts? It's hard to say. I believe there are a lot of market participants that are holding on for the election to be over because, as we know, there can be a significant amount of volatility and we have a lot of events coming up in the next few weeks. We have non-farm payroll, we have the election, and then we have the Fed right after that. There are a lot of reasons to do nothing and I think that there are a lot of investors right now that are happy to just sit and watch right now. I believe that explains a lot of the reasons why we've seen mortgage spreads move out as they have. At the moment, if you ask me, right, today, if I had money to invest, I would put it into the mortgage side because I think mortgage spreads are very attractive. My sense is that won't last for a longer period of time unless we really have a different environment for one reason or another, unless we're again moving back to higher rates or some questioning about whether the Fed's really cutting or not. I think the base case should be that mortgage spreads probably do better once we get through these market events that are coming up. We love our MSR asset, as we say, it's a great risk-reward asset. It's fairly easy to hedge and provides a lot of great cash flows and prepays are very stable. From a longer-term perspective, we really do like the MSR.

Harsh Hemnani

Got it. Great. Thank you.

Bill Greenberg

Thank you, Harsh.

Operator

There are no further questions at this time, Mr. Greenberg, I will turn the conference back to you for any additional or closing remarks.

Bill Greenberg

I'd like to thank everyone for joining us today. Thank you, as always, for your interest in Two Harbors. Go TWO.

Operator

This concludes today's call, thank you for your participation. You may now disconnect.