FINAL TRANSCRIPT

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PRESENTATION

Operator

Good morning. My name is Mary Ann. I will be your conference facilitator. At this time, I would like to welcome everyone to Two Harbors Third Quarter 2011 Financial Results Conference Call. All participants are 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 Christine Battist, Managing Director for Two Harbors.

Christine Battist - *Two Harbors Investment Corp. - Managing Director*

Thank you, Mary, and good morning. Welcome to Two Harbors Third Quarter 2011 Financial Results Conference Call. With me this morning are Tom Siering, President and Chief Executive Officer; Jeff Stolt, Chief Financial Officer; Bill Roth, Co--Chief Investment Officer; and Brad Farrell, Controller. As we previously announced, Brad will assume the CFO role from Jeff effective January 2012.

After my introductory comments, Tom will share some insights on the quarter and our strategic direction. Jeff will highlight the key items from our financial results, and Bill will review our portfolio performance and assess the current market environment. Bill will also share some additional insights on hedging strategy.

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 the Company's website at www.twoharborsinvestment.com.

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. In addition, we'd like to encourage you to reference the accompanying presentation to this call, which can also be found on our website.

Before management begins the discussions of the third quarter results, we wish to remind you that remarks by Two Harbors' 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 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 SEC's 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, Director, CEO*

Thank you, Christine, and thank you to everyone for joining us today. I'd like to apologize for our delay this morning. It was due to an overlapping call from another mortgage REIT. Two Harbors had a solid quarter despite the continued volatility in the mortgage and REIT markets. For those of you with access to the slide presentation, please refer to slide three.

During the third quarter, Adjusted GAAP earnings were $0.55 per weighted share, representing a 22% return on average equity on an annualized basis. Core Earnings were robust at $0.40 per weighted share, representing a 16% return on average equity on an annualized basis.

For the fourth consecutive quarter, we declared a dividend of $0.40 per share. This dividend represents an 18% yield on an annualized basis based upon our stocks September 30, 2011, closing price of $8.83. Book value declined 4% on a sequential quarterly basis to $9.30 per share on September 30, from $9.73 on June 30, reflecting weaker non-Agency price performance. Our relative portfolio performance this quarter exceeded many indices for the same period.

During the quarter, our Agency portfolio did quite well. We had strong underlying performance in the portfolio, and our hedging strategy protected book value. Bill will provide more details on our performance shortly.

During the quarter, we completed an accretive secondary stock offering of 48.3 million shares for net proceeds of approximately $484. This has allowed us to increase our asset portfolio, continue to reduce our expense ratio and increase liquidity of our shares.

There were several significant macro events that clouded the financial markets in the past few months. They included the ongoing debt problems in Europe and the United States; S&P's downgrade of the U.S. credit rating; and the Federal Reserve's announcement that it would keep interest rates near zero at leastfor a couple of years.

Finally, in September, the Fed announced the deployment of Operation Twist. Collectively, these events caused great trepidation in the financial markets. As a result, interest rates declined to generational lows. The spill over in to our sector included concerns about mass refinancing or blanket government programs to assist struggling homeowners.

We proactively repositioned our portfolio for this quarter in anticipation of HARP 2.0 and in light of the substantially lower interest rate environment. We believe the non-Agency is attractive on both an absolute and relative basis.

I'm proud of our investment team and in the manner they managed our portfolio this quarter despite these conditions. The advantage of a hybrid mortgage REIT is that we have a flexibility with two levers, Agency and non-Agency securities on our portfolio. We believe over the long run, we can better mitigate risks including volatility in interest rates, prepayments, home prices and homeowner defaults.

In early October, we announced that our Board of Directors authorized a share repurchase plan for up to 10 million shares. Our motivations around this are simple and no way should be taken as a statement on the prospects for our business model, but markets have acted irrationally lately. Rather, this plan should be seen as another tool to optimize shareholder value. We will evaluate its use on a continual basis. We believe such a share repurchase program will benefit our shareholders and affirms our long--term approach to the companies' care.

Now, I'd like to update you on the progress we're making on the securitization program as summarized on slide four. I'm excited about this program because it will further diversify our business and draw on our strength on credit analysis. We're gaining traction on signing originators and are being thoughtful in our approach.

We expect to begin purchasing loans by the end of the calendar year. As we've indicated before, securitization program will not have a material impact of 2011 results, but we expect it will generate long--term value for our shareholders.

Finally, I would like to update you on the recent interest the SEC has had in the mortgage REIT industry as summarized on slide five. In late August, the SEC issued a Concept Release requesting public common concern exemption from the Investment Company Act of 1940 for mortgage REITs such as Two Harbors.

We plan to submit a response to the SEC by the November 7 deadline. Although it's difficult to predict the timing or steps the SEC may take, we are prepared to work with them to help them understand our industry and answer any questions. In the near term, we do not expect any impact on our operations as we outline in our September letter to shareholders.

In the longer term, we believe the SEC will use this process as an opportunity to clarify and strengthen the regulatory framework of mortgage REITs without unduly constraining the business model. From a quality perspective, companies like Two Harbors have stepped into the mortgage void created by the financial crisis and are important to improving the health of the housing market. This process is in the early stages, and we will keep you informed as it unfolds. This concludes my opening remarks. I will now turn the call to Jeff to discuss our financial results for the quarter.

Jeffrey Stolt - *Two Harbors Investment Corp. - Treasurer, CFO*

Thank you, Tom. I would like to highlight a couple of items from the quarter as outlined starting on slide six. As Tom mentioned, during the third quarter, Core Earnings increased by $20 million on a sequential quarter basis to $52 million, or $0.40 per share. Note that there were significantly higher average asset base due to the deployment of the $484 million in net proceeds raised in the July secondary offering.

For the third quarter, our average investment portfolio grew to approximately $5.4 billion compared to approximately $3.4 billion in the previous quarter. GAAP net income for the quarter increased nearly $56 million on a sequential quarter basis to

$55 million or $0.42. This increase is partially by driven by the increased core and underlying yield performance in both portfolios as well as realized gains.

During the quarter, we sold RMBS and terminated certain interest rate swaps to realign our Agency portfolio as well as to reduce our cost of financing in a low interest rate environment. In addition, we had sizably unrealized gains of $14.3 million on other derivatives such as TBAs and credit default swaps that favorably impacted GAAP net income.

By comparison, Adjusted GAAP earnings were $0.55 per share representing the 22% return on average equity on an annualized basis. As a reminder, due to our elected accounting treatment, unrealized mark-to-market valuations on our swap and swaptions are captured in GAAP net income as opposed to the balance sheet.

Since these swaps and swaptions are used for purposes of hedging our interest rate exposure, their unrealized valuation losses are generally offset by unrealized gains in our Agency RMBS portfolio, which are recorded in stockholder's equity through other comprehensive income.

We encourage our investors to view this as an accounting mismatch and not as an economic reflection of the Agency portfolio net of hedges. Adjusted GAAP earnings is a metric that attempts to reconcile this accounting disparity by excluding both unrealized gains and losses of swaps and swaptions.

Please turn to slide seven. For the third quarter, we reported a comprehensive loss of $18 million, representing an unrealized loss on an average equity of nearly 6%. This loss reflects the drop in the market's valuation of non-Agency securities this quarter.

Our operating expense ratio as a percentage of average equity was 0.9% for the quarter. Our expense ratio has improved on a sequential quarter basis as we achieved economies of scale on an increased capital base and delayed certain of our infrastructure costs associated with our securitization program. We expect our run rate expense ratio will be in the range of 1.1% to 1.3% in the fourth quarter of 2011 as we incur operational expenses to acquire and hold loans in our portfolio prior to securitization.

As a reminder, certain hedging activities are accounted for on a tax basis outside the REIT in the taxable REIT subsidiaries and are therefore subject to federal income tax. During the quarter, income tax expense on derivatives was $9.4 million related to this activity.

I would like to take a few minutes and elaborate on our counter party risk. The ongoing global debt crisis, and most recently MF Global's announced bankruptcy, has reinforced the importance of diversification in our counterparties as well as our ongoing assessment of their financial stability and potential risk. As of September 30, we had 20 repo counterparties. I am also pleased to note that we have no counterparty exposure with MF Global, and as you will see in our upcoming 10Q, 75% of our counterparty exposures with North American institutions.

Finally, we have previously disclosed that we evaluate our dividends against a number of measures including our ability to generate income cash returns to support our outgoing dividend stream. As a measure of this, we would note that our Core Earnings and realized gains for 2011 through September 30 were approximately $109 million as compared to our 2011 dividend distribution of $109.3 million. While our obligation to distribute our taxable income ultimately drives our dividend distribution, we are pleased with this taxable relationship through this third quarter end. I would now like to turn the call over to Bill to discuss the portfolio in further detail.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Thanks, Jeff, and with another eventful quarter due to the numerous macro factors that Tom highlighted in his opening remarks, I'd like to start to by sharing some portfolio highlights as shown on slide eight.

On our last earnings call, we indicated that we are highly focused on the non-Agency sector for our July capital raise to take advantage of the pullback in prices. This presented a terrific investment environment and over the course of the quarter, we allocated the majority of the capital rate in July into the non-Agency strategy at expected loss adjusted yields averaging around 10%.

As Tom indicated earlier, non-Agency pricing has continued to be weak especially given the rally in other sectors. We believe this is based on technical factors as opposed to fundamentals. More on this later. On the Agency side, with interest rates much lower and in an anticipation of the potential release of HARP 2.0, we repositioned our Agency portfolio during the quarter. Due to today's lower rates and HARP refinancing, prepayments will likely increase. But we believe our portfolio is designed to perform well. I will cover this in more details shortly.

Our portfolio delivered another quarter of strong returns in light of the volatility experienced in the market. The chart on the bottom left side shows our margin by strategy. Not only did our Agency strategy provide an attractive spread of 3.2%, but our overall margin increased as a result of much better margins in the non-Agency sector.

Total net interest spread increased to 4.2% from 4.1% in the previous quarter. On the non-Agency side, our annualized yield was 9.8% this quarter, an increase of 100 basis points. This was driven primarily by the new purchases at projected yields in the 10% range. We believe that our ability to opportunistically allocate capital demonstrate the attractiveness of the hybrid model especially in this period of generally contracting interest margins.

On the bottom right of slide eight, we've included some familiar indices to compare the performance of Two Harbors for the quarter. We are pleased that Two Harbors' performance was relatively flat compared to returns on these benchmarks.

Please turn to slide nine. Our portfolio was comprised of $5.3 billion in Agency securities, including inverse IOs, and $1.3 billion in non-Agency securities as of September 30. With our recent focus on non-Agency, our capital allocation shifted slightly and stands today at roughly 55%/45% in favor of Agencies at September 30, as compared to a 60%, 40% split at June 30.

As I mentioned earlier, we repositioned our Agency portfolio during the quarter. Specifically, we sold some 30-year high coupon pools and 15-year non-prepayment protective pools. We reinvested in 4% and 4.5% low loan balance 30-year pools, which greatly increased our prepayment protection. We also implemented a net short position in high-coupon TBAs, as we believe the market did not appropriately price in the potential for substantially faster speeds on these coupons.

As you can see from our Agency holdings on the top right, 96% have some form of prepayment protection. We believe our holdings are unlikely to experience a large increase in traditional refinancing and while the prepayment impact of HARP 2.0 will not be known until 2012, we do not expect a dramatic effect on our holdings from this policy action. We have added a slide in the Appendix, which more fully discloses our Agency holdings. We believe that you will find this information useful.

Turning to the non-Agency market. In the third quarter, we increased our allocation to Sub-Prime bonds given the values available in that sector. Our purchases included senior bonds as well as seasoned mezzanine bonds, and these additions were a key driver in our higher realized yield on non--agencies in the quarter. As you may have noted on the prior side, our financing cost on these bonds was a bit over 2%.

Please turn to slide ten. We believe that our Agency's asset selection process has enabled us to continue to realize slower prepayments in the overall market. Agency securities we held as of September 30 experienced a favorable three--month CPR of 5%, consistent with the prior quarter.

In this lower rate environment, we have seen an overall pickup in refinancing activity with a sharp increase in mortgage prepayments reported in October. Despite this overall increase in speed, it is worth noting that Two Harbors' one-month CPR, reported in October, was only 5.8%.

On the leverage side, our RMBS debt-to-equity ratio was 4.4 times this quarter, in line with our expectations. We anticipate continuing to apply leverage in the range of six to seven times on the Agency portfolio and one to 1.5 times on the non-Agency portfolio, and we expect our debt-to-equity ratio to be in the low to mid 4s as we close out 2011.

We continue to maintain a relatively low level of interest rate exposure. For the third quarter the estimated variance in equity value for an up 100, down 100 combined basis point move was only 4.3%. Given the dramatic drop in rates, we increased our position in two- to four-year swaps, given the swap rates were so low and are bounded by zero floor. Our average pay rate on swaps as of quarter end was only 1.02%.

Finally, while we maintain 40% optional protection, we have substantially less premium at risk as most of our swaptions are designed to protect against much higher rates than we have today. More details on our swaps and swaptions are displayed in the appendix.

Liquidity management remains an important component of managing our portfolio. During the quarter, we continue to focus on long-dated repos, and at September 30, 36% of our total RMBS borrowings have maturities of over 90 days. Additionally, we increased our U.S. Treasuries versus swaps position as a hedge against our funding costs.

At this point, I'd like to spend a few minutes to explain how we think about interest rate hedging and its use in our portfolio as outlined on slide 11. At Two Harbors, we utilize a variety of instruments and securities to construct a hedging strategy with the primary intention of preserving book value in the event of significant interest rates movements. The aim is to hedge the interest rate exposure of our Agency portfolio and does not apply to bonds whose return is primarily driven by credit performance. Thus, we have no swaps or other interest rate hedges against our non-Agency portfolio.

Our Agency hedging strategy is designed to perform in different market environments. For example, ten-year rates fell roughly 125 basis points in the third quarter, and our Agency strategy performed well. However, the first quarter of this year offered a contrasting scenario in which ten-year rates hit a high of 375.

During that period, our Agency strategy performed exceptionally well and contributed to our overall book value growth of 4.9% for that quarter. One key component to this performance is the incorporation of swaptions in our portfolio. Put simply, a swaption is an option to enter in to an interest rate swap. When rates rise, swaptions increase in value. This is similar to the way swaps behave. When rates fall, they decrease in value.

It is important to note, however, that when swaptions decline in value, they decline far less than a similar maturity swap would have due to the optional nature of the protection. The key point is that the optionality embedded in the swaption benefits the portfolio in a rising rate environment as we become more hedged as rates rise. Conversely, we are less hedged when rates fall as we would not exercise the option.

Finally, our loss is limited to the premium paid to the swaption. This concept, the ability to enter in to a swap when it benefits the portfolio is what we refer to as optional protection. Lastly, I'd like to spend a minute on the non-Agency opportunity. Please turn to slide 12. In the past few years, there has been a tremendous rally in many asset classes. The non-Agency market, however, has largely missed this rally. And furthermore, you will see that ABX pricing levels are actually similar to early 2009.

Compared to high yield in the S&P, for instance, non-Agencies have dramatically underperformed. Currently, most investors and dealers agree that there are very good returns available for those with a longer investment horizon, but few are inclined to purchase today given potentially poor near--term price action.

What is driving these poor technicals? A few reasons include lack of buyer interest and adding risk this late in the year; reduced balance sheet availability on the dealer side; and lingering concerns about potential supply from distressed sellers. Fundamentally, however, non-Agency bonds are in substantially better shape than two to three years ago.

Home values, while much lower than 2009, are more stable and are unlikely to decline a similar 30% or more from here. Services are taking actions to improve loans through modifications and today's mods are working much better than earlier ones.

Finally, underlying loan performance continues to improve. For example, bonds that Two Harbors owned at September 30 had better delinquency and loss severity statistics today then they did six months ago. In short, the perspective performance is substantially better than a few years ago yet pricing is not. This is especially evident in the Sub-Prime space. We believe non-Agencies represent attractive returns on both on an absolute and relative basis and continue to focus opportunistically on this sector. I will now turn the call back over to Tom.

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

Thanks, Bill. Thank you for that recap. Mary will now open the questions -- or open the call to question--and--answer period, please.

QUESTIONS AND ANSWERS

Operator

Certainly.

(Operator Instructions)

Our first question comes from the line Mark DeVries from Barclays Capital. Your line is open.

Mark DeVries - *Barclays Capital - Analyst*

Bill, could you give us an update on where spreads and supply are right now in the non-Agency market?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Sure. Hey, good morning, Mark.

Mark DeVries - *Barclays Capital - Analyst*

Good morning.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

So, let me talk in terms of the yields a little bit as opposed to spreads because they're pretty close to the same thing actually. Yields, since quarter end, are modestly higher, i.e. prices are slightly weaker. And we see bonds, on the sub-prime space, that can be bought in the 10% to 12% range.

Option ARMs are probably in the 9% to 10% range. Alt-As are anywhere from 7% to 10% depending on the type of bond. And then prime bonds are still at lower end of that range.

Mark DeVries - *Barclays Capital - Analyst*

Okay. And what --

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

As for the supply. You know, actually, volumes are substantially lower than they had during this, let's say, the first six months of the year. There's been substantially less selling. A lot of people that owned them are looking at them and realizing what their yields are.

So, I'd say bid list volume and general supply volume has dropped probably to 50% of it was during the first six months. But the concern is obviously about potential supply that comes from some of the big banks that may need to sell.

Mark DeVries - *Barclays Capital - Analyst*

Okay. And then what type of leverage are you applying to your latest investment in non-Agency?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

On non-Agency, we target a range of one to 1.5 times.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Can you remind us how much more room you have given kind of your whole pool asset requirements to reallocate into the non-Agency space at this point?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Sure. If you run the math on what you need to hold in whole pools, it quick sort of a floor on your capital allocation to Agencies of somewhere in the 35% to 40% range, which means we could be obviously 60% or maybe a little bit higher on non-Agency. So, we're not actually near that at this point. So, we would if we desire to have more room to move in to non-Agency to reallocate.

Mark DeVries - *Barclays Capital - Analyst*

Okay, thanks. And finally, just one last question, when did you reposition the Agency book? Was that kind of towards the end of the quarter? And if so, should we expect that the average spread on the Agency book is a little bit lower in 4Q relative to 3Q.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Yes. Let me give a little bit more color on that, Mark. Thanks for asking about that. You know, actually, it was, I don't know the exact date, but it was more in the middle of quarter, if you will. You know, we felt that there was a reasonable chance that whatever was announced by the Obama administration in terms of their desire to get homeowners through the door, through the process, could be fairly meaningful.

So, to give you an idea, we sold higher coupons that we felt while - we thought that they had reasonable protection. They could be at risk. Those bonds we sold north of 110, and we sold some 15-year 3s that were purchased at a discount, but then traded above 103. And so, we're a little bit of concern about those because there weren't loan balance pools.

The average sell yield was about 3%. Our average reinvestment yield was about 3.25%. So, we picked up 25 basis points, but from a book yield, we obviously had to give some because there was some - we had booked them at lower prices. But if you recall we also said that we repositioned our swaps to better manage the hedge. So, we got most of that back, not quite all of it but most of it.

So, for a net interest, the book yield will be slightly lower. You should expect it to be slightly lower, but our liability, our hedging cost would be also lower, not quite by the same amount.

Mark DeVries - *Barclays Capital - Analyst*

Okay, that's helpful. Thanks.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Sure.

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

Thanks, Mark.

Operator

Thank you. Our next question comes from Bose George of KBW. Your line is open.

Bose George - *Keefe, Bruyette & Woods - Analyst*

Good morning. I wanted to ask just how long it'd take you to deploy the capital from the raise. I mean was average assets meaningfully different from what it was at quarter end?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Well, our typical deployment period, Bose, is sort of one to two months. And we said on our August earnings call that we had deployed, which I think, was on the fourth, that we had deployed roughly half the capital. And then the remainder was deployed over the rest of quarter. I don't have the exact number on average assets, but that should give you some idea.

Bose George - *Keefe, Bruyette & Woods - Analyst*

Okay.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

But I shouldn't say over the remainder of the quarter, I would say over the remainder of the two-month period from the capital raise.

Bose George - *Keefe, Bruyette & Woods - Analyst*

Okay, great. Then I wanted to follow up on HARP. Again, just curious about your thoughts, and then given how you're positioned, I mean do you think FHFA's estimate of HARP volume, which seems to be roughly a million and more loans, would end up being too low? Do you think we could see more volume coming through HARP 2.0?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Yes. I mean that's the real - that's the $64,000 question. I think the real - I don't think we really know for sure until we see what comes out on the 15th. What they've come out with is clearly geared towards getting people through the process, but the big wild card is what kind of rep and warranty relief are provided to the banks and what kind of incentives the banks are going to have to get as many borrowers they can.

The other issue as you know is the whole mortgage insurance issue in terms of whether that's portable to new loans and what happens if somebody - if you refinance a loan with another originator. So, I think until we see those details, we're not going to really know for sure. If there's substantial rep and warranty relief, I think that number could be low because it's in the bank's best interest to get as many guides as they can.

Bose George - *Keefe, Bruyette & Woods - Analyst*

That makes sense. Do you think the risk is to the upside that --

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William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Well, no. I would just say that if the rep and warranty relief isn't substantial, then the risk could be to the downside. I mean it could go either way. That's our opinion.

Bose George - *Keefe, Bruyette & Woods - Analyst*

Okay. Well, that makes sense. Thanks.

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

Thanks, Bose.

Operator

Thank you. Our next question comes from Douglas Harter of Credit Suisse. Your line is open.

Douglas Harter - *Credit Suisse Securities, LLC - Analyst*

Thanks. Good morning.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Hey Doug.

Douglas Harter. Hey. You are talking about the fact that you have the capacity to add more non-Agency. Can you sort of talk about sort of how you're thinking about it and your kind of thoughts as to take advantage of further opportunities in the Sub-Prime space?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Yes. I mean we're - as you can tell, we're fully deployed from our capital raise. So, any future opportunity that we took advantage of whether it was on the non--Agency side or on the Agency side, as we know there's decent volatility there. It would be partly due to reinvesting cash flows that we get every month or something we think is extremely worthwhile we could reallocate capital.

We're in the markets every day. We're looking at valuations. We're looking at trades. We're looking at where offerings are, and we make those decisions sort of as we go. So, I can't tell you there's this master plan when we walk out of this room today.

Douglas Harter - *Credit Suisse Securities, LLC - Analyst*

All right. That's helpful. Then I guess just sort of on the hedging side, so you said you mentioned you saw the large book of swaptions, are you thinking about sort of incremental hedges today or are you thinking more plain vanilla swaps? Or would you still be adding new swaptions if you had to replace anything.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Well, yes. I mentioned in my remarks that we had added a decent amount of swaps in the two to four--year part of the curve. I mean REITs at one point had gotten so low that to us, it just seemed like the odds of going much lower were not likely.

Optional protection is particularly valuable, as you can imagine the higher rates are. And the lower rates are, the less of it you need. So, if you look at - the thing you have to look at is our premium at risk. It's not so much the notional amount of the swaptions that you have, but it's how much money you have at risk there. So, to the extent the volatility is cheap and we think that there's - it's worthwhile to add than we might to do so. But certainly the lower rates are the less optional protection we need.

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

Yes, Doug. The team has done a really good job in respect to managing interest rate exposure. So, if you look at sort of the belly of the curve of our exposure of the two to four year, rates got so low that the price action just seem to us to be asymmetric, the risk being one way and so, and so in that sense it made sense to shift for more optional protection to more plain vanilla swaps.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

In our average pay rates, roughly 1%.

Douglas Harter - *Credit Suisse Securities, LLC - Analyst*

And what's the average duration?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

There's actually - there's a slide that - we try to give you, guys, better information on that. There's a slide in the appendix. It's 2.8 years.

Douglas Harter - *Credit Suisse Securities, LLC - Analyst*

Great. Thank you.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Sure.

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

Thanks, Doug.

Operator

Thank you. Our next question comes from Joel Houck from Wells Fargo. Your line is open.

Joel Houck - *Wells Fargo - Analyst*

Thanks and good morning, everybody. In looking at the - just back on slide 12 and your comments about how the non-Agency, particularly sub-prime, has underperformed for quite a period of time, can you kind of remind us of what your home price depreciation and assumptions are in your underwriting right now at your sub-prime book?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Sure. Our base assumption is that home prices on a national basis, and it's obviously going to vary by regions, but just on average, declines 10% over the next 12 months. When we analyze funds, we also make assumptions that are more severe than that. So, that affects the total defaults as well as the severities that are outputs from those assumptions.

Joel Houck - *Wells Fargo - Analyst*

Right.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

In general, to give you an idea, if we look at the sub--prime bond, it's got 30% or 40% of the pool is delinquent. We'll generally assume 80% or more default. So, everybody that is delinquent plus another 40% or 50%.

Joel Houck - *Wells Fargo - Analyst*

OK. And what does that translate in terms of IRR under that scenario?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Well, when I talk about expected loss adjusted yields of 10%?

Joel Houck - *Wells Fargo - Analyst*

Yes. Is that the same thing?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

That's correct.

Joel Houck - *Wells Fargo - Analyst*

Okay, great. Thank you very much.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Sure.

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

Thanks, Joel.

Operator

Thank you. Our next question comes from David Walrod from Ladenburg. Your line is open.

David Walrod - *Ladenburg Thalmann & Co. - Analyst*

Good morning. You got on your income statement now this other-than-temporary impairment losses. Can you guys describe what's going on there? And had that been falling through different parts of income statement in the past?

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

Sure. We're going to have Brad Farrell address that for you.

Brad Farrell - *Two Harbors Investment Corp. - Controller*

Hi, David.

David Walrod - *Ladenburg Thalmann & Co. - Analyst*

Hi.

Brad Farrell - *Two Harbors Investment Corp. - Controller*

Yes. This is the same line as it's been. Last quarter was the first time we had any bonds that we an OTTI on. It's a very small number. So, this quarter, we just have few more bonds, I think in total it's eight bonds. Just a normal course, the assumptions around either credit loss or severity has performed worse than we'd expected. Just a normal course of business, we would expect some sort of this activity across our portfolio. So, we had a pretty clean slate-up until last quarter. We would expect a fairly nominal amount like this coming through each quarter going forward to this line.

David Walrod - *Ladenburg Thalmann & Co. - Analyst*

Okay. And then when you're calculating your adjusted GAAP number, are these losses included there or are they excluded?

Brad Farrell - *Two Harbors Investment Corp. - Controller*

They are included.

David Walrod - *Ladenburg Thalmann & Co. - Analyst*

They are included, okay, good.

Brad Farrell - *Two Harbors Investment Corp. - Controller*

So, for Adjusted GAAP, the only thing we back out of there is the swap and swaption unrealized portions.

David Walrod - *Ladenburg Thalmann & Co. - Analyst*

OK, good. And then just a couple of housekeeping, you commented briefly in the beginning of your prepared remarks about the share buyback. Was that utilized at all to date?

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

It's Tom again. We have repurchased no shares to this point.

David Walrod - *Ladenburg Thalmann & Co. - Analyst*

Okay. And then, I believe you mentioned the equity allocation right now is 55% Agency, 45% non-Agency. Is that right?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

That's correct.

David Walrod - *Ladenburg Thalmann & Co. - Analyst*

Given your commentary with the attractiveness of the non--Agency space, do you have a target for how that will look going forward?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

We don't actually have a specific target. I think I might have mentioned that we sort of evaluate opportunities on a daily basis. So, as we get monthly cash flows, which are from principal and interest or if there's something particularly special that we deem appropriate to sell something to buy something else, you know, we're constantly evaluating that. No specific target at this point.

David Walrod - *Ladenburg Thalmann & Co. - Analyst*

But probably going to continue to drift more towards the non-Agency.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Potentially.

David Walrod - *Ladenburg Thalmann & Co. - Analyst*

Okay, all right. Thank you.

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

Thanks, David.

Operator

Thank you. Our next question is a follow--up from Mark DeVries from Barclays Capital. Your line is open.

Mark DeVries - *Barclays Capital - Analyst*

Yes, thanks. Understanding that it would be kind of pretty insignificant contributor in the near term, you know, the securitization effort, we're hearing that there's decent chance that Congress is going to roll back the high loan limits to $729,000. What are your thoughts and kind of what the implications would be that for your jumbo securitization effort?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Yes. Sure, Mark. Yes, that's obviously the - you know, the Senate is in favor of that and the House will be weighing in on that at some point here in the near future. The actual - obviously, it would reduce somewhat the amount of loans that would be available for us or anyone else who's looking at the prime jumbo space. But it's actually not that big of a number. It's less than 3% of the total production in terms of monthly production.

So, it's not a big number, but certainly it's going the wrong way at least in terms of that program. So, it would be a minor impact, it would not be a major impact.

Mark DeVries - *Barclays Capital - Analyst*

Okay, thanks.

THOMSON REUTERS

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

Thanks, Mark.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Thanks, Mark.

Operator

Thank you. Our next question comes from Boris Pialloux from National Securities. Your line is open.

Boris Pialloux - *National Securities - Analyst*

Hi, thanks for taking for my taking question. I also have a question regarding the securitization program and also your CDS portfolio. The first thing is about your securitization program, what type of leverage here are you trying to get with this securitization program? And second is about your CDS book, do you still have CDS on your books?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Yes. So, the first question about the securitization program. The way that works just generally is you're taking given pool of mortgage loans and you create AAA securities which are roughly 90% to 92%-93% of the capital structure which are then sold. And the subordinate tranches are the remaining. So, for $100 of loans, you might retain somewhere in that 7% of the capital structure. So, from that standpoint - and those would be subordinate bonds. There's also an IO tranche that's thrown off, and we can go into this in more detail if you like offline, but you can think of it in terms of just retaining the bottom credit pieces.

In terms of our hedges which include TBAs and CDS positions, we continually assess the marketplace for opportunities that might benefit the portfolio whether it's in any of these derivative type instruments. There'll be more detail on the 10Q in terms of positions and our derivatives. Just so understand, that's not typically a core part of our business, but can benefit us from time to time.

Operator

Thank you. Our next question comes from Jim Fowler from Harvest Capital. Your line is open.

James Fowler - *Harvest Capital - Analyst*

Good morning, Bill. Quick question from page 18 in your slide deck, the WAA on you IO and inverse IO is 65 months. I wonder if you just might comment on how you believe that position is specifically protected from HARP 2.0. Thanks.

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Okay. Thanks, Jim. Good morning. Yeah, I mean we don't break out the detailed holdings of the different buckets. We're just trying to get sort of an overall. You know, in some cases, we own IOs that - frankly, they're not in the HARP zone, but they might be better borrowers, who when rates go up would clearly not refinance and when rates go down, will have the opportunity too.

So, those might be newer. And in some cases, they're extremely seasoned, in which case, we don't think that they're likely to refinance or go through HARP at all. The 65 WAA, you shouldn't think of that as all the pools are 65 WAA. I mean that's everything from new to super seasoned. And we've done extensive analysis on what we owned and what the potential impacts not only from HARP might be but also from just traditional refinancing.

Operator

Thank you. Our next question comes from Jay McCanless from Guggenheim. Your line is open.

Jay McCanless - *Guggenheim Securities, LLC - Analyst*

Hey, good morning, everyone. Thanks for taking my questions. I've got two of them. The first one is a technical kind of accounting question. With the use of swaptions for so much of your hedge portfolio versus just outright swaps, is there any difference in the accounting for unrealized gains or losses? And is it minimized because you all use swaptions? Or is it no different on whether you held actual swaps versus the swaptions?

Brad Farrell - *Two Harbors Investment Corp. - Controller*

Great question. This is Brad. Because we don't do cash flow hedge accounting for our swaps, we let the unrealized gains or losses flow through the P&L. So, in that case, our swaps and swaptions are treated the exact same as far as unrealized market price movement. So, I think that kind of directly answers your question.

Jay McCanless - *Guggenheim Securities, LLC - Analyst*

Okay, great. And then my second question is I'm trying to reconcile your commentary on where you expect home prices to go and then your, apparent to me, bullishness on the sub-prime market. Given that prices most likely are in the decline next year for housing, what's the point right now of being more aggressive in the sub-prime space rather than buying back your stock at below book value right now?

William Roth - *Two Harbors Investment Corp. - Co--Chief Investment Officer*

Also, there's kind of two questions in there. The first is with regard - being involved in non-Agencies, and then the second, I'll let Tom discuss any buyback related question.

So, if you look at - I kind of mentioned this a little bit earlier, but if you think about sub-prime pools and their fundamental performance, many of the pools that are out there, there's borrower who is just not going to make it, and that accounts for the substantial amount of delinquency, 30%, 40%, whatever the number is.

The remaining 50% or 60% of the guys are paying. And these have been modified or they were able to pay all along. And so, typically, people - every month that a guy pays again, the probability of them continuing to pay goes up. And if you look it fundamentally in non-Agency, statistics are actually better than they were six months ago, 12 months ago, et cetera.

You can continue to assume that the bad borrowers are going to go away. So, even if housing does decline from here, assuming it's not catastrophic, that's already built in to the analysis. So, the yields that we expect to get are based on that forward path of housing prices as well defaults playing out. I mean it could be better than that, it could be worse than that, but we're - the thing that's nice about defaulting so many of the borrowers is you're not counting on them and paying you back. So, on the buyback, I'll let Tom address that.

THOMSON REUTERS

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

Sure. In respect to this stock buyback, we just don't -- we want to be noncommittal around the metrics and how we think about those. You know, Bill and I are a couple of old war horses, that if you put yourself in a box that the market rarely allows you to get out of the box. So, we'd like to be flexible and opportunistic in how we think about that and about how we enact any stock repurchase.

Operator

Thank you. There are no further questions in the queue. I would like to turn the call back to Tom Siering for concluding remarks.

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

Thanks, Mary. Before we go, I would like to reflect for a moment on the past two years. We launched Two Harbors on October 29, 2009, just two years ago, and we started our operations with a book value of $9.30 per share and a market capitalization of $124 million.

Since that date, we have increased the market capitalization of Two Harbors more than [10--fold] of $1.3 billion. More importantly, stockholders who have been with us from the start received $2.94 per share in dividend, yet our book value remains unchanged with $9.30 per share on September 30, 2011.

Additionally, we have substantially reduced our expense rations and greatly increased liquidity of our shares. As we say, past performance is no guarantee of future results, but we look forward to continuing our efforts to provide stockholders with solid risk adjustment returns. With that, we'll sign off. Have a great day.

Operator

Ladies and gentlemen, this concludes our conference for today, you may all disconnect, and thank you for participating.