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TWO - Q2 2012 Two Harbors Investment Corp Earnings Conference Call

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PRESENTATION

Operator

Good morning, my name is Mimi and I will be your conference facilitator. At this time I would like to welcome everyone to Two Harbors' Second Quarter 2012 Financial Results Conference Call. All participants will be on a listen-only mode. After the speaker's remarks, there will be a question-and-answer period.

I would now like to turn over the call to Christine Battist, Managing Director for Two Harbors. You may begin.

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

Thank you, Mimi, and good morning. Welcome to Two Harbors' second 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 stock 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. This call is also 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 its discussion of its second quarter results, we wish to remind you that remarks made 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.

Before we discuss second quarter results, I would like to draw your attention to our recently launched webinar series, beginning with our views on Investing in Sub-Prime. The webinar can be found on our website. We intend to post additional webinars in the future to provide investors and analysts with management insights regarding the market and our business.

I will now turn the call over to Tom who will provide some highlights as summarized on slide three.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks Christine. Good morning, everyone, and thank you for joining our call today.

We had remarkable performance in the second quarter, delivering 6.9% in total return as we recorded comprehensive income of $0.66 per share. We are pleased to report total stockholder return of nearly 79% since our launch in October 2009. Our book value increased $0.27 cents to $9.94 per share during the second quarter. Finally, we generated core earnings of $0.35 per share. Brad will provide additional comments regarding our financials in a few moments.

In mid-July, we completed a public offering raising approximately $592 million in net proceeds. We plan to use these proceeds primarily to purchase Agency bonds, but we will also purchase non-Agency securities when we find them at attractive prices, as well as acquiring single family residential properties. In addition, during the second quarter, we commenced an At-the-Market Offering program, more commonly referred to as an ATM, and sold nearly $78 million worth of additional common stock during the quarter.

Although we are quite early in the quarter, non-Agency prices rallied smartly in July, causing Two Harbor's book value to rise noticeably since June 30th. As a result of this and a flatter yield curve, we believe that yields and net interest spreads on Agency and non- Agency RMBS that are currently available for investment are generally lower than we have historically realized in our portfolio. That said, we believe the opportunity to produce attractive returns for stockholders still exists.

Please turn to slide four. During last quarter's call, I highlighted some insights on the key macroeconomic factors that would impact our business and the mortgage and housing sectors, including home prices, unemployment and interest rates. This quarter I'd like to provide an update based upon the changing macroeconomic landscape and, in light of recent economic data indicating a weakening economic recovery, concerns around the "fiscal cliff" created by potential tax increases and spending cuts at the end of 2012, and continued concerns about Europe as global markets deteriorated in the second quarter.

The European situation is unsettled and it is not clear that a congress of nations with disparate fiscal policies and a common monetary policy is viable. Dissolution of the euro or EU represents a significant risk to global markets. With the November presidential election looming, uncertainties abound and near-term policy changes seem unlikely.

Home price performance is meaningful both to our non-Agency portfolio and to our strategy of buying single family residential properties. Despite uncertainties surrounding the housing market, we are continuing to see signs of stabilization of home prices, and even improvements in certain markets such as Phoenix.

For example, national home prices have risen four consecutive months according to Zillow and are up 0.2% year-over-year as of June 30th. This is the first annual increase since 2007. Importantly, buying single family residential property gives us real-time data on home pricing in key markets, which provides meaningful insights for managing our non- Agency portfolio.

As it relates to interest rates, another key factor that we monitor, it appears that low funding costs will be available for the next few years which is a positive for our business. At the same time, we don' t think it is a good time to be taking interest rate risk, and we believe that our portfolio is structured in such a way that changes to interest rates will currently have a modest impact on our book value.

During the second quarter, weak economic numbers and concerns about global growth led to lower rates, which generally stimulates refinancing activity. To put current interest rates into perspective, US 10-year Treasuries fell to an all-time low in June at a 1.46% yield. As Bill will share in greater detail, we try to position our Agency portfolio with securities that have embedded prepayment protection.

Current unemployment data continues to be stubbornly high and is an ongoing concern. This is a key metric for our portfolio as next to loan-to-value, employment is the most powerful determinant of a homeowner's ongoing likelihood to pay their mortgage.

So while there appears to be a constant stream of uneven economic headlines, we believe there is great opportunity ahead for our business. We believe mortgage REITs like Two Harbors can be key participants in the restructuring and rejuvenation of the housing market as we provide a new source of capital.

Please turn to slide five. We have continued to make progress purchasing single family residential properties. As of June 30th, we had acquired roughly $72 million dollars in properties. Since quarter-end, we have continued to purchase homes. We have added $48 million, amounting to a total portfolio of approximately $120 million through the end of July. We are purchasing in cities where current yields are attractive, discounts to replacement costs exist and absorption metrics are favorable. We are currently invested in eight different markets in Arizona, California, Florida, Nevada and Georgia.

In respect of our asset securitization program, loan production remains muted and our exposure is reflective of that. The government is currently financing over 90% of all mortgages. We will be opportunistic, yet patient, because the economics of this initiative must make sense versus our other investment alternatives.

This was a fantastic quarter for our investment team and we are optimistic as we look ahead. Brad, I'll turn the call over to you now.

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

Thank you, Tom. I'd like to focus on three topics this morning. I'll start with an overview of our earnings and financing, comment on our investment in real estate properties and conclude on our book value.

Let's move to the financial summary on slide six. Core earnings at $0.35 per share represented a 14.3% annualized return on average equity. As a reminder, core earnings is largely a function of our portfolio size, our investment spread and our expense management. I would also add one more item to this mix, which is the cost of hedging our portfolio in an effort to protect book value. I will comment further on this in a moment.

So first let's discuss our portfolio size. On February 24th we completed a public offering of 34.5 million shares for net proceeds of approximately $337 million. Consistent with our expectations and historical experience, we completed the deployment of proceeds within approximately two months. This translates into a deployment completion time frame of late April, and as a result impacted core earnings for the second quarter.

Relative to our investment spread, we saw lower projected yields on securities acquired in recent months driving a marginally lower net interest margin for the quarter. Bill will comment further on today's investing environment. Third, our expense ratio as a percent of average equity remained consistent with the first quarter.

Finally, our hedging strategy which is designed to protect book value, also contributed to lower core earnings as a result of the cost of credit default swaps hedging our non-Agency RMBS and amortization run-off in our interest-only securities, which hedge interest rate risk on our Agency RMBS portfolio. These hedging costs drive lower core earnings while providing protections on our book value.

GAAP net income of $24 million for the quarter not only included core earnings, but was also negatively impacted by other-than-temporary impairments on our non-Agency RMBS and mark-to-market losses in our hedging portfolio, namely losses on swaps which hedged our interest rate exposure and swaptions.

As we have previously discussed, 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 15.

This quarter, we had an OTTI adjustment of $4.5 million. This adjustment is in line with our portfolio growth and continues to represent an immaterial amount relative to our overall holdings.

On the financing front, I am very pleased to report that we have increased our financing counterparties as of June 30th to 23 counterparties, up from 21 at the end of the first quarter. And we have also recently renewed our facility with Wells Fargo. In addition, we took steps to extend our maturity profile, including the addition of long-term repos. Bill will comment further on this.

I would like to add a few accounting based comments associated with our investment in real estate to assist investors. For the quarter, we had a weighted average investment in rental properties of approximately $32 million as compared to our June 30th balance of $71.7 million. This weighted average measure is important on two fronts.

First, it illustrates the immaterial nature of our holdings in the second quarter and its correlated immaterial impact on our income statement. Second, the significant portion of our investment to date has been acquired within the last 30-60 days. This short holding period of our investment illustrates that the cost basis on the balance sheet remains consistent with the fair value of these properties in the marketplace. As such, our stockholders' equity remains consistent with our economic book value as of June 30th.

Now, let's move to slide seven, which contains sequential quarterly book value roll forwards that we believe are meaningful. As Tom noted, our book value per share was $9.94 this quarter, a $0.27 increase relative to book value per share of $9.67 at the end of the first quarter. The key drivers to this increase were the positive impact of fair value strengthening in both our Agency and non-Agency strategies, net of hedges.

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

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

Thanks, Brad. I will begin today with an update on our portfolio, followed by commentary on the market and our outlook. Please turn to slide eight. Our portfolio delivered another quarter of attractive returns. We are quite pleased with our total return on book value for the quarter of 6.9%, which we believe is due to our opportunistic hybrid approach.

Before I move into the results from the quarter, I'd like to touch on the capital raise we completed in July. We are about 40% through deployment, focusing on Agency securities with similar attributes that we have in our June portfolio. We believe the deployment will take approximately one to two months, which means that we expect to finish up around the end of September.

Our results for the second quarter were driven by strong underlying portfolio performance as well as unrealized gains from both Agency and non-Agencies, net of hedges. At Two Harbors, we are focused on delivering an attractive risk-adjusted return as measured by comprehensive income and, as Brad noted earlier, core earnings can sometimes be impacted by the cost of hedging.

On the bottom left side of this slide, we have a chart depicting our portfolio metrics by strategy. Our aggregate asset yield for the quarter was 4.6% and our aggregate net interest spread was 3.6%. Both metrics were slightly lower than last quarter, but still produced an attractive investment ROE.

Funding cost, including hedges, was 1%, which was in line with the prior quarter. Our Agency cost of financing increased slightly due to modestly higher repo costs and the extension of maturities in our repo book.

Our Agency net interest spread was 2.5%, down from 2.8% in the first quarter. Factors impacting this tightening included the overall lower yield environment, continued Fed purchases of securities during the quarter, the flattening yield curve, and the market's outlook regarding the increasing likelihood of QE3. While this environment has been good for our book value, it has led to lower spreads on reinvestment.

On the bottom right of slide eight we've included some benchmarking metrics. As you can see, a simple duration-hedged Agency strategy would have had a return for the quarter of 3.7%, and mortgage credit returns, as measured by an ABX index, would have been in the 3% range.

A simple capital allocation strategy of 50% Agency and 50% non-Agency Sub-Prime would have generated a blended return of 3.4% for the quarter. We believe that our return of 6.9% is compelling compared to these indices and speaks to the importance of security selection and dynamic capital allocation.

As regards security selection, I would like to take a minute to highlight its importance with an example from our Agency portfolio. Please turn to slide nine.

Here we compare the performance of generic Fannie 4.5s, which we don't own, to low loan balance 4.5s, which we do. Even though the latter costs more than the generic, the pay off can be well worth it.

In the second quarter, generic Fannie 4.5s appreciated 1.5% and experienced a three-month CPR of 25.6%. Low loan balance 4.5s appreciated 2.8% and realized only a 5.6% CPR. When you combine the better price performance with the difference in loss due to prepayments, we see that the low loan balance pools outperformed by 1.3%.

One other point to note at the bottom of the slide is that despite being about four points higher in price than generic Fannie 4.5s at June 30, the low loan balance pools at the June 30 price still have a much higher expected yield and lower expected prepayment speed. We own approximately $1 billion of these bonds, which represents about 12% of our Agency portfolio. The performance of these, and other prepay protected securities, was a major contributor to our strong Agency portfolio performance in the second quarter.

On the non-Agency side, our strategy delivered an annualized yield of 9.6%, and a net interest spread of 7.3% in the second quarter. We continue to be pleased with the performance of our portfolio as underlying fundamentals continued to improve.

Delinquencies have declined relative to the last several years and the 12-month current pay metric is increasing, which points to fewer borrowers having problems making mortgage payments and to more successful loan modifications. Also, we have seen a slight uptick in prepays, although there has been nothing meaningful yet.

Furthermore, the housing market at the lower price end is stable and in some cases improving, which bodes well for Sub-Prime bond performance. The non-Agency market enjoyed a modest rally in the quarter with Sub-Prime bond prices up a few percent.

As we show on slide 10, our portfolio has grown to $9 billion in Agency securities, including inverse IOs, and $2 billion in non-Agencies, or about an 82/18 asset split. Our total portfolio grew by nearly $1.6 billion as a result of capital raised and appreciation of our holdings. Our asset mix is comparable to last quarter, although the allocation to Agencies is a bit higher.

As you can see, the portfolio composition was relatively consistent in mix and type of securities. We continue to emphasize Agency securities with prepayment protection and Sub-Prime bonds for our non-Agency portfolio. On the top right you can see that we shifted our capital allocation slightly to Agency securities following the rally in non-Agencies. There is more detailed information on our Agency and non- Agency holdings in the appendix.

Next, I would like to discuss portfolio metrics and our risk profile. Please turn to slide 11. Despite generally higher prepayments in the overall market, our Agency CPR remains in the 5% to 6% range, increasing modestly to 5.6%, from 5.2% in the first quarter.

While we continue to expect prepayments to increase due to both the lower rate environment and the influence of policy initiatives, we believe that our securities are unlikely to experience a significant increase in prepayments, as 97% of our Agency portfolio has some degree of prepayment protection.

Our capital allocation figures are based on applying leverage in the range of 6 to 7 times for Agency and one to 1.5 times for non-Agencies, which is consistent with our approach since Two Harbors was formed. You can see at the bottom that in the second quarter, our aggregate portfolio had a debt-to-equity ratio of 4.3 to 1.0. This is higher than at March 31, which was lower due to the timing of the capital deployments of our February 2012 stock offering.

We currently estimate our leverage going forward to be in the mid four range, up slightly from a range of four to 4.5 previously, due to a higher allocation to the Agency strategy as we deploy capital from our July stock offering.

As Tom mentioned earlier, with rates so low, we don't believe this is a good time to take interest rate risk. As of quarter-end, we estimate an impact of approximately 3% on our equity for an up 100 basis point move in interest rates. This modest increase versus the first quarter comes from having gained duration on our swaptions as a result of the second quarter rate rally.

As a reminder, swaptions lose hedging effectiveness in a rally, so we gain duration in the portfolio, but the swaptions increase in efficacy in a sell-off, which is the beauty of using them as part of a mortgage hedging strategy.

Currently, the cost of long-dated protection is cheap, and we are pleased to report that we have over $3 billion in notional protection via swaptions with over six months to expiration. More details on our swaps and swaptions are included in the appendix. You will note that the bulk of our swaptions average four years to expiration, and underlying swap tenors are almost 10 years.

While rates may not go up anytime soon, we believe these long-dated swaptions will protect us if and when they do. Lastly, our interest rate swaps average pay rate as of quarter end was 0.87%, with an average maturity of about 2.5 years.

As Brad mentioned, we increased our counterparties during the second quarter and have recently extended for another year the Wells Fargo facility which funds some of our non-Agency holdings. To further fortify our financing for non-Agencies, we also have entered into both three-year and four-year repo lines for up to $200 million in funding, of which about $50 million was being used as of quarter end.

While a bit more costly than standard repo, we believe the substantially longer term provides stability and certainty to our funding mix. As a result of this continued endeavor to lengthen funding terms, the weighted average days to maturity on our RMBS repo borrowings at June 30th increased to 86 days, up from 80 at March 31st. More financing details are in the appendix.

I'd like wrap up today with some general comments on the market as summarized on slide 12. Rates are low and have continued their march lower since quarter end. A variety of factors have led to this, as Tom mentioned.

Funding rates are low and are likely to remain so for quite awhile. Prepayments are higher and that will probably persist as well, but market participants do not expect they will be as fast as they were in 2003. Finally, there is the prospect of QE3. As a result of all these factors, the curve is much flatter and Agency RMBS have performed quite well. This has been a boon to our existing portfolio since quarter end, but somewhat challenging for new investments.

On the non-Agency side, we have seen a strong rally since quarter end, as the stabilizing housing market and improving fundamentals have led to widespread buying by investors looking to lock in attractive yields. Additionally, the technicals remain strong with currently few distressed sellers and a significant amount of capital that has been raised for distressed US assets which needs to get invested.

The Maiden Lane 3 auctions of CDOs have gone very well, with some bonds trading above the value of the underlying assets. All of this is occurring amidst an environment of ever-shrinking yields in other market sectors. Thus, the yields available in the non-Agency market are markedly lower than what we saw in the first half of this year.

On slide 12 you can see the expected yields on our portfolio as of June 30th and also representative yields available in the market today. The lower yields mean higher asset prices, and as a result of this, our book value has grown meaningfully since quarter end. While we are only one month into the quarter, and are certainly pleased with the increase in book value, the rally obviously results in generally lower expected returns on capital being deployed today, particularly within the non- Agency market.

In conclusion, we are happy about our performance this quarter, our current capital allocation and the characteristics of our portfolio. We will continue to be mindful of security selection and believe that opportunities will continue to exist for attractive returns for our stockholders.

I would now like to turn the call back over to Mimi for the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first call is from Bose George of KBW. Your line is open.

Bose George - *KBW - Analyst*

Hey guys. Good morning.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Morning, Bose.

Bose George - *KBW - Analyst*

So the first question was just on the yields on the new investments. On page 12 you show the yields on June 30th, but then for July it's kind of broad. So I was just wondering if you could just narrow that down a little bit in terms of the net yields on the stuff you're putting on.

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

Yes. Good morning. Thanks for joining us, Bose. That's a great question. Let me start with the non-Agency first.

We tried to capture the range of where we're seeing yields on Prime through Sub-Prime. So the range is obviously pretty broad there. Some of the bonds are at the lower end. The bonds that we've typically focused on which have been the more deeply discounted Sub-Prime where we can make pretty draconian assumptions are near the higher end of that range. So given that that's a sector that we continue to like I think you should expect to the extent that we get non-Agencies they'll be closer to the high end than the low end of that range.

On the Agency side there's a tremendous amount of variability in yields, depending on whether you're looking at hybrid ARMs, or reverse mortgages or 30-year current coupons. So we didn't actually capture the entire yield range because some of the paper is in the 1% to 2% range, but we try to be more indicative of the security, the sectors that we particularly like and provide a range that was more indicative of that.

Bose George - *KBW - Analyst*

Okay great. Thanks. That's helpful. And just actually switching to the single family business I was just wondering how large that could get. And also when could you potentially start putting some leverage on there?

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Yes, Bose. It's Tom. Good morning. The honest answer is we don't know how big it could be. And it's going to be a function of opportunity and supply. So obviously it's got to be attractive relative to our other investment alternatives.

And given the size of our portfolio and the size of the single family allocation, right now it finances really easily within our portfolio so we can essentially use our portfolio to effectively apply leverage to it. If it were to grow meaningfully in the context of the portfolio at some point maybe that becomes untenable, but today it finances quite well within the REIT.

Bose George - *KBW - Analyst*

Hey great. Thanks a lot.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Bose.

Operator

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

Douglas Harter - *Credit Suisse - Analyst*

Thanks. I was just wondering if you could talk about your philosophy of whether you'll be sort of leveraging up the nice book value appreciation you've had? Or would you just use that book value appreciation to take down the leverage?

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

Yeah. Hey good morning, Doug. Thanks for joining. Yes in the short run we have to be mindful that the market is can be volatile. And so you need to be careful about leveraging gains that are capital, but as it becomes evident that those gains are frankly permanent and there for a longer period of time that is part of our capital base. So we would look at that as capital that could be leveraged and would be leveraged in the context of our overall portfolio construction.

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

Yes. And I would also note that we do carry a fairly sizable amount of cash on hand and we continuously monitor our excess liquidity so we take those into account as well in how we look at our leverage, and fairly conservative in how we approach it.

Douglas Harter - *Credit Suisse - Analyst*

Great. And just again with your stock above 11 if you could just sort of refresh us about the outstanding warrants?

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Sure, Doug. It's Tom. Thanks for joining us. With respect to the warrants obviously they're in the money now. And so it's possible that people may exercise those warrants, but other than that we really don't have any information to share about them.

They're struck, for everyone's benefit they're struck at $11. They expire in a little over a year. So people may start to exercise those. And obviously to the extent that they do that will be released in upcoming financial data in our various filings.

Douglas Harter - *Credit Suisse - Analyst*

And just for perspective, how would you -- at this point I guess that would be accretive to your book value to the extent that people exercise them at $11?

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Well obviously versus June 30th book value it would be. As we said in July and our book value rallied smartly, so obviously book value is always fluid.

Douglas Harter - *Credit Suisse - Analyst*

Sure.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

So it's possible. It's possible that it is accretive to book value, but at a certain point it may not be too. It's a function of what book value at any given moment.

Douglas Harter - *Credit Suisse - Analyst*

Got it. Thank you.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thank you.

Operator

Our next question comes from Mark DeVries of Barclays. Your line is open.

Mark DeVries - *Barclays Capital - Analyst*

Yes. Thanks. I just want to go back to the current July yields you're seeing. The yields you gave for Agency is there any way you can give us some sense what that would translate into a hedge-adjusted spread?

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

Yes sure. Hey, Mark, thanks for joining us. Good morning. Yes, when we looked at the market earlier in July it looked to us and we said on the call when we came to the market with an offering that we saw low teens returns available. And the way you get there using if you took the midpoint of our six to seven on Agency, call it 6.5, the asset yields at the time were at the high end of what you see on slide 12 and funding cost including hedges was sort of in the 95, 100 basis points. So that would get you a NIM of call it roughly 175 plus or minus and an ROE in 14 area.

So what we've seen since then is we've seen the market continue to rally. So you could expect yields will be lower than the high end of the range and yet hedging costs have also come down. So spreads are not significantly different than what we saw at that time.

Mark DeVries - *Barclays Capital - Analyst*

Okay, got it. And, Bill, I'd be interested to get your thoughts on how you would expect non-Agencies to react if we get QE3. If I remember correctly we've had pretty divergent reactions to QE1 and QE2 or I think risk assets really rallied in the QE1 and sold off on QE2. Which direction would you expect non-Agencies would take if we get QE3?

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

Yes. I think QE2 sort of took place in a time when there was a lot of other stuff going on which wasn't that favorable for risk assets. We're in an environment now that, as I mentioned in my prepared remarks, the technicals are highly favoring risk assets and frankly any assets with yield.

Yields right now are very tough to come by. We've seen a substantial amount of money raised to buy distressed US residential and commercial assets. I think there's a belief that housing is at or near a bottom, or maybe off the bottom. And so people feel it's safe to go back in the water, if you will.

So if there are assets available that have any sort of reasonable yield and people feel comfortable with their assumptions, I think that that's what we've seen so far. And I don't think that QE3 would do anything to change -- if anything it might have people feel more comfortable in risk assets or assets with yields to the extent that QE3 diminishes yields further.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Yes, Mark. I would -- it's Tom. Good morning. The thing that I would add to that too, we think what's really sort of the mean around non-Agencies are what's going on in the housing market. Obviously non-Agencies are greatly impacted by probability of default and recovery. And to the extent that you have a flattening in the pricing of the housing market or, God forbid, even a rally that's very impactful on non-Agency price performance.

And we think that is probably more of a driver in the market today than any sort of government policy. We really think that's why people are being attracted to the non-Agency market.

Mark DeVries - *Barclays Capital - Analyst*

Okay. That's helpful. And then just last question, have your non-Agencies rallied enough that you might actually consider selling some of them? Or do you still think they're kind of trading below what you'd view as their trended value?

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Well Bill and I say everything's for sale at a price except for our wives and children, but we continuously evaluate the market. I will say that while non-agencies have rallied substantially they're still arguably very attractive relative to other investment alternatives. So it's something that Bill and the team constantly evaluate, so we may sell securities at some point. We may not. It's something that we monitor on a daily basis.

And one thing that I would point out and we really mean this sincerely, our initiative in the residential housing market really gives us good data, real, live data about what's going on in the housing market. And at the end of the day, the performance of non-Agency securities are going to be determined by the underlying loan performance. And so that's the pulse that we constantly monitor.

Mark DeVries - *Barclays Capital - Analyst*

Great. Thank you.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thank you.

Operator

Our next question comes from Trevor Cranston of JMP Securities. Your line is open.

Trevor Cranston - *JMP Securities - Analyst*

Hi. Good morning.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Hi Trevor.

Trevor Cranston - *JMP Securities - Analyst*

Hi. Can you talk a little bit more about the increased hedging costs this quarter on the default swaps and IOs? Is that more a function of larger hedge positions? Or is it more related to things like faster prepayment speeds increasing the amortization on the IOs?

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

Yes. So on IOs and I'll defer to Brad on this to add some accounting related comments, but basically IOs at their amortized cost the yield that we realize on that will be driven by how fast prepayments are. So to the extent that we've had basically a continuous rally and the speed has picked up, the realized yields on those are obviously lower.

Trevor Cranston - *JMP Securities - Analyst*

Yes.

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

So that's obviously a contributor. Now at the end of the day the way we look at it is that's actually if you think about the total economic return of the IOs, right, basically whatever the realized prepays are plus the change in price. So we compare that as a hedging tool to swaps. Clearly if you put swaps on and you had a big rally you're going to have more cost from the negative carry as well as the mark-to-market. So it's not that different, but the IOs did pick up in speed over the last three to six months, which drove a lower yield.

Then on the credit side as you know we do from time to time take modest hedge positions that we believe will protect our non-Agencies. And you'll see in the Q which comes out tomorrow what those positions are. In your typical CDS there's a running cost that you pay for protection, whether it's on high yield, or investment grade, or single name, or ADX or anything else.

And so there was a slight drag from that as well, but we believe that including that in our mix is very important to protecting book value. You may recall the third quarter last year we had a tremendous benefit from having some protection in place when the non-Agency market sold off dramatically.

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

This is Brad, just to add a couple of points more quantitative around the size. If you go to our slide 16 in our deck we have added a bit more disclosure around the numerical impact on our CDSs. And if you look at footnote two we do note that in Q1 we had $2.7 million of net cost on the CDS and that up ticked to $3.9 million in the second quarter, as well as we did disclose it.

The gains on our IOs, the kind of yield, numerical number was 6.7 in Q1 relative to 7.6 in Q2, which actually equates to a drop in yield, as Bill mentioned. So hopefully I gave you a bit more quantitative color in addition to Bill's comments.

Trevor Cranston - *JMP Securities - Analyst*

Yes, very helpful. Okay thanks, guys.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Trevor.

Operator

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

Joel Houck - *Wells Fargo Securities - Analyst*

Good morning. I guess to start off with on the single family strategy you have a comment in here. It says long duration and potential home price appreciation. That to me implies that you're looking at this as a longer term asset, a couple of questions. What is your typical holding period for these properties?

And the second is how do you look at the expected IRR of this strategy versus buying a seasoned credit bond because we get lots of questions from clients about this strategy. And while I know it's still relatively small, there are others looking at this strategy and it just strikes me as interesting because with the carrying cost associated with the strategy one would think that you guys see massive amounts of value here. Otherwise why bother?

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Sure, Joel. It's Tom. Good morning to you. In respect to the holding period the answer to that is we really don't know. What's driving the strategy is that we can buy, as we said, homes that attract current yields and discounts to replacement cost. And we are in markets where we think absorption metrics provide a wind to our back, but we will say honestly if there was a sharp rally in the housing market tomorrow our holding period might be quite small.

There's a lot of research data out there that says that in key markets supply/demand metrics will come back into balance in anywhere from two to six years, dependent upon the market that you're talking about, but it's really going to be a function of the price of that house relative to what we think fair value is. Today this initiative is quite nascent so we don't want to be disingenuous and spit out a lot of numbers around it, but our early experience has been quite pleasing and we're quite excited about this program.

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

Yes. The only thing I would add is obviously within the REIT as well there are a number of kind of safe harbors to comply with a holding period. So generally speaking we are looking as a long-term asset to fall inside those guidelines.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Yes. We don't expect the housing market to recover overnight. As we've said we're seeing a flattening of prices in some markets we're seeing somewhat of a rally in other markets, but our business is to optimize shareholder value. So we'll just continuously monitor this versus our other alternatives. And it's got to compete well.

We never want to be in a business just to be in a business. It's got to be attractive for our shareholders. And so as I responded to an earlier question how big we get in this will be just an opportunity of supply and opportunity.

Joel Houck - *Wells Fargo Securities - Analyst*

Okay. That's helpful. I guess maybe dovetailing it is more on the Agency side. I mean given where spreads have gone and particularly where prices are, not just with the generics, but the SPEC pools obviously. You gave a nice example here of just about a billion dollar trading at 111.

I'm a little surprised if we continue to see and all of the REITs are continuing to raise capital and deploy in the Agency space, and I understand that most of the capital was deployed months ago, you still have some to go. What are your thoughts in terms of the allocation because it seems like the tone in this call is more positive toward housing, which I tend to agree with. I don't know what others think.

And secondly is there any way to express a short view inside a REIT with respect to the Agency sector? If you felt like the Agency space was too overvalued, perhaps we get QE3 and that pushes up price more, then what would the strategy be to protect value? Would you just simply sell and take down leverage? Or are there ways to officially express a short view on the Agency side within REIT?

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

I guess I have two remarks to that. One is that despite the fact that spreads are lower from a historical perspective the ability to generate double-digit investment returns from an Agency strategy is still attractive. So and that's consistent with my remarks to the question that Mark asked earlier.

The second thing I would say, and this is not commenting necessarily on what we may or may not do, but certainly to the extent that you want to take a position that protects against the mortgage prices in a REIT or frankly in any investment vehicle, you have the ability to short TBAs. We have done that occasionally over time to protect certain parts of our Agency bucket.

A perfect example is when there was substantially higher prices and HARP was being discussed about being standard high coupons were at risk, and we took a substantial position on the short side in TBAs and high coupons that we held for several months until we fully understood what the implications were. So certainly we and others have the ability to do that, but keep in mind as a REIT our investors are looking for exposure to mortgage markets, so we would be reticent to have effectively no position in the mortgage sector for an extended period of time.

Joel Houck - *Wells Fargo Securities - Analyst*

Yes. I guess that's helpful. I guess the performance has been outstanding. It would seem like if you were to -- and it would be interesting to hear your comments, Bill. If you looked out over the next three to five years and ignoring potential QE3, which might be coming, what's your viewpoint on the relative long-term value of non-Agency versus Agency on a three to five-year basis?

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

Well we have roughly half our capital allocated to each strategy, so I think that kind of tells you how we feel about it. In non-Agency it's just a question of making sure the math works on new purchases in terms of generating attractive ROE and finding bonds that we like at the right price.

And on Agency I think it's frankly, you know the reality is that the valuations on agencies are driven largely by where rates are right now. So it's not necessarily protecting on let's say mortgages as much it's just protecting your interest rate risk. If rates go up 200 basis points mortgage prices are going to go down.

That's why we don't maintain a high exposure to interest rates. And that's why we have a substantial amount of protection both in swaps and swaptions. And you can see that in the appendix. So I think that that's really kind of at the heart of what I think you're asking, which is that rates are low and prices are high, and the way to protect that is not to take much interest rate risk.

Joel Houck - *Wells Fargo Securities - Analyst*

So you're looking at it and you may say, well, the market it could still revalue. We're going to protect ourselves through hedging, but we're not going to make a directional bed. If it happens we're protected, but we're not going to sit out there and expose ourselves to a broad sell off in mortgages.

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

Yes, basically yeah. We're trying to generate an attractive dividend and protect or grow book value. And that's really been our endeavor since we started the Company almost three years ago. And we continue to have that same approach. So yes, you're correct.

Joel Houck - *Wells Fargo Securities - Analyst*

Okay. And lastly I think you made a comment awhile back and just wanted to see how you still feel about it. You made a comment about it's a great time to be an Agency investor just given the structural impediments to refinancing. That has been very good call obviously if it's played out. Do you still feel the same way structurally that prepayments still seem to be low, and if we are more like Japan that perhaps the Agency strategy has a lot more life and then perhaps what some may be thinking given where rates have gone?

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Yes. Thanks, Joel. It's Tom. Bill and the team have done a fantastic job staying out of the crosshairs of policy initiatives. And that's why our prepayment speeds have been so low and so consistent. And I have every expectation that they will continue to be able to do that and so, yes, we're still quite excited about the opportunity within the Agency space.

They have done a very good job being thoughtful around what bonds are prone to be included in various government policies and have stayed out of the way of all of that. And so for those reasons we are quite confident about the future in the Agency space.

Joel Houck - *Wells Fargo Securities - Analyst*

All right. Thank you very much and a terrific job.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks a lot, Joel.

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

Thanks, Joel.

Operator

Thank you. Our next question comes from Jason Weaver Sterne Agee. Your line is open.

Calvin Hotrum - *Sterne, Agee & Leach - Analyst*

Hey, guys. This is actually Calvin Hotrum. I'm standing in for Jason. Can you guys comment at all in your book value since quarter end?

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Sure. It's Tom. Good morning. So in respect of that the non-Agency if you look at ABX it has rallied 2% to 5% since quarter end. Generally people would tell you that cash bonds have modestly outperformed the synthetics, and additionally we have seen a continued flattening of the yield curve within the Agency space. So it's very early in the quarter so we don't want address this quantitatively, but hopefully that gives you some qualitative perspective.

Calvin Hotrum - *Sterne, Agee & Leach - Analyst*

All right, definitely. All right, thanks guys.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thank you.

Operator

Thank you. Our next question comes from Gabe Poggi of FBR. Your line is open.

Gabe Poggi - *FBR & Co. - Analyst*

Hey. Good morning, guys. It's Gabe, just a quick question. You mentioned extending the non-Agency funding maturity. Do you guys expect to kind of continue to do that over time, you know payup but just to have a little more extension on your funding of non-Agencies?

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

Yes. Hey, good morning. Yes, we have about $2 billion market value and as you know our leverage target of one to 1.5 means roughly call it $1 billion. We've got the Wells Fargo facility as you know, which is a one year. And then we have $200 million of three to four years.

So we feel like we have pretty good percentage of potential borrowings that we have for an extended period of time. Now that being said it's all a question of opportunities that we get presented. Certainly if someone called us up tomorrow and presented a fabulous deal for whatever, two years, three years, four years we would absolutely consider that.

Agencies even during the crisis funded really very easily. Non-Agencies as you know you couldn't fund at all. So we feel like well things are good now. We're just protecting and fortifying our finance ability of those assets.

Gabe Poggi - *FBR & Co. - Analyst*

No. I agree wholeheartedly and thanks for the color.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Gabe, it's Tom. Good morning. The one thing I would add particularly in the non-Agency space, funding of non-Agencies are absolutely as healthy as they been today since the crisis has unfolded in respect of number of counterparties that are willing to fund them, terms, maturity, et cetera. So there's really been a return to a sense of normalcy in that space. And so today it's as good as it's been since the crisis.

Gabe Poggi - *FBR & Co. - Analyst*

Thanks, guys, great quarter.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Gabe.

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

Thanks, Gabe.

Operator

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

Boris Pialloux - *National Securities - Analyst*

Yes. Good morning and thanks for taking my questions. I just had two quick questions. One is regarding your non-Agency funding. If the rates, actually the yields are coming down, would you actually consider increasing your leverage target? I know that you have one to 1.5, but just trying to figure out if this will be a policy for this type of situation.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Yes. Good morning. It's Tom. Bill and I have been around despite our youthful appearance. We've been around awhile. And how people have traditionally gotten in trouble in the mortgage market is levering up at the wrong time.

And so we feel quite comfortable with the amount of leverage that we're applying to the non-Agency space. And you shouldn't expect that that's going to change meaningfully anytime soon.

Boris Pialloux - *National Securities - Analyst*

Okay thanks. And second is did your view regarding credit supports have changed because let's say of eminent domains right and mortgage modification efforts?

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

I'm sorry. Could you repeat your question?

Boris Pialloux - *National Securities - Analyst*

Yes. Basically in your Sub-Prime bond investment strategy I know that you have some type of credit supports, but now you are having talks about eminent domain and you also have all the mortgage modification efforts from the banks. So just trying to figure out if this has changed your views regarding credit supports.

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

Yes no. So yes there's obviously a lot going on, not just with banks' efforts to help homeowners, but obviously there's a number of, many different policy initiatives as well as the one you mentioned, the eminent domain. At the end of the day one of the things that we really like about the deeply discounted Sub-Prime sector is that almost anything that you do to help a borrower is good for those bonds.

And I'll give you an example. When we've had in the past and if you look at the webinar you'll see that give an example of a non-Agency bond where there's only say 30% delinquent, but we're assuming 70% of them default. So there's a lot of guys that are paying their mortgage that we assume default as well as where we take a big loss.

So if you think about borrowers who potentially get helped such that they don't default, or even if there is a modification which results in a minor loss that's a tremendous benefit to that type of bond. Furthermore, so in terms of any of the modification efforts typically the kind of bonds that we own benefit from anything that helps the homeowner.

And then regarding eminent domain, frankly it's an extremely new proposal. I think our understanding is that municipalities are studying this and trying to determine if it's worthwhile. Clearly to the extent that you did see something like that come about it would result in a prepayment to the trust.

So that would be a good thing for discount bonds, but I have to tell you that there is great concern, and it's been mentioned and noted that this is potentially unconstitutional. So we're not assigning any value, any positive value to this at this point, but certainly we're monitoring it and we would take into consideration anything that does happen on that front.

Boris Pialloux - *National Securities - Analyst*

Okay. Thank you for the feedback.

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

Thanks a lot.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thank you.

Operator

Thank you. There are no more questions in the queue. I will turn the call back to Mr. Siering for concluding comments.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Mimi. Before we close today's call, we wanted to announce the timing of our upcoming Analyst & Investor Day in New York on October 10th. More details regarding this event will be forthcoming in the coming weeks. We hope you can join us in person or via the webcast for this event. We think that it will be a very informative day.

Thank you and have a great week.

Operator

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

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