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TWO - Q4 2012 Two Harbors Investment Corp Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to Two Harbors' fourth-quarter 2012 financial results conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session, and instructions will be given at that time. (Operator Instructions). As a reminder, this conference call is being recorded.

I would now like to hand the conference over to your host, Ms. July Hugen, Director of Investor Relations. Ma'am, you may begin.

July Hugen - *Two Harbors Investment Corp. - Director of IR*

Thank you, and good morning. Welcome to Two Harbors' fourth-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, Chief Investment Officer. After my introductory comments, Tom will provide a recap of our 2012 results; Brad will highlight some key items from our financials; and Bill will review our portfolio performance.

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 webpage 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 a discussion of fourth-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 other similar words. We caution investors not to rely unduly on forward-looking statements. They imply risks and uncertainties, and actual results may differ materially from expectations.

We urge you to carefully consider the risks described in our filings with the SEC, which may be obtained on the SEC's website at www.SEC.gov. We do not undertake any obligation to update or correct any forward-looking statements if later events prove them to be inaccurate.

I would like to draw your attention to the third webinar in our ongoing series, titled Prepayments, Part Two, Concepts in Agency Valuation. The webinar can be found on our webpage under Events and Presentations. We intend to post additional webinars in the future to provide investors and analysts with management insight 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, July. Good morning, everyone. Thank you for joining our fourth-quarter earnings call. Before I comment on the quarterly results, I would like to discuss the full year, as 2012 was truly a remarkable year for our shareholders.

We are delighted to report that for the full year, we delivered total return on book value of 47%, with dividends of $1.71 per share. We believe this is a testament to our rigorous security selection and the talent of our investment team. It is important to note that we were able to accomplish this in a way that is consistent with our mission of protecting book value through thoughtful hedging.

Our total shareholder return for 2012 was 40%, as measured by change in share price, which compares to a return of 19% for the sector in 2012, as measured by the Pine River Mortgage REIT Index. As you know, delivering shareholder value is our primary goal.

Our economic returns during the year were outsized. Our investment team generated $1.05 billion in total comprehensive income during 2012, and we give all credit to them for that remarkable result. Approximately 67% of the attribution of return in 2012 was derived from our non-agency strategy, with the remainder from the agency portfolio. Over the last year, we have grown our business threefold, as measured by market capitalization.

At the start of 2012, our market capitalization was approximately $1.3 billion. Through the completion of three capital raises and portfolio appreciation, our current market capitalization is nearly $3.7 billion. Today, we are the largest public hybrid mortgage REIT.

However, it has never been our ambition to be the largest hybrid mortgage REIT, but rather to be the best. We believe the growth in our business over the past year can be attributed to our alpha generation and Two Harbors' best practice policy in respect to governance and disclosure.

Of course, the key to our pursuit of excellence is our team. This year was transformative for both our investment and administrative teams. On the investment side of our business, Bill Roth became the sole CIO, after serving as co-CIO with Steve Kuhn since our inception of the Company in 2009. We would again like to thank Steve for his service and we look forward to our continued alliance with him.

As you may recall from the third quarter call, we have also expanded our senior investment management team with the hiring of Nick Smith, Dan Koch and Bill Greenberg. These key additions expand our investment expertise and enhance our ability to diversify our business model and drive shareholder value over time. Today, we have a dedicated administrative team, which we believe is tremendously important to the long-term success of our business and critical as we position ourselves to explore new business initiatives.

Effective as of the beginning of 2012, we named Brad Farrell as CFO, and most recently, Rebecca Sandberg was named General Counsel effective March 1 of 2013. Brad had previously served as Two Harbors' controller and Rebecca was previously our Deputy General Counsel. So these [top] transitions have been seamless and natural.

Another important accomplishment in 2012 was the contribution of our portfolio of single-family homes to Silver Bay in exchange for 17.8 million shares of common stock concurrent with Silver Bay's IPO in December. Since the IPO, the shares have appreciated approximately 10%. These shares are subject to a 90-day lockup, which expires in mid-March. As we discussed previously, subject to the approval of our Board, it is our intention to distribute the Silver Bay shares to our shareholders by means of a special dividend at some point following the expiry of the 90-day lockup on those shares. We will continue to keep you advised if and when the Board should make such determination.

Now, moving to fourth-quarter results, we recorded $185 million of comprehensive income. Our book value increased to $11.54 per share during the fourth quarter, representing the total return of 6% when combined with our fourth-quarter dividend of $0.55. We reported GAAP earnings of $0.64 and core earnings of $0.28 per share, which Brad will discuss further.

Let's take a moment to discuss the fourth-quarter dividend. As you may recall, this dividend included taxable income from the contribution of our single-family homes to Silver Bay, as well as from realized gains from our agency portfolio repositioning, which Bill will comment on later. The $0.55 dividend was also, we believe, important in terms of timing for our shareholders, given changes to tax policy in 2013. It should not be taken that this dividend level is representative of our ongoing earnings power.

In the fourth quarter, approximately 3.5 million of our warrants were exercised, leaving just over 13.5 million of the original 33 million warrants outstanding. This resulted in proceeds of approximately $38 million to Two Harbors. As a reminder, the warrants are struck at $11 with an expiry date of November 7, 2013, so the warrants are currently in the money. As of December 31, 2012, we had approximately 299 million shares outstanding.

Please turn to slide four. I'll next provide some brief commentary on some developments that could impact our business in the mortgage and housing sectors. On a macro level, home price performance, which is important to our non-agency portfolio, has been a bright spot in a murky macroeconomic environment. Home prices continue to improve across much of the United States. According to Core Logic, home prices increased 7.5% as of January 1 on a rolling 12-month basis. Most forecasts call for a continuation of HBA in the next several years, albeit at a slower pace than 2012.

Unemployment metrics have continued to languish at a level higher than we would like to see, although generally seem to be improving.

But importantly, supply of distressed homes and shadow inventory have been diminishing. Interest rates, while still low by historic levels, have moved a bit higher lately on the back of improving economic data and market sentiment. Despite the Fed's stated intentions, we continue to prudently hedge against a spike in interest rates, as Bill will discuss further. We also continue to monitor developments regarding policy and regulatory changes, a few of which are noted on the bottom of the slide.

we always manage our business with these and other potential changes in mind.

Please turn to slide five. You may recall that last quarter we outlined a variety of opportunities that we were evaluating, some of which we may ultimately pursue. I would note that several of the opportunities we are evaluating have the potential to diversify our business, provide returns uncorrelated to our existing Agency and non-Agency portfolios and may offer more attractive returns than are currently available in our legacy portfolios. Also, they may be even more compelling if and when the interest-rate environment changes.

When we evaluate investment opportunities in the mortgage market, there are several factors we consider. New opportunities must be grounded in our core competencies, such as understanding and managing prepayment and mortgage credit risk. They must also enhance the overall risk-reward profile of our business. Lastly, we must have confidence that we have the proper infrastructure in place to support them. So with all this in mind, we anticipate a measured move into new opportunities over time.

Silver Bay is a great example of this. Based on our analysis of distressed non-Agency market, we found an emerging asset class with an attractive return profile for our shareholders. Bill will comment more fully on some of these nascent investment initiatives.

The fourth quarter and the entirety of the year were remarkable periods for our investment strategies, and we believe our performance speaks not only to the quality of our team, our analytics and infrastructure, but also to the advantage of our structure as a hybrid mortgage REIT. We are very excited about the ongoing opportunity set in the mortgage market, and we look forward to 2013. I will now turn the call over to Brad.

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

Thank you, Tom, and good morning. I will begin my prepared comments with an overview of our financials and a few pertinent accounting topics, discuss quarterly changes to book value, provide an overview of our financing profile and conclude with comments on our 2012 dividend distributions relative to our 2012 taxable income.

Please turn to slide six. Core earnings of $0.28 per share represented a 9.8% annualized return on average equity, while GAAP earnings, albeit often a less meaningful metric due to mark-to-market accounting vagaries, were $0.64 per share. Strong GAAP earnings were principally driven by realized gains in our RMBS portfolio as we sold certain Agency securities to adjust our risk profile and take advantage of their high relative market valuation.

Core earnings were impacted by a number of things, which I will detail shortly. But before that, I would also note that we defined core earnings to exclude the revenue and expenses associated with our real estate investment portfolio, which is now presented as discontinued operations in our financial statements. This refinement to the core earnings definition increased our core earnings by $0.01 per share.

Core earnings were largely impacted by leverage in the quarter. Total leverage ticked modestly lower to 3.4 times from 3.8 times as of September 30, due to the sale of the aforementioned RMBS and also reflecting slightly lower leverage on our Agency portfolio, which Bill will expand upon.

We would be remiss to not also mention the approximate $336 million invested in Silver Bay common stock. During the quarter, the average capital of $295 million associated with the single family homes due to its ramp stage caused a drag on EPS and ROE metrics. Similar to prior quarters, core earnings were also pressured by our hedging strategy, as well as lower projected yields on securities recently acquired.

While we acknowledge that some of the mortgage REIT investors and analysts monitor core earnings to provide a dividend benchmark, it is not the principle metric we focus on when managing our portfolio and its associated risks. Our primary goal is to deliver total return for our shareholders over time, and it is not our intention to deliver short-term results, such as core earnings, at the expense of the long-term protection of book value.

Our expense ratio as a percent of average equity modestly increased quarter over quarter at 0.7%, excluding expenses related to discontinued operations. As we have talked about in the past, the size of our investment portfolio and new business diversification initiatives will likely impact this metric in current and future quarters.

I would like to briefly touch upon a few accounting matters that are relatively immaterial on a quantitative basis, but provide further color into our portfolio performance and financials. Other than temporary impairments on our non-agency RMBS were an adjustment of $1.6 million this quarter. This adjustment continues to represent an immaterial amount relative to our overall holdings.

I would also note that we reclassified $65 million of our credit reserves to accretable discount during the fourth quarter across 22 bonds. This is our first sizeable release of credit reserves. The release of credit reserves was driven by fundamental credit improvement in the bond's cash flows, but I would note that the amount represents less than 5% of our credit reserves. This release of credit reserves will prospectively adjust the yield recognized on these bonds over their remaining life.

Even with lower projected credit losses on these bonds, the yield impact is viewed to be marginal due to offsetting extension of these bond's lives and timing of principal and interest cash flows. While we are prudent when it comes to releasing credit reserves, due to ongoing uncertainties in fundamental cash flow drivers, we felt it was appropriate for these bonds, but cannot be considered indicative of future releases.

The other accounting topic worth discussing concerns the realized gain accounting for our contribution to Silver Bay. As of December 31, 2012, we recognized $10.6 million of realized gains, which represents the difference in the cost basis of our properties relative to the value of the 17.8 million shares of common stock received in the IPO. Not included in this figure, but which will be recognized in 2013, are installment sales gains of approximately $4 million, reduction in future Two Harbors management fees of circa $4.3 million in the second quarter of 2013, and additional working capital adjustments, which are anticipated to be immaterial, but subject to final determination, in accordance with the contribution agreement we entered into with Silver Bay.

Now, please turn to slide seven, which contains a quarterly book value roll forward. As Tom noted, our book value per diluted share was $11.54 this quarter, up from $11.44 last quarter. More importantly, this is a significant increase from book value a year ago of $9.03, a 28% increase, while also distributing $1.71 in dividends. As of quarter end, you will note that the remaining warrants have a slight negative impact on a fully-diluted basis as of December 31 due to the closing share price of $11.08.

Please turn to slide eight. As it relates to our financing profile, our total number of counterparties remained unchanged at 23. We continue to have a lengthy repo maturity profile, with days to maturity an average of 85 days at December 31. We continue to focus on high-quality counterparties, as represented by the low overall credit scores. As noted in our Analyst Day presentation in October, credit scores are one indicator of the health of our financing profile.

As this slide illustrates, we focus on both diversification in our Agency counterparties and strong credit stability in our non-Agency counterparties due to the less liquid nature of the investments.

I'd like to next to discuss the dividend from an accounting perspective. Please turn to slide nine. As many of you know, our dividend distribution requirements are based on taxable income. Although GAAP net income for the REIT was $374 million, its total taxable income was $440 million in 2012, consisting primarily of core earnings of approximately $315 million, realized gains on RMBS and hedges of $106 million, and gains from the Silver Bay contribution of approximately $11 million. This taxable income, combined with the amount carried forward from 2011 of $13.7 million, supported our dividends paid during 2012, resulting in the distribution of approximately 98% of our 2012 taxable income.

We will have a minimum taxable income carryover of $11 million into 2013, which you can see on the bottom right-hand corner of this slide.

As it relates to the turnover in our RMBS portfolio during the quarter, sales of securities generated capital gains of $103 million. As part of any repositioning in the Agency portfolio, we generally realign our swap and swaption hedges to align hedge duration with that of our assets. Importantly, in unwinding and resetting new swaps, we decided to realize the losses on the unwinds in January 2013 rather than in the fourth quarter. This benefited our taxable income in the fourth quarter and our ability to make tax-advantageous distributions to our shareholders, while lowering our taxable income profile in early 2013 by approximately $58 million.

Bill will discuss the positive impact to the net interest margin as of January 31 for modeling purposes. We don't expect this timing difference to materially impact our 2013 taxable income due to the offsetting reduction in hedging costs and anticipated taxable gains in our RMBS portfolio and potential distribution of Silver Bay common stock to our shareholders.

Now, I'd like to turn the call over to Bill for a portfolio update.

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

Thank you, Brad, and good morning, everyone. The investment team had another busy quarter, both managing our current portfolio and working on potential new opportunities, which I will discuss later.

Please turn to slide 10. 2012 was a great year for our investors, who have enjoyed a total return on book value of 47%. Both our Agency and non-Agency portfolios had an excellent year, with non-Agencies driving performance in the fourth quarter. As some of you may remember, we raised capital early in the year to deploy into the non-Agency market, as prices were low and yields were in the 9% to 11% range. These investments have performed exceptionally well.

Last summer, the investment ROE on the Agency strategy was attractive, so we completed another capital raise, which also proved fortuitous to both earnings and book value. We focused on securities with cheap prepayment protection, which was important, given the low rate environment and the propensity of borrowers to refi.

On the bottom left of this slide, you can see our return on book value versus some indices for the year. We are very proud of this accomplishment. This also demonstrates why we believe it is important to dynamically allocate capital to different sectors of the market as opportunities change.

In terms of yields and spreads, on the bottom right, you will see that our yields and NIM for the fourth quarter came in better than we had expected as of September 30.

Please turn to slide 11. As you can see, our RMBS portfolio is $14 billion in size, including $11.3 billion in Agency securities and $2.7 billion in non-Agencies. You can see on the right that out allocation to Agencies has dropped, and the allocation to non-Agencies and single-family homes ticked higher. This reflects our reducing capital and overall leverage to the Agency strategy as spreads were generally tight much of the quarter.

That is a good segue to a discussion about our Agency portfolio repositioning. The market's appetite for prepayment protection continued to favorably impact the payups of our Agency pre-pay protected pools during the quarter. And due to appreciation to what we believe was full value, we sold a significant amount of our higher dollar priced Agencies. In aggregate, we sold over $3 billion of high payup, loan balance and MHA 4 and 4.5% coupon securities, and subsequently purchased $2.5 billion of prepay protected, 3% coupon securities at lower dollar prices and much lower payups over TBAs. This portfolio repositioning reduced both our prepayment risk and payup risk.

Generally, the bonds we bought with lower coupons and lower payups are much easier to hedge than the bonds we sold, which were higher coupon securities with high payups over TBAs. These transactions generated substantial realized gains and were impactful to our $0.55 dividend in the quarter, as was mentioned earlier.

For our non-Agency portfolio, declines in severe delinquencies, improving home prices and better overall borrower performance have been continuing trends. As a reminder, our non-Agency portfolio was purchased at around $0.50 on the dollar. These bonds have performed well so far, and our mark at December 31 was around $0.60 on the dollar. As such, we believe there is further room for upside as borrower performance and housing continues to improve.

Unfortunately, with a very strong technical in place and limited availability of bonds, the ability to upsize our non-Agency position at yields we find attractive is much more challenging today than it was a year ago, when there was abundant supply and not many bidders.

Although we generally do not comment on book value intra-quarter, and obviously a month does not a quarter make, we did want to note that non-Agency performance has been strong thus far in the new year. This has been a positive for book value. Agency spread-widening in January was a small offset to this. But on a combined basis, our book value for the month moved markedly higher.

As I turn to slide 12, I would like to highlight a few key metrics of our portfolio. The overall profile of our portfolio remained fairly consistent with prior quarters. Our agency prepayment rate for the quarter, including inverse IOs, was 6.6%. We believe that this prepayment rate is a result of our dedication to a stringent security selection approach when purchasing assets. Given the lower NIMs generally available today and the low rate environment, we believe security selection is of paramount importance to our portfolio. About 98% of our Agency portfolio has some type of prepayment protection, and we find these assets much easier to hedge, as their cash flows are generally more stable than those of generic pools. More details about our agency holdings can be found in the appendix on slides 20 and 22.

Next, let's talk about leverage. Our overall debt-to-equity ratio is 3.4 times, somewhat lower than 3.8 times at the end of the third quarter. It is important to point out that we have not taken our leverage up on the Agency portfolio to try to generate additional yield in this period of tighter MBS spreads. In fact, our leverage on the agency strategy dipped to about 5.7 times this quarter.

Our top priority is generating shareholder returns over the long term, which makes book value protection critical to the way we think about portfolio management. Carrying lower leverage at certain times to protect book value is worth the short-term sacrifice in core earnings.

Broadly speaking, we continue to target a leverage ratio of 6 to 7 times for the Agency portfolio and 1 to 1.5 times for the non-Agency portfolio. And we anticipate increasing our leverage on the Agency strategy from 5.7 times should valuations look more compelling to us.

On the non-Agency side, our leverage remains low and within the one to 1.5 times range we have historically carried.

Let's discuss hedging next, which is another important element in protecting book value. Although interest rates remain low, protecting our portfolio against higher interest rates makes a lot of sense to us, especially given that the cost of hedging remains cheap. As a reminder, we use swaps, swaptions and IO bonds to protect our book value. We aim to keep the portfolio's interest-rate exposure low and we continue to have little duration exposure, as you can see on the top right.

We had over $17 billion notional in hedges, comprised of over $12 billion in swaps and approximately $5 billion in swaptions, as of December 31. As Brad mentioned, our hedge profile changed from the end of December to the end of January as we unwound swaps related to the portfolio repositioning in December. Because of these changes to our portfolio, at the end of January, we had $13.7 billion in swaps with an average pay rate of 0.66% and an average maturity of about three years, which will be helpful if you are modeling our hedge portfolio. More details on our hedging positions as of December 31 are in the appendix on slide 19.

As a result of higher asset prices, lower yields and tighter spreads, the current environment for investing today is more challenging than in the past few years. While we are pleased with our performance in 2012, it is our goal to continue delivering attractive returns to shareholders. Our hybrid model provides us an ideal platform to take an opportunistic approach to the residential sector, which includes all real estate asset classes, including unsecuritized assets.

On slide 13 we have highlighted, as we did last quarter, a variety of potential opportunities that dovetail with our core competencies of credit and prepayment risk management. For the benefit of our shareholders, it is worthwhile to spend time exploring different avenues to add value. But as you might expect, some opportunities may make sense to pursue, and some will not.

As Tom noted, we continued to build our team with high-quality talent, both on the investment and administrative side, to give us the ability to expand into areas that will deliver value to shareholders.

Let's talk about securitization first. Last quarter, we noted that the math around creating subordinate bonds and IOs via a securitization have become more attractive recently. Over the past quarter, we have continued to make progress on the securitization front. Recently, there has been some media attention concerning a deal that mentions Two Harbors. We are currently not at liberty to comment on any specific transaction, but will keep you posted when and if we close on a securitization.

Importantly, we continued to build our originator network to source loans, which will enable us to be an ongoing issuer over a time. We are pleased with our progress to date on developing securitization as one of our tools to drive shareholder value, and we are excited about the future of this initiative.

Credit-sensitive loans, or CSLs, fits nicely with our skill set in analyzing legacy non-Agency securities, as these loans are very similar to those in subprime or Alt-A deals. These loans are currently performing, but where the borrower has either had some payment troubles in the past, is underwater on his mortgage or both. It is also not unusual for a loan to have been modified at some point in the past, and in many cases, the borrower is in a better position to make the monthly payment now than when the loan was originated.

Like loans in non-agency deals, these loans, although currently paying, have a reasonable probability of default and possible loss. The advantage CSLs have over legacy non-agency securities is that with CSLs, we own the servicing rights for the loans and oversee and direct the work that the sub-servicer does to maximize value.

At this point, we have some small pools that we expect to close on this month. As we accumulate more size, there is the potential to securitize these assets to generate attractive credit investments for our portfolio. While this endeavor is exciting, and capitalizes on our credit expertise, supply is limited typically to what the banks decide to sell, and, as such, we have little control over how much we can purchase at any point in time.

Finally, keep in mind that our current position is quite small relative to our overall portfolio.

Another opportunity we are evaluating is MSRs, or Mortgage Servicing Rights, which we have discussed in the past. We believe MSRs are a good fit for our business as they provide a good hedge to our Agency MBS portfolio and leverage our expertise on prepayment. As I have noted before, the barriers to entry are quite high, but we feel we have been making progress evaluating this opportunity, and will keep you posted when and if we enter this market.

Finally, as we have also discussed before, credit investments from the GSEs fall into the "when and if" category.

Before wrapping up, I would highlight that we are excited about 2013 for a variety of reasons, including the new initiatives I just mentioned. While at this point they are quite small relative to our portfolio or in the investigation stage, we believe there is substantial value to our shareholders in seriously considering these opportunities. We aim to continue driving value for our shareholders over the long term and look forward to keeping you informed on opportunities we see across all facets of our business.

Thank you again for joining us today. I would like to turn this back to the operator at this point.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Douglas Harter, Credit Suisse.

Douglas Harter - *Credit Suisse - Analyst*

Thanks. I guess if you could just talk a little bit about the new opportunities on the loan side. Can you talk about the returns there relative to securitizations and what makes that attractive today versus, say, a year ago?

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

Sure. Good morning, Doug. Thanks for joining us. So on the -- I think there were two questions in there. On credit-sensitive loans, yields in that market are very competitive with yields that we see in the non-agency side. Although I will tell you that the value of owning and controlling the servicing is actually fairly substantial.

In terms of securitization of credit-sensitive loans, there have been some deals done in the past, not very many. But we'll have to wait and see. Certainly, if we get enough size to securitize and then see what the math around securitization is. But in terms of just the raw product, we find them very competitive with their counterparts in the securities side.

In terms of securitization, as I mentioned, we are not at liberty to comment on any deals that are currently in the market. But what we've said before is that securitization math looks a lot more interesting than it did a year ago. And that is due primarily to the AAA part of the capital structure trading at tighter levels than it had back then. And also the fact that credit enhancement from the rating agencies seems to have found its footing and come down a little bit.

Certainly if and when we complete the securitization, we'll be happy to talk about what the math looks like.

Douglas Harter - *Credit Suisse - Analyst*

Great. Appreciate that. Thanks, Bill.

Operator

Mark Devries, Barclays.

Mark Devries - *Barclays - Analyst*

I had a follow-up question on securitization. At the end of the third quarter, you had about $15 million in mortgages held for sale and purchase commitments of [$320 million], but ended the fourth quarter at about $59 million. Did you sell any mortgages to another investor during the quarter?

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

No, there is always a fallout element in our pipeline process, so until they are funded, they are either subject to fallout or subject to any sort of bulk transaction that does not complete.

Mark Devries - *Barclays - Analyst*

Okay, got it. Next question is for Tom. I think Brad touched on this a little bit. But how do you think about the dividend here with the core earnings obviously kind of below the run rate of kind of the quarterly value you guys are generating, particularly through the appreciation of your non-agency book? How do you think about kind of using that appreciation through either realized gains to support the dividend going forward?

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

I think there is a couple elements to that question. As you know, we do not provide dividend projections, but maybe I can answer that in a couple of steps.

One, if you look at our core earnings for the quarter coming in at $0.28, that will always be driven by a number of things that we think are important, leverage being one, which Bill expanded upon. Our hedging strategy, which -- the use of swaps and other instruments.

But also, we don't want to lose sight of the fact that we had Silver Bay capital on our balance sheet, which due to the ramp stage, we estimate had a dilution impact of $0.03. So that is kind of one element is removing that capital, that average capital that we had, we would be closer to probably around the $0.31 mark, based on our current management of our portfolio.

And then going forward, it is always a balancing act between book value and dividend, but really it gets back to risk management. If Bill feels -- as the team feels that there is opportunities to derisk our profile by harvesting gains, that will drive those decisions, and might or might not impact the dividend.

Mark Devries - *Barclays - Analyst*

Okay. And then finally, for Bill, what type of yields do you expect on the CSLs, and what kind of leverage do you think you could put against those?

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

I think I alluded to this just a bit ago with Doug. The yields on credit-sensitive loans are very competitive with non-agency subprime bonds. And the leverage that you could get in the securitization frankly depends on what that pool looks like. There have been a handful -- a small handful of deals that have been done. We obviously haven't done one, so I can't tell you what ours might look like. But on an unlevered basis, we find the yields to be attractive. And on a levered basis through a securitization, we would be very pleased if we could get something like that done. We think it would be very worthwhile.

Mark Devries - *Barclays - Analyst*

Okay, thanks.

Operator

Bose George, KBW.

Bose George - *KBW - Analyst*

Just wanted to ask about incremental spreads on agencies and non-agencies, just given the changes in book value since quarter end.

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

Sure. So just to give you an idea, on non-agencies, I have a couple remarks. First of all, that market today, there are a lot of bonds that we would typically look at that would be in the 5% to 6% range. Now, one bright spot I'll mention is -- which is something we haven't seen in a long time -- is we've started to see the repo funding spread come in on non-agencies, which I think is very worthwhile certainly from the funding standpoint. Funding is very plentiful, but we've seen some spreads come in about 25 basis points from certain dealers, not everyone. But I think that obviously bodes well.

So if you kind of put that together, you will see, using the kind of leverage that we use, expected ROE, somewhere in the 10% area on a gross basis.

Then on the agency side, what we've seen so far in January is actually the mortgage -- we've seen a curve -- bear steepener on the curve, and mortgages have underperformed quite a bit. One of the reasons actually we took our leverage down was because mortgages appeared to be fully priced to us at certain times during the quarter. And certainly that has helped us out in January, as the agency strategy would have suffered.

But that being said, today, I think that ROEs are also roughly 10% on the agency strategy, using leverage sort of in that 6, 6.5 times that we typically carry.

Bose George - *KBW - Analyst*

Okay, great. Thanks. And then actually on leverage, I guess you guys said the agencies, no plans to change leverage. But just curious on the non-agencies. If the world continues to improve, could there be a change in leverage over there?

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

Bose, good morning. This is Tom. How are you? You shouldn't expect that our leverage is going to change significantly in either our agency or non-agency portfolios. As you know, Bill and I have been around a while, and we don't want to treat leverage as a mechanism to create a certain dividend yield. But rather, we want to manage the book prudently for a total return perspective. So in short, don't expect much change in our leverage levels.

Bose George - *KBW - Analyst*

Okay, great. Makes sense. Thanks. And just one last one. Just the GSE prepaid numbers that were out last night, any surprises there?

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

No, they were pretty much -- they were generally flat. Some were up or some down a little bit, but generally mixed. Next month, expected to be down 10% to 15%. That is generally due to day count. But no, there were not any terrific surprises there.

Bose George - *KBW - Analyst*

Okay, great. Thanks a lot.

Operator

Trevor Cranston, JMP Securities.

Trevor Cranston - *JMP Securities - Analyst*

Thanks. Most of my questions have been asked, but I guess one more maybe on the securitization platform. Are you able to give us any sense about the pace at which you are able to acquire loans currently? And maybe can you talk about if you have any sort of goal or target for the year in terms of kind of getting up to a rate of maybe a deal per quarter, or is it just still too early to comment on that? Thanks.

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

Trevor, good morning. It's Tom. In respect to that, it is -- the very honest answer is we are just not sure. It is going to be dictated by supply and it is going to be dictated by the economics and the economics relative to our other alternatives. As we've said before, we don't want to do things to do things. We just want to do things that (technical difficulty), and so we'll just have to see.

But we are going to do things -- our commitment is only to do things that are smart for our shareholders.

Trevor Cranston - *JMP Securities - Analyst*

Okay, that's helpful. Congratulations on a good year. Thanks.

Operator

Ken Bruce, Bank of America.

Ken Bruce - *BofA Merrill Lynch - Analyst*

Thank you. Good morning. My question is a bit more philosophical. You've pointed out on a number of occasions that you like the flexibility of the hybrid model, and clearly, you are starting to demonstrate that now. It sounds like you are going to see some more changes just as the year kind of comes to pass.

I guess I would like to maybe understand where you see the boundaries of any strategy shift away from agencies, what might be a gating factor to that, whether it be whole pool tests and things of that nature, or just how to think about how far you may evolve the strategy.

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

Sure. Yes, Ken. Thanks. It's Tom. In respect to that, obviously the retest, the whole pool test, is a gating factor, certainly. Non-agencies don't conform to that, particularly well, if at all.

But really, how we think about it is this. We want to have new initiatives that are grounded in our core competencies, and we are not going to divert very far from that. So the things that Bill has talked about, be it MSRs or securitization or CSLs, obviously are all very close to our legacy portfolios. They are just new wrinkles, if you will.

And the other thing is, so it's got to be -- rely upon our core competencies, and you should expect anything to be incremental, such as these new initiatives are.

Ken Bruce - *BofA Merrill Lynch - Analyst*

Okay, and just as you look at potentially harvesting effectively gains or where there has been -- relative value has effectively been expressed through market prices already and you rotate out, how much of that would you look to do on any given period? There is obviously some school of thought that you can effectively pull forward earnings through gain recognition, and you see some of that from time to time this past quarter as part of that. And how should we think about how quickly you may move a strategy around, understanding you just had incremental? But I guess I'm trying to gauge exactly what that might mean.

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

Sure. You know, it is very tough to say. We are just going to do things that are smart. If value is wrung out of a sector, we will rotate out. Bill and the team did a marvelous job in the fourth quarter of repositioning the agency portfolio by rolling down in coupon to enhance prepayment protection. Obviously, that resulted in some capital gains in the fourth quarter.

And it is very difficult to say. Obviously, we have considerations of being a REIT, and so we can't be a high-velocity trading vehicle. But we just want to do things that are smart. I was delighted at the reposition in the fourth quarter, and Bill and the team constantly look at ways to enhance value.

Ken Bruce - *BofA Merrill Lynch - Analyst*

Okay. And lastly, you've seen a number of REITs in one form or another begin to develop operating platforms that have, in a sense, kind of positioned those companies for doing different things. Is that something that Two Harbors would envision as it relates to some of the conduit activities? Or how should we be thinking about your involvement in the loan side of the equation, understanding again you've made some comments to that, but I am trying to get a sense as to what the scale of that might look like.

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

These new initiatives, it's tough to say. All of these things are attractive mathematically. Some of them have operating hair on them all or some complicated issues around that. But we are just going to do things, again, that are smart for our shareholders and things that play into our core competencies where we have the infrastructure to support it, where we have the staff to support it, et cetera.

We are very excited about these new things. We don't want to oversell them today because they are not a significant part of our portfolio. But it is just our commitment to enhance shareholder value.

Ken Bruce - *BofA Merrill Lynch - Analyst*

Okay, well, thank you for your comments. Congratulations on a good quarter and good year. And I look forward to seeing you in 2013.

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

Thanks for those kind words, Ken.

Operator

Joel Houck, Wells Fargo.

Joel Houck - *Wells Fargo - Analyst*

Thank you, and good morning. I'm wondering if you can -- maybe it's a crystal ball lookout through 2013, and give us maybe a range of what you think the net ROEs are for the agency business, assuming a six to seven times leverage. Obviously, you guys are running a bit below that. And then, what the marginal ROEs look like on the non-agency side, again assuming your target leverage ratio of 1 to 1.5.

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

I tell you, Joel, if I had a crystal ball, I would be in a warmer place than Minnesota right now. Bill commented on the ROEs that exist in the market today, and that is really all that we can say. Mortgage spreads are pretty ephemeral. We've seen a lot of volatility in the past few years. So it is very difficult for us to predict, and certainly, we would be reluctant to give any guidance.

Market conditions just change too rapidly. Today, they are somewhat lower than they've been in the past few years. We are trying to enhance our ROEs through new initiatives. But outside that, we really can't say a lot.

Joel Houck - *Wells Fargo - Analyst*

So Bill's comments, I guess, are the best assessment, I guess at this point, in terms of modeling this out for the balance of 2013. Is that fair?

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

Well, yes, that's difficult to say. ROEs move around a lot, so what they are today is some indication, but they change an awful lot. So we'll just have to see. We are optimistic, but market conditions change daily.

Joel Houck - *Wells Fargo - Analyst*

And I guess, in terms of the new initiative, what is the -- obviously, these are small right now. But as you kind of look out, how do you think about these businesses, particularly -- our understanding is that purchased MSRs can be structured so they are REIT-eligible assets. So would you guys envision any potential challenges maintaining your REIT status with respect to either the asset or the income test? Or is that really kind of dependent upon the opportunity that you kind of put into the Company going forward or (multiple speakers)?

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

Yes, thanks for the question. We're not going to do anything to jeopardize our REIT status. So -- and how big the initiatives are just -- it depends. These things are mathematically attractive today. They have operating complexities. But anything that we do, we're going to do well. That is our commitment.

Joel Houck - *Wells Fargo - Analyst*

Okay, and then last, I guess it is safe to say that anything you guys are currently looking at, you already have the existing infrastructure expertise with your affiliation with Pine River. Is that a fair statement?

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

I'm not going to spend one money of shareholder value that I don't feel confident that I can manage prudently and demonstrate best-in-class on everything investment, controls, accounting, audit, the whole thing. So when we say we want to be the best, we mean it. We want to be the best.

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

And I can maybe expand upon that. As each of those initiatives have their own unique characteristics, they also overlap with each other. So areas of underwriting, due diligence, operational components, those will continue to be expanded upon as each of those grow. And really try to understand each of the -- the opportunities in each of those three buckets, you can actually get to the underwriting stage early in a phase, and so you can really understand the credit components or the prepayment components.

And so we obviously will build out the appropriate team to kind of maximize the value in those areas.

Silver Bay is probably a good example of that. There was appropriate hiring to support that initiative, make sure that we're managing the risks. Those are operational risks, those are different asset class risks. We will be approaching it the same way on each of those initiatives. Fortunately, they overlap a lot, so it can be fairly streamlined in what we do.

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

And finally, I would say to your point, yes, without a doubt, the external manager being part of the Pine River family gives us a lot of support in a variety of areas. And we rely upon that relationship and benefit from it, certainly. We are very proud to be part of the Pine River family.

Joel Houck - *Wells Fargo - Analyst*

All right. Thank you very much.

Operator

Stephen Laws, Deutsche Bank.

Stephen Laws - *Deutsche Bank - Analyst*

Specific stuff has been covered in the deck or the Q&A. I just wondered if you guys could take a minute and maybe talk about the competitive landscape, particularly with respect to nonregulated mortgage rates versus regulated financial institutions and their unknown balance sheet requirements and other issues that they may or may not have addressed for them anytime soon, and kind of how that positions you guys to target more of these credit-sensitive investments.

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

Good morning. Thanks for the question. Yes, that is -- well, I'll try and be brief, because that sounds like it could be a lengthy discussion we could have over a beer sometime.

But the banking industry obviously has had, they have had their headaches with regards to a whole host of issues in the mortgage arena. There is a hangover that exists certainly for certain institutions. And obviously, they are being highly regulated in terms of their participation, as well as capital rules.

On the other hand, the banks enjoy the tremendous benefit of being able to collect deposits, which is certainly tremendous from the funding standpoint.

In our case, we are basically focused on a very small part of what banks do in general. We are focused on the residential market, with an extremely high emphasis on securities. And we also fund ourselves using the Street, and that is not something that enjoys the benefit of Federal Deposit Insurance, certainly. So the business models are very different.

What I would say is that in terms of taking a look at mortgage credit, I think the REIT model is very, very well set up, ourselves particularly, since that is one of our core competencies, to be a long-term provider of mortgage credit. And as the government goes through and figures out what they are going to do with housing finance, the GSEs, the new definitions of what qualifies, we are very excited about our ability to put capital to work at what we think are going to be attractive returns that don't have any necessarily regulatory burden due to the deposit insurance that the banks enjoy.

Stephen Laws - *Deutsche Bank - Analyst*

Great. Thanks for the brief color on that, and definitely look forward to catching up on that in more detail in person some time.

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

Sounds great. Thank you.

Operator

Boris Pialloux, National Securities.

Boris Pialloux - *National Securities - Analyst*

Just quick questions. The first one is until March, are you hedging your exposure to Silver Bay? And second question is, you were mentioning the press release that you have $56.9 million of purchase commitment. Does that include CSLs?

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

Good morning, Boris. This is Tom. I'll answer the first question, then hand it over to Bill for the second question. In respect of hedging our exposure to Silver Bay, the answer is no. It is an unhedged position. So in respect of our overall portfolio, it is not that impactful, but there is a correlation obviously mathematically between our holdings and Silver Bay and book value for Two Harbors. So it is relatively de minimis, but it is an unhedged position.

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

This is Brad. I can take the second. The answer is no. Those small CSL trades that Bill mentioned are not part of the pipeline as noted in our 12-31 position.

Boris Pialloux - *National Securities - Analyst*

Okay, thank you.

Operator

Jackie Earle, Compass Point.

Jackie Earle - *Compass Point - Analyst*

-- question, just one quick one. Given the investments in the platform, what could we expect for the run rate operating expenses on a go-forward basis?

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

That is -- I think that's a question just like the -- just with all these strategies, we can say a fairly limited amount. It all really drives on which one and what size and how fast.

I think, in the near term, it is a fairly small amount in correlation to the size of the balance sheet position. And we are really unable to provide much more color than that. As we go through each quarter and generate a focus on our balance sheet and showing the assets that we are building, we are going to be able to give a lot more color on how the basis points might change.

Now, with all these strategies, it is important to realize that a large part of them have operational costs to them that are really embedded in the investment themselves. Due diligence of loans, underwriting, for example, which might from an accounting perspective show an increase in the operating expense ratio, but are really just embedded in the ROEs of that strategy. So those are some things to think about. At this time, I can't really provide much more color.

Jackie Earle - *Compass Point - Analyst*

All right. Thank you.

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

Sure, and I'll just add onto that, too. Importantly, as we might spend money on these new initiatives, we are making sure that we are getting value for that. So we go through what it costs to create and operate these new strategies, and we want to make sure that they are incrementally accretive to earnings. So that is how we think about it.

Jackie Earle - *Compass Point - Analyst*

Thank you very much.

Operator

Thank you. I would now like to hand the conference over to Mr. Tom Siering for any closing remarks.

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

Well, thank you for joining our call today. As we've discussed, we are greatly pleased with the returns we generated for shareholders in 2012 and are optimistic about the opportunities that we see over the coming year. Thanks for listening. Have a great day.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes our program for today. You may all disconnect, and have a wonderful day.
