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TWO - Q1 2012 Two Harbors Investment Corp Earnings Conference Call

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PRESENTATION

Operator

Good morning, my name is Mary and I will be your conference facilitator. At this time, I would like to welcome everyone to Two Harbors First Quarter 2012 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 like to turn the call over to Christine Battist, Managing Director for Two Harbors.

Christine Battist - *Two Harbors Investment - Managing Director*

Thank you, Mary, and good morning. Welcome to Two Harbors First Quarter 2012 Financial Results Conference Call. With me this morning are Tom Siering, President and Chief Executive Officer; Brad Farrell, Chief Financial Officer; and, Bill Roth, Co-Chief Investment Officer.

After my introductory comments, Tom will provide some insights into the current macro environment and potential impact to our strategy. Then, Brad will highlight some key items from our financial results and Bill will review our portfolio performance, provide an update on the deployment of capital from our recent public offerings and discuss the market outlook.

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 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 encourage you to reference the accompanying presentation to this call, which can also be found on our website. This quarter we added the press release tables in downloadable excel format to our website as well.

Before management begins its discussion of its first 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 words such as anticipates, target, except, 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 statement if later events prove them to be inaccurate.

I will now turn the call over to Tom.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Thanks, Christine. Good morning and thank you to everyone for joining us today. Please turn to slide three. I'm proud to report that we had truly exceptional performance this quarter, delivering a record 11.5% in total return as we recorded comprehensive income of $1.05 per share. As impressive is our total stockholder return of 57% since we commenced operations in October 2009. Our book value increased $0.64 to $9.67 per share during the period due primarily to appreciation in our non-agency holdings.

Finally, core earnings of $0.34 per share were in line with our internal estimates as we set the first quarter dividend. While the timing of our capital raises did cause core earnings to come in lower than prior quarters, our offerings enabled us to purchase securities that greatly enhance book value and the Company's earning power. We feel this minor near term trade off for longer term benefits is terrific for our shareholders. Brad will do a deeper dive into our results in a few moments.

We raised nearly $700 million in net proceeds from two public offerings this quarter. We are pleased to report that those proceeds are now fully invested. We focused on the non-agency sector for deploying capital from the January offering and a more diversified mix for the February offering. Bill will provide more specific detail on these deployments during his comments. We appreciate the market's confidence in us related to these offerings and believe our shareholders benefit from increased stock liquidity, scale and lower expense ratios. We also advanced a new strategic initiative, which I'll discuss shortly.

Next, I'd like to share some insights on key macro economic factors that could impact our business in the mortgage and housing sectors as summarized on slide four. Three critical factors in our view include employment data, interest rates and home prices. This decade has demonstrated an undeniable correlation between these metrics. Home price performance is meaningful both to our non-agency portfolio, but also in regard to our announced strategy of buying single family residential properties.

Let's start with the first factor, employment. Let's face it, it's been tough for many since losing their jobs post the 2008 economic crisis. A steady income is necessary to be eligible to refinance or purchase a home and, in most cases, essential to making a monthly mortgage payment on an existing loan. Current employment trends are positive, but erratic. Next to loan-to-value, employment is the next most meaningful determinant of probability of default on a mortgage.

A second factor that impacts our business is interest rates. Interest rates dictate funding costs as well as influence prepayment speeds on our agency portfolio. As you are aware, the Fed stated that it anticipates the target federal funds rate low until at least late 2014. We believe this will benefit financing costs for the next few years. Generally, low interest rates, all other things being equal, will stimulate refinancing and home purchases. As Bill will share in greater detail, we look to position our agency portfolio with securities that have embedded prepayment protection.

A third factor that influenced our business is home prices. We are all well aware that the US housing market has not yet recovered from the 2008 meltdown with declines on average in the mid 30% range. This has left some homeowners with high loan to value ratios, limiting the refi ability, despite lower rates and government policy programs. Others may wish to move or locate but cannot because they will incur a substantial loss on their home. Today, home affordability is at an all time high.

While concerns remain on the macro front, we see opportunity for our business. The US housing and mortgage markets are going through a prolonged period of stress and change. The confluence of several factors has resulted in a high inventory of foreclosed homes held by the government and banks. As a result, there's a great need for new sources of capital in this key sector of the American economy and mortgage REITS, like Two Harbors, can play a key role in the restructuring and rejuvenation of these markets.

Despite all the uncertainty, we are starting to see stabilization of home prices. This is encouraging for our non-agency book, and provides a perfect segue into wrapping up my comments with some update on a business diversification efforts that we outlined during our last call.

Please turn to slide five. We made significant progress purchasing single family residential properties, including establishing the necessary infrastructure to purchase, own and manage the properties.

As you see from our balance sheet, we acquired $6 million in properties during the first quarter, and we more than quadrupled our holdings, subject to closing to over 300 homes since quarter end. We are targeting properties at significant discounts to replacement costs and are working to create scale in selected markets. We plan to hold these properties for investment and rent them for income, and we believe there is potential for increased rents over time.

We believe this is an attractive asset class, given its long duration, financeability, current yield and the potential for home price appreciation. We have often stated that any business diversification for Two Harbors must be logical and incremental. One of our strengths lies in data analysis, and we believe property selection will be key, similar to how we think about security selection. How big this becomes in our portfolio will depend upon two factors; available supply and its expected economic return in comparison to other available alternatives.

The formation of Pine Rivers affiliate, Silver Bay, creates the opportunity to bring in institutional excellence to this sector, which here to fore has largely been a cottage industry. Near term, we expect this business to have little or no impact on our dividend. In respect of our asset securitization program, we have purchased a few loans but have yet to do a deal. The credit component that is available via securitization in the current environment simply has not competed well against non-agency yields.

We will be opportunistic, yet patient, because the economics must make sense. This is something we monitor constantly. Optimization of shareholder value is our highest objective. While this was a fantastic order from our investment team, we were even more enthusiastic as we look ahead. We'll take a measured approach as we diversify building upon core competencies for the benefit of our stockholders.

Brad, I will now turn the call to you.

Brad Farrell - *Two Harbors Investment - Chief Financial Officer*

Thank you, Tom. I'd like to focus on three topics this morning. I'll start with some highlights from the quarter, comment on our book value and wrap up with some financial and accounting insights on our business diversification into residential properties.

Let's move to the financial summary on slide six. Core earnings at $0.34, represent a 14.5% return on average equity. As discussed last earnings call, core earnings is largely a function of our portfolio size, our investment spread and our expense management. This quarter, core earnings was also impacted by our deployment of proceeds, as we took advantage of investment opportunities in the marketplace and grew our portfolio by $3 billion as a result of two accretive common stock offerings.

We recognize that it can be challenging for investors and analysts to estimate the timing of capital deployment and the impact on earnings from these offerings. What I can share with you is that our deployment time periods were consistent with our target of one to two months, and core earnings were in line with our expectations and the estimates we utilize for our first quarter dividend.

Our investment spreads were consistent with a quarter ago, and our operating expense ratio as a percent of average equity, trended down slightly. This was a function of the higher equity base from the capital raised this quarter. In the near term, our operating expense ratio will be dependent on our business diversification initiatives.

GAAP net income for the quarter not only included core earnings, but it was also negatively impacted by other than temporary impairments on our non-agency RMBS and mark-to-market losses in our hedging portfolio, namely swaps which hedge our interest rate exposure and credit default swaps where we received credit protection.

Because the fair value changes in these hedging instruments are recorded in earnings, while the offsetting fair value changes in our RMBS portfolio are in equity, GAAP net income will experience volatility quarter to quarter. This is illustrated in the appendix on slide 13.

Impairment reviews on our non-agency portfolio are critical to our GAAP compliance, and something that I'm intimately involved in reviewing. We perform an extensive impairment analysis on a quarterly basis at the individual security level. This quarter, we had an OTTI adjustment of $4.3 million on 15 bonds. This adjustment is in line with our portfolio growth and continues to represent an insignificant amount to our overall holdings.

For context, $4.3 million represents a 0.5% change in our December 31, 2011 credit reserve of $783 million. We believe that our process is robust and has been consistently applied since our formation.

Beginning this quarter, we will no longer be reporting results on an adjusted GAAP basis. Several quarters ago, we began reporting this non GAAP measure in response to inquiries about our swap accounting and financial statement presentation. As previously noted, we mark our swaps to fair value through the income statement. Since then, several of our peers have adopted accounting treatments similar to ours, and we've expanded our use of other hedge instruments which have made this metric less meaningful to an investor.

Now, let's move to slide seven, which contains sequential quarterly book value roll forwards based on shares at end of period. As Tom noted, our book value per share was $9.67 this quarter, a $0.64 increase on a sequential quarter basis. The key drivers to this increase were portfolio performance, which I've already discussed; the capital raise and the positive impacts of fair value strengthening in both our agency and non-agency strategies.

Finally, I'd like to share some financial and accounting insights on our diversification into single family residential properties. We began purchasing properties this quarter and you will note on our balance sheet, $6.1 million of single family homes classified as investment and real estate. We recorded the purchase price at cost and will depreciate these assets over their estimated remaining life, which will typically be for a 27.5 year period.

Unlike our investment portfolio, we will not record fair value changes on a quarterly basis, rather we will review these assets for impairment on a periodic basis in accordance with GAAP.

We're in the ramping up phase of this business. In future periods we will generate return through rental income. To-date, the income statement impact for this new business has been immaterial, and we do not expect there to be any significant impact to our second quarter dividend from this business. We plan to share more financial metrics in coming months.

Now, I'll turn the call over to Bill.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Thanks, Brad. Two Harbors portfolio delivered another quarter of outstanding returns, as you can see from the highlights on slide eight. As Tom mentioned, our total return for the quarter was 11.5%. This was driven by strong underlying performance, as well as unrealized gains from both agency and non-agency of $32 million and $112 million respectively. Our portfolio grew by over $3 billion, as we fully deployed capital from our two raises. We also increased our allocation to non agencies due to the compelling values we saw in that sector in the first quarter.

The chart on the bottom left shows our portfolio metrics by strategy. Our asset yield for the quarter was 4.9% and our aggregate net interest margin was 3.9%, ten basis points higher than a quarter ago and slightly above our expectations. This yield in net interest spread, combined with our leverage provided an attractive investment ROE for the quarter.

As you can see, our overall funding costs, including hedges was consistent with a quarter ago at 1%. Our agency spread expanded as the cost of hedging declined, leading to a 2.8% net interest spread up from 2.6%. Our non-agency strategy delivered an annualized yield of 9.7% and a NIM of 7.4%, in line with the prior quarter. We are very pleased with the performance of both sectors of our business this quarter.

On the bottom right of this slide, we've included some metrics to compare to our performance. A simple duration hedged agency strategy would have had a return of less than 1%, while credit returns would have been closer to 11%. As a reminder, ABX is a proxy for the subprime market, but does not necessarily mirror cash bond performance.

Form this table, you can see that the simple strategy of 50% agency and 50% non-agency subprime would have generated a return of 5.6% for the quarter. While our capital mix is not quite 50/50, we believe that our returns compare quite favorably versus these indices for the quarter.

Please turn to slide nine. Our portfolio has grown to $7.5 billion in agency securities, including inverse IOs and $1.9 billion in non-agency or about a 80/20 asset split, comparable to last quarter. The portfolio composition was relatively consistent in mix and types of securities as well. We continue to emphasize agency securities with prepayment protection and subprime bonds for our non-agency portfolio.

During the quarter, we added approximately $700 million in subprime bonds, increasing our allocation to 84% of our non-agency portfolio. These senior and mezzanine bonds were a key driver in our nearly 10% yield on non-agencies for the past three quarters.

On the agency side, we focused heavily on prepaid protected assets for our capital deployment, particularly on high LTV pools. These pools are typically 100% refinanced loans that have come through the HARP program. We believe it is unlikely that these borrowers will refi again anytime soon. While we still highly favor low loan balance, HECM, and multifamily pools, all of which we added to in the first quarter, for many of our new purchases, the prices of high LTV pools provided a more compelling value. The appendix includes some additional slides on both our agency and non-agency holdings that you may find useful.

As capital allocation is a key component of Two Harbors strategy, we have charted our historical capital allocation in the upper right hand corner of this slide. Our goal is to allocate capital to those sectors we believe have the best risk adjusted return, and we believe that our agility in adjusting our capital allocation to the best opportunities and keen focus on securities election continue to be a key factor in our performance.

As you can see, our non-agency capital allocations shifted upward slightly in the first quarter to 48%. This is a direct result of our focus on the non-agency sector as we were deploying capital from our recent public offerings. Given current valuations and opportunities in the market, you can expect our capital allocation to remain reasonably consistent in the near term.

Turning to slide 10, we are very pleased with our overall portfolio metrics and risk profile. On the prepayment front, for the first quarter our agency CPR declined to 5.2% from 5.6% in the fourth quarter. This result is particularly compelling given the generally high prepayments realized in the agency market this past quarter. While prepayments in 2012 will likely pick up due to both the lower rate environment and from the influence of policy initiatives, we believe that we have selected securities that are unlikely to experience a significant increase in prepayments.

Our aggregate portfolio had a debt-to-equity ratio of 3.7 to one for the first quarter. This is slightly lower than our historical averages, due to the timing of the capital deployment of our 2012 stock offering. We estimate our post deployment leverage in the range of four to four and a half times. Our capital allocation figures are based on applying leverage in the range of six to seven times for agency and one to one and a half time for non-agency, which is consistent with our approach since Two Harbors was formed.

We continue to maintain a low level of interest rate exposure in our agency portfolio. As of quarter end, we estimate a less than 1% impact on our equity for an up 100 basis point move in rates. This is down from a 2.3% exposure at December 31. Our average pay rate on swaps as of quarter end was down slightly from a quarter ago to 85 basis points. Given the low rate environment, we increased our protection against higher rates, particularly through the use of longer dated swaptions. More details on our swap and swaptions are included in the appendix.

Please note in particular, the swaption months to expiration and the underlying swap tenors as evidence of the protection we carry.

On the financing side, as we have discussed on previous calls, we continue to believe that a laddered approach to financing with a focus on longer dated repos provides stability to our funding. At March 31st, the weighted average days to maturity on our RMBS repo borrowings was 80 days. This is a new metric we will be sharing with you on a go forward basis. Additionally, 38% of our non-agency repos were for terms of over 90 days. More financing details are in the appendix.

I would like to wrap up this morning with some comments on the market. Interest rates remain low, which is favorable for repo, funding and hedging costs. The repo market also remains quite liquid for funding our type of assets. It appears that funding rates will remain low for the next few years, although that is certainly subject to change. Mortgage spreads have been volatile for the past few years, which has to for the ability to deploy capital opportunistically.

Currently, spreads are reasonably attractive from a long term historic perspective, but not as interesting as has been available in certain times in recent years. More importantly, we believe that as a result of the drain of capital that has occurred form the agency mortgage space, attractive returns over time will be available for those who have capital to deploy.

On the non-agency side, the market seems to be in much better technical shape recently, given the successful sales and distribution of the Maiden Lane II asset. We also know, however, that distressed markets can be fickle and subject to rapid change. Further, there is certainly the possibility of more distress sales occurring, but it does seem today that there is a better balance of buyers and sellers. For instance, while it is unclear how Maiden Lane III will play out, there's certainly a great deal of focus by the buy side and dealer community on that process.

More importantly than the technicals, the fundamental backdrop has been improving. The housing market seems to be stabilizing somewhat, especially in the $50,000 to $200,000 price range. New delinquencies have continued to decline. Employment continues to grow, albeit slowly, and home affordability, as Tom mentioned, is very high.

Further, both servicer and policy actions are aiming to help borrowers through various means. We believe that this landscape bodes well for assets with exposure to this sector of the housing market, particularly distressed subprime RMBS. Strategically, we aim to take advantage of the price volatility that can occur in these markets, and our approach is to purchase assets that we believe will perform well over time.

To conclude, we are pleased with our performance, our current capital allocation and overall portfolio positioning, and we will continue to be opportunistic in the market to find the best investments to generate value in returns for our stockholders.

I will now turn the call back over to the operator.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

And our first question comes from Bose George from KBW, your line is open.

Bose George - *KBW - Analyst*

Guys, good morning. Actually I wanted to start just with a question on spreads on the capital that you guys deployed since quarter end. I was just curious where that was relative to your portfolio spreads.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Hey, Bose. Good morning. Thanks for joining us. I think the best way to answer that is to look in the appendix on slide -- I believe it is 15. You'll see the metrics where we showed the yields that we expect on our assets on a spread at March 31. And if you think about it, that's on the entirety of the whole portfolio, which includes everything we had before -- before the capital raises, and then also everything that we had deployed up until that date.

So given that our portfolio is roughly $10 billion, I think that's really, frankly, a good indication of the bulk of what you should expect to see.

Bose George - *KBW - Analyst*

Okay, perfect. And then just to follow up on your comment on Maiden Lane III. Is there anything in there that you guys might like or is that sort of different asset types generally?

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Yes, so Maiden Lane III -- and there's some on the call that might not know, this is another segment that the Fed had set up for some of these assets. The bulk of the assets in there are CDOs of some sort. Now, there are some that are not, but the bulk of them are CDOs. Many of them are backed by commercial real estate bonds. There's certainly some that are backed by non-agency residential bonds.

So it's possible that we could consider something like that, but clearly it would have to meet all the tests that any other asset that would. So the first thing would be is it in our wheelhouse, which the residential could be. And then second, is a question of price and the quality of the assets that are there.

Bose George - *KBW - Analyst*

Okay, great. And then just one last thing on this residential -- the REO property questions you guys are doing. Two things, one is just a logistics of the property management stuff. How does that happen? And then are these unlevered investments and what kind of returns are you targeting?

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Sure, good morning Bose, its Tom. In respect to the REO, we've set up --Pine River has set up an affiliate called Silver Bay, which will be responsible for purchasing and managing the properties, and will charge Two Harbors a market or below market rate for those services.

In respect to the return profile that we see, there's been a lot of research published on this. For instance, Morgan Stanley's published quite extensively. And I might refer you to some of that if -- which suggests returns in the 10% to 20% range on an all in basis -- on an unlevered basis. And in respect of how we think about levering these, they finance obviously quite well within Two Harbors today as part of our overall financing availability.

I hope that answers all your questions.

Bose George - *KBW - Analyst*

I mean in terms of the financing, I mean is it just specifically the -- I mean, what is the financing for those properties?

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Well, obviously, we can use the financing of our entire portfolio. But keep in mind that the amounts that we own and -- is quite small. Today, as I've mentioned, we've quadrupled our holdings, so you can think about that as being in the high 20s to say $30 million. Obviously, within the context of our portfolio that's still quite small.

Bose George - *KBW - Analyst*

Right, right. Okay, that makes sense. Thanks a lot.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Thank you, Bose.

Operator

Thank you, our next question comes from Douglas Harter from Credit Suisse, your line is open.

Douglas Harter - *Credit Suisse - Analyst*

Thanks. Was hoping, Bill, you could just touch a little bit more about your comment about where you saw spreads today. Were you talking specifically about agency, non-agency as being sort of less attractive than some of the recent past?

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Sure. Hey, good morning, Doug. The -- yes, so just to give you an idea, the -- in the sector of the non-agency, let me just start there. The sector in non-agency that we typically prefer is obviously subprime. And those bonds today are sort of anywhere in the seven to eight and change plus yields on a loss adjusted basis. So, in the construct of the fixed income market and available investment opportunities, that's certainly still very attractive. Clearly, it's not as attractive as when we put money to work earlier in the quarter, but that's sort of where that sector currently is trading.

On the agency side, spreads are sort of attractive on a long term basis, but not as attractive as they have been earlier. So we think returns are still sort of mid teens-ish on an ROE basis and that's something that can be reasonably volatile. So, you can get some spread moves or curve shaped moves that can actually make that much more interesting from time to time.

Douglas Harter - *Credit Suisse - Analyst*

Great. And then can you just talk a little bit about what is the sort of the volume of activity in the non-agency space right now? How liquid is that market today?

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Yes, I mean volumes -- during the first quarter volumes were extremely high, especially around the large sales that took place. And then, follow on volume was actually quite high. Recently, and I say that meaning like in the last few weeks, that's been a little bit less. But part of that was because there was a huge amount of focus on the first Maiden Lane III auctions.

The -- anytime you have large amounts of securities that are coming to market like that, the market tends to focus on those. So if you look at like a given day it might be light, but if you look over the course of several weeks, the volumes are still actually quite high.

Douglas Harter - *Credit Suisse - Analyst*

Great. Thank you, Bill.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Liquidity is completely fine.

Douglas Harter - *Credit Suisse - Analyst*

Thank you, Bill.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Thanks, Doug, for the question, Mary?

Operator

Thank you, our next question comes from Mark DeVries from Barclays. Your line is open.

Mark DeVries - *Barclays - Analyst*

Yes, good morning. Could you give us your thoughts on potentially locking in some of the gains on your prepaid protected agency securities? One of your peers alluded to that in their press release that that's something they did.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Yes, well, you think -- the way that we think about -- and I made this comment earlier, markets are -- can be volatile and non-agency prices you've certainly seen they go up, they go down and the same has happened on -- the same happens on agency -- on the agency side as well. And we've seen pay ups -- I actually alluded to that in my comments, that some of the pay ups has actually gone up quite a bit.

So the question then is, are we looking at this as something we're going to hold over a long period of time and earn the returns from, or are we going to try and trade it around or swap it into something that's more attractive? And we're constantly looking at whether what we own is worth holding or if there's something else that's more attractive.

You may recall that last year we sold a substantial amount of agency bonds in the third quarter, specifically because they got to prices that didn't make sense for us to hold. So we're certainly willing and able and happy to do that, but we -- we haven't done that. We didn't do anything of that sort in the first quarter, and as I mentioned on the call, we're very happy with what we own today, but we're constantly monitoring the market for opportunity.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Sure, and the second thing is true, obviously on the non-agency side, non-agency prices continue to appreciate during the month of April, albeit, much more modestly than they did in the first quarter. So Bill and the team have done a really good job of moving allocations around. For instance, our non-agency exposure has ranged anywhere from on a -- how we think about it on a risk basis from the mid 30s to the mid 60s. And so, the team is always looking at the market and so that applies both to agency and non-agency.

Mark DeVries - *Barclays - Analyst*

Okay. And have those prepaid protected securities rallied so much that they're become a little less attractive on a relative basis than other securities, and therefore those kind of mid teens returns that you alluded to are -- maybe have a little bit less predictability in the cash flows than what you were seeing a few months ago?

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Well, yes, I mean look, pay ups have gone up but there's a good reason for that, right? If you look at a pool that's paying at five and you look at a pool that -- if you buy TBAs, you're going to get the worst deliverable pool. You won't get the average, you'll get the worst. So you could get a pool that's paying at 50 CPR. The difference between five and 50 is almost 50%, so if you have a bond that's 106, that's worth three points the first year. Right?

Six points times a 50% differential in pay down. So the reality is that, yes, pay ups have gone up, but I think it's really frankly justified given the environment we're in. So, it's really a question of which -- which securities that offer the best value. And just because pay ups have gone up doesn't mean that they're unattractive.

I mean keep in mind, it's not 100% of our portfolio. Right? We own HECM bonds -- are almost 20%. We own multifamily bonds. So we have a very diverse group of holdings and, frankly, are very comfortable with the predictability of the cash flows on the specified pools that we own.

Mark DeVries - *Barclays - Analyst*

Okay --

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Yes, this gets back -- Mark, this gets back a little to Doug's question too. Keep in mind, given the accounting conventions to which we must comply that what we own is much more important in determining our ability to generate a dividend than what our current spreads are.

Mark DeVries - *Barclays - Analyst*

Got it. Got it. And Bill, any more color you can provide on kind of what the supply outlook is in the non-agency in the near term?

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

The visibility of that can be challenging frankly, because we know that what the Fed's process has been, they were sellers and then they weren't sellers for a long time and then they sold -- successfully sold a bunch of stuff and now Maiden Lane III is out there and we can't really predict how that will play out.

But it appears that irrespective of that, there's probably going to be continual supply, although not on a very large and chunky basis, it probably comes out from banks who are looking at risk weighted assets and would like to sell this stuff over time. So, I think you're going to see continued supply. It's unlikely to be super chunky, at least given current market levels, but it's very hard to predict on a moment by month basis what kind of supply we might see.

Mark DeVries - *Barclays - Analyst*

Okay, thanks.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Thanks, Mark.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Thanks, Mark.

Operator

Thank you. Our next question comes from Amit Agrawal from Wells Fargo, your line is open.

Amit Agrawal - *Wells Fargo - Analyst*

Hi, good morning. You mentioned early a little bit about HPA, can you give us a little bit of color on what your thoughts are on that going forward?

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Sure, Bill, do you want to address that?

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Yes, I mean sure. Happy to. Got to put on the little economist hat here, which I'm not qualified to do, so just assume that it doesn't fit very well, but I'll take a stab at it. What we're seeing in the various geographies that we examined, which is obviously the ones where most of our loans in the securities are is we're actually seeing reasonably good stabilization at the low end, and there's a good reason for that.

If you think about $100,000 house, and you think about where mortgage rates are. It's very, very inexpensive for the median homebuyer. It's very affordable for them to purchase that house. Now what we've seen is we've seen challenges because of the ability to come up with the appropriate amount of down payment. Or, a lot of people have credit problems, which need typically three years to clear before you can -- since a foreclosure, since you can qualify for an agency pool. But, the investor bid at that level is also quite strong because you can rent these houses out and have a decent return as we alluded to.

So, at the lower end of the market, we're typically seeing really very stable pricing, which makes us even more comfortable with our non-agency subprime exposure. I don't think we expect that the market is going to turn around and ramp -- race back up any time soon. There is still decent shadow supply and there is enough absorption that needs to take place, but we're also reasonably comfortable that it's unlikely to see a big downdraft from here. So, I guess we fall probably in the similar range as most, which is we're bouncing along the bottom.

So I hope that -- I hope that's helpful to you.

Amit Agrawal - *Wells Fargo - Analyst*

Okay.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Yes, in fact in a market like Phoenix we're seeing even maybe a modest uptick in prices, obviously up of a very low base, for the reasons that Bill alluded to.

Amit Agrawal - *Wells Fargo - Analyst*

Okay, thank you.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

You bet. Mary?

Operator

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

David Walrod - *Ladenburg - Analyst*

Good morning. I just wanted to follow up on the topic of the residential home buying. You mentioned that it's quadrupled -- the amount you've invested has quadrupled since the end of the quarter, what kind of a ramp rate are you targeting throughout the rest of the year?

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

That's difficult to say because we've seen some variability in various markets due to a number of factors, some of which is government action, some of which is just kind of the cycle of foreclosure waves. So it's really difficult -- its really difficult to say. Obviously, how much we've grown it since quarter end is somewhat instructive in respect of what we're seeing in ramp.

David Walrod - *Ladenburg - Analyst*

You mentioned Phoenix, are there any specific markets that you're targeting or seeing particular opportunities in?

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Yes, we're operating within several markets and all within the sand states and what we're looking for is obviously good economics and the ability to scale. So, I would guess that if you took a stab at what markets those are you probably would come to a good conclusion. But it -- for proprietary reasons, we want to be somewhat limited in what we say on today's call.

David Walrod - *Ladenburg - Analyst*

Understood, thank you.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Thanks, Dave.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Thank you.

Operator

Thank you. (Operator instructions)

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

Boris Pialloux - *National Securities - Analyst*

Yes, thank you for taking my questions. I had like three questions, one is regarding Maiden Lane III. And are you looking more into investing into CDOs? And if not, with Maiden Lane are there like opportunities with let's say French bank selling or European bank selling legacy CDOs.

Second question is about hedging non-agency. Can you do that using the ABX index? And third is, I think you mentioned -- I may have caught that multifamily bonds. So, I'd like to know if it was a case.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Hey, Boris. Good morning.

Boris Pialloux - *National Securities - Analyst*

Morning.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Okay, so the first question, regarding CDOs, to the extent that an asset, whether it's a residential home or a multifamily bond or a CDO is attractive and is our wheelhouse of our core competencies, which is basically our ability to analyze prepayment risk and credit risk, then it's certainly a candidate. With regard to CDOs, we don't have any particular affinity one way or another, but CDOs are somewhat more complicated, as you know, so we would need to make sure that we're in full compliance with the REIT rules and good income, etc. if we were to look at something like that.

On your second question, you may recall from our prior filings and conversations that we do have the ability to do some hedging of credit risks in a taxable REIT subsidiary. And as of the end of prior quarter, as disclosed, we did have both long and short positions in certain CDS, which could include ABX or other potential CDS contracts.

So we do have the ability and have, in the past, done some limited amount of credit hedging. We -- and that will be -- the notional amount of those contracts will be in our Q which is coming out shortly.

And I apologize, I can't remember your third question?

Boris Pialloux - *National Securities - Analyst*

Sorry, I think you responded to a question -- prior question mentioning multifamily bonds. So I was wondering if you were investing in this asset class?

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Absolutely, great question. We have and -- we do and we have. The multifamily bonds that we own are --if you look on slide 19, you will see they're agency -- these are agency only. And they fall under what we call prepayment protected because with your typical agency multifamily bond, the borrower rate is either typically five, seven, 10, 15 year fixed. But with explicit prepayment protection for all but the last six months of the term of the loan. So, while we do invest in multifamily, they're all agency securities.

Boris Pialloux - *National Securities - Analyst*

Would they be like the K series from Freddie Mac, or something like that, or --?

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

It would be yes, Fannie Mae DUS or Freddie Mac K series, that's correct.

Boris Pialloux - *National Securities - Analyst*

Okay. And one point if you're investing in K series, would you -- I mean, would you have to put that in your balance sheet if you own most of the -- I mean, if you invest -- sorry, you don't invest in the equity piece. Am I correct?

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

We haven't disclosed that, but --

Boris Pialloux - *National Securities - Analyst*

Okay, all right.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

-- to the extent that they're agency guaranteed, I'm not -- I don't believe that equity piece is agency guaranteed. If that helps you.

Boris Pialloux - *National Securities - Analyst*

Exactly, yes. Okay, thank you very much. I really appreciate. And I will look forward to the Q.

Bill Roth - *Two Harbors Investment - Co-Chief Investment Officer*

Thanks, Boris.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Thanks, Boris.

Operator

There are no more questions in the queue. I would like to turn the call back to Mr. Siering for concluding comments.

Tom Siering - *Two Harbors Investment - President and Chief Executive Officer*

Thanks, Mary. We hope today has been an informative and instructive. We were happy to share information about our terrific quarter. Thanks for listening, and have a great day.

Operator

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