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TWO - Q1 2013 Two Harbors Investment Corp Earnings Conference Call

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PRESENTATION

Operator

Good day ladies and gentlemen and welcome to the Two Harbors first quarter 2013 financial results. At this time all participants are in a listen-only mode. Later we will conduct a question-and-answer session with instructions following at that time.

(Operator Instructions)

As a reminder this conference is being recorded. Now I will turn the conference over to your host, July Hugen, Director of Investor Relations. Please begin.

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

Thank you, Tyrone, and good morning. Welcome to Two Harbors' first quarter 2013 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 first quarter 2013 results, Brad will highlight some key items from our financials, and Bill will review our portfolio performance and our new investment opportunities.

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 web page 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 first quarter results, we wish to remind you that remarks by Two Harbors' management during this conference call and the supporting slide presentation may include forward looking statements. Forward looking statements reflect our views regarding future events and are typically associated with the 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 fourth webinar in our ongoing series, titled "Mortgage REIT Primer". The webinar provides general information about REITs, mortgage REITs and Two Harbors' business model and can be found on our website under the "Webinar" link. 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 3

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

Thank you, July. Good morning everyone and thank you for joining our first quarter earnings call. It has certainly been a busy start to the year and we are pleased to provide you with updates regarding our business. After I comment on the quarterly results and provide some insights related to the macroeconomic environment, I would like to discuss some of our new investment opportunities. Brad and Bill will cover these in greater detail later.

In the quarter, we recorded $248 million of comprehensive income, or $0.81 per weighted average diluted share. This is remarkable in the context of the sector's first quarter performance as Agencies were pressured and interest rates displayed volatility. Our comprehensive income was driven by non-Agency performance. There was also a minor impact from the appreciation of our Silver Bay common stock, as Brad will discuss later. Our performance this quarter speaks to the benefit of our hybrid model, our rigorous security selection and our sophisticated approach to hedging. Non-Agencies have continued to rally into the second quarter while Agencies have staged a modest rebound.

Our book value was $11.19 per share on March 31, representing a total return of 8.5% when combined with our first quarter cash dividend of $0.32 and special dividend of Silver Bay stock which amounted to $1.01 per share. We reported GAAP earnings of $0.47 and core earnings of $0.29 per share which Brad will discuss further.

The distribution of Silver Bay common stock to Two Harbors' shareholders which was completed on or about April 24 was an important accomplishment this quarter. As you may recall in late 2012, we announced that, concurrent with Silver Bay's IPO we would contribute our portfolio of Single Family Homes in exchange for 17.8 million shares Silver Bay common stock. At the same time, we announced that, subject to the approval of the Board and following the expiry of a 90-day lockup, it was our intention to distribute the Silver Bay stock to our stockholders by means of a special dividend. We were pleased to have met this goal. Silver Bay went from nascency to the public markets in less than a year's time. It hopes to capitalize on America's improving housing markets.

Next I'd like to talk about the capital we recently raised. Late in the quarter we completed an accretive public offering raising approximately $763 million in net proceeds. We expect to use the proceeds to purchase Agency and non-Agency bonds, Credit Sensitive Loans or CSLs. We also hope to deploy capital into Mortgage Servicing Rights and prime jumbo securitization as market conditions allow. We think the timing of this raise was good for investors given available yields in the market and would note that Agency spreads became more interesting late in the quarter. Bill will comment further on the capital deployment shortly.

During the first quarter, we also reported progress related to several of the new business initiatives that we have discussed in prior quarters, which we will expand on later.

In the first quarter, approximately 6 million of our warrants were exercised, with an additional 3 million since quarter-end. Today, that leaves just about 4.6 million of the original 33 million warrants outstanding. As previously announced, the declaration of the Silver Bay stock dividend triggered certain adjustments to the warrants under the terms of the warrant agreement. As a result, they are now struck with an exercise price of $10.25 and each warrant can be converted into 1.0727 shares of common stock. The warrants expire on November 7, 2013 and are currently in the money. We should note the impact of this adjustment to the company was de minimis.

Please turn to slide 4. Next I will provide some brief commentary on a few developments that could impact our business and the mortgage and housing sectors.

National home price performance continues to improve, which is important to our non-Agency portfolio and CSLs. According to Core Logic, home prices increased 10% as of February 28th on a rolling 12 month basis. Most forecasts call for a continuation of home price appreciation in the next several years as well.

Unemployment metrics continue to languish. However, signs of strengthening GDP and other economic indicators led to a modest increase in interest rates during the first quarter. We continue to hedge against a potential rise in interest rates by using swaps, swaptions and interest only securities as we believe that is a prudent way to manage our exposure at different points on the yield curve. Preservation of book value through risk mitigation is a paramount objective.

From a policy perspective, one thing I'd like to touch on is the extension of the Home Affordable Refinance Program or HARP, through 2015, which was announced in mid-April. We were not surprised by this extension. We had been expecting an announcement of this nature for some time. It is important to note that we have very little exposure to HARP pools in our portfolio, and therefore, we do not view this as a meaningful development in terms of managing our existing portfolio. Of course, we are mindful of other potential developments regarding policy and regulatory changes, few of which are noted on this slide.

Another item that has formed recent media headlines is the Financial Stability Oversight Council's annual report and its potential commentary on mortgage REITs. The published report, which came out last week, was benign in its remarks regarding mortgage REITs, although it did discuss interest rate risk and liquidity risk associated with leverage. As many of you know, we hedge our interest rate exposure quite closely. We are also prudent regarding the leverage we employ and have a historically low amount of leverage currently.

Next I would like to discuss some of our new investment opportunities, as noted on slide 5. On May 2nd, we announced that one of our wholly-owned subsidiaries acquired a company, Matrix Financial Services Corporation, that has approvals from Fannie Mae, Freddie Mac and Ginnie Mae to hold and manage mortgage servicing rights. Importantly, Matrix, with less than 10 employees, has little in the way of operations or potential legacy liabilities, but has all the necessary Agency approvals that will position us to own and acquire MSRs. Additionally, we recently received a Private Letter Ruling from the IRS advising that we can treat the beneficial ownership of excess servicing spread as good income for REIT compliance purposes.

Let's discuss securitization. In the first quarter, we participated in a $400 million prime jumbo securitization. We are pleased with our progress giving the attractive economics and risk-return profile. We continue to build out our originator platform for aggregating loans. Bill will elaborate on this.

Next, let me provide an update on our CSL investment initiative. During the quarter, we continued to make progress on purchasing CSLs, and we anticipate securitizing them at some point. These are portfolios of whole loans that often have been modified and commonly have high LTVs.

As many of you know, a compelling aspect of these new investment opportunities is that they dovetail nicely with our existing strategies and our core competencies of credit and prepayment analysis.

These are exciting times in the housing and mortgage markets and for our company. I will now turn the call over to Brad for a deeper dive into our financial results.

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

Thank you, Tom, and good morning everyone. I will begin my prepared comments with an overview of our first quarter financial results and a few pertinent accounting insights, discuss quarterly changes to book value including the impact of our recent capital raise, and finally provide a brief update to our financing profile. Please turn to slide 6.

Core earnings of $0.29 per weighted share represented a 9.7% annualized return on average equity while GAAP earnings, albeit a less meaningful metric due to mark-to-market accounting vagaries, were $0.47 per weighted share.

Core earnings were driven 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 deal costs related to the securitization we completed in the first quarter, which we believe stays true to the "run rate" measurement objectives of core earnings within the industry and reflects how we think about the economics of a securitization. I will expand upon this in a moment.

Core earnings were largely in-line with the fourth quarter of 2012 and our internal expectations for this quarter. As we have been discussing for some months, we saw lower projected yields on securities acquired in the latter half of 2012 and into early 2013, driving a marginally lower net interest margin. Importantly, the CPR on our current portfolio has remained low and stable despite low interest rates.

Similar to prior quarters, core earnings were also pressured by our robust financing and hedging strategy. In addition, the core earnings measurement was diluted by approximately $0.03 per share as a result of the capital allocation to Silver Bay common stock. While the investment in Silver Bay common stock resulted in unrealized fair value appreciation within the quarter, it did not generate meaningful core earnings.

Our operating expense ratio as percent of average equity was static quarter-over-quarter at 0.7%. As we look forward, we expect that the size of our investment portfolio and new business diversification initiatives may impact this in future quarters.

I would like to briefly touch upon a few accounting matters that provide further color into our portfolio performance and financials.

First, other-than-temporary impairments on our non-Agency RMBS were an immaterial adjustment of $0.2 million this quarter, with only one bond impacted. Again, this illustrates continued fundamental soundness in our non-Agency holdings.

The next accounting topic I would like to discuss is the accounting for the prime jumbo securitization Tom noted. Due to management's conclusion that we are deemed the primary beneficiary of the securitization due to certain loss mitigation and servicer control rights we hold within our subordinate securities, the securitization is accounted for as an on-balance sheet transaction. Consistent with our accounting for our own portfolio of mortgage loans, we are accounting for the mortgage loans held within the trust and the associated collateralized borrowings under the fair value option election. Under this election, the changes in fair value of these items will run through the income statement and deal costs which are typically capitalized in the basis of the securities were immediately expensed.

In summary, this fair value election creates a few accounting nuances, but ultimately management feels this accounting most accurately reflects the "real" economics of the securitization in the financial statements relative to alternative accounting options under GAAP. We will continue to provide investors transparency related to this and other accounting topics in the future.

The final accounting topic concerns the Silver Bay common stock and associated earnings. On April 24, 2013, we recognized a taxable realized gain of approximately $16 million, which was roughly the difference between the closing share price of Silver Bay on that date of $19.40 and our cost basis of $18.50 in the approximate 17.8 million shares we held in our portfolio. A portion of this gain was included within our first quarter GAAP income statement as we recognize $7.8 million of mark-to-market gains, representing the difference in the December 31st market price of $18.83 per common share and the value of the shares on March 18th, which was the day we announced our stock dividend. Due to the accounting requirements surrounding the special dividend, the fair market value appreciation between March 18 and the distribution date, April 24th, were captured as an adjustment to the dividend payable, rather than through the income statement.

Finally, we recognize $1.4 million of installment sales gains from Silver Bay that we classified as discontinued operations, and, as previously disclosed, a reduction to the management fee of circa $4.3 million in accordance with the contribution agreement.

Now, please turn to slide 7 which contains a quarterly book value roll forward. As Tom noted, our book value per diluted share was $11.19 this quarter. I'd like to take a moment to highlight a few key items from the book value roll forward.

First, on March 22nd, we completed an accretive public offering of 57.5 million shares for net proceeds of approximately $763 million. Due to the timing within the quarter, this capital raised impacted our overall leverage at quarter-end. Similar to other raises, we anticipate the deployment process will take a few months which will impact Core Earnings and average leverage in the current quarter as well.

Second, book value increased due to strong comprehensive income for the quarter of $248 million. This is an important note, as comprehensive income is a key way we judge our performance over the long-term.

Third, we announced dividends to our shareholders in the form of a cash dividend of $0.32 per share and the distribution of 17.8 million shares of Silver Bay stock to our shareholders, which amounted to $1.01 per share. As a reminder, for every 100 shares of Two Harbors stock, a stockholder received approximately 4.9 shares of Silver Bay stock. We were pleased to be able to complete the cash dividend as well as the special dividend during the first quarter while growing the underlying book value.

As of quarter end, you will note that the remaining warrants have a slight negative impact on a fully diluted basis with a fully diluted book value per share of $11.19 versus $11.23 on a basic basis.

Please turn to slide 8. As it relates to our financing profile, we continue to maintain a lengthy repo maturity profile with an average of 82 days to maturity at March 31st, in-line with our profile at the end of the fourth quarter. Consistent with prior quarters, we also continue to manage our repo across a variety of counterparties, which during the quarter comprised 24 different firms. On this slide, we have highlighted our diverse Agency counterparty relationships as well as the high-quality of our non-Agency counterparties based on CDS spread.

Finally, I would point our listeners to slide 17 in the Appendix. Outlined on this slide is additional information a stockholder might find useful when understanding the Silver Bay stock dividend.

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. This morning I would like to discuss our first quarter performance, our current portfolio, the recent capital raise, and give you an update on the progress we've made in respect to the new investment opportunities we have highlighted in the past. Before diving into quarterly results, there are a couple of policy-related topics I would like to mention. Recently, President Obama has nominated Mel Watt to be the Director of the FHFA. While there has been a lot of press around his nomination and qualifications, his appointment is still uncertain. Additionally last week the Congressional Budget Office released a report noting that principle forgiveness could potentially save taxpayers money. Mr. Watt's nomination has raised concerns in the market about potential changes to HARP and the CBO report implies a possibility of principal forgiveness being introduced for delinquent Agency loans. Both of these possibilities could lead to higher uncertainty within the mortgage market, which would likely be expressed through higher mortgage rates. While these possible changes may benefit some stake holders, overall higher mortgage rates are clearly uneconomical. Importantly, our portfolio is not at significant risk if either of these possibilities takes form.

Please turn to slide 9. The first quarter of 2013 was a great start to the year. The benefit of our hybrid model was demonstrated this quarter, as we had strong overall return, despite mixed performance within our portfolio segments. To start, Agency securities underperformed in the first quarter. With improving economic sentiment and interest rates moving modestly higher, there was some concern in the market regarding how long the Fed will continue to be a buyer of Agency mortgages, which cause spreads to widen. Further, payups on specified pools were under pressure as a result of the interest rate environment. As a result, our Agency strategy suffered slightly on a total return basis, losing a small amount.

The non-Agency portfolio, on the other hand, had a wonderful quarter, generating an economic return of approximately $274 million. This was generally due to improving data around housing prices, declines in severe delinquencies, and better overall borrow performance, similar to the trends experienced in recent quarters. We also realized a gain in our CSLs, which reflect the same type of exposure as non-agencies. We believe these trends are likely to continue, given the tremendous affordability of housing and as the economic backdrop and the housing market improves. Similar to prior quarters, supply of non-Agencies remains muted today, although we do continue to find securities at attractive valuations from time-to-time. More information on our non-Agency portfolio is available in the appendix on slide 21.

On the bottom left of the slide, you can see our return on book value versus some familiar indices for the first quarter. We are pleased that our return on book value of 8.5% greatly outperformed a simple 50/50 Agency/non-Agency capital allocation strategy. We believe this demonstrates the importance of having the ability to dynamically allocate capital. On the bottom right, you will see that our yields and spreads for the first quarter were in-line with results from the fourth quarter.

Turning to slide 10, let's take a look at the portfolio. Our portfolio as of March 31st is $15.5 billion in total size, including $12.3 billion in Agency securities and $3 billion in non-Agencies, as well as other investments. On the top right you will see that our capital allocation is roughly in line with last quarter, with a little over 50% to Agency, almost 40% to non-Agency and CSLs, and the rest to homes via our holdings in Silver Bay common stock. Going forward, our allocation to residential properties through Silver Bay will be zero given the distribution of the shares to stockholders.

It is important to note that we are under-deployed as of quarter end as a result of our most recent capital raise. As we complete the deployment, we expect to put capital to work across the Agency and non-Agency portfolios as well as with CSLs and MSRs, which I will discuss later. As of April 30 we are approximately 75% deployed although we expect it to take a few months to complete the deployment process. This is similar to the deployment lag experienced during prior raises.

On the Agency side, we have been focusing on prepay protected pools in certain 30 year coupons at much lower payups than in past months. And we have also been able to take advantage of attractive implied funding REITs available in the TBA market. These TBAs are not reflected in our pool holdings but still represent exposure to Agency RMBS. At quarter end we had $2.2 billion in TBA exposure, up from $1.9 billion at December 31. TBA exposure can be converted to specified pools opportunistically over time depending on how long the TBA funding advantage persists and the attractiveness of pools that become available. On the credit side, we have been able to pick up some non-Agency bonds as well as several hundred million in credit sensitive loan pools. As we noted at the time of the capital raise we are expecting returns in the low double digits from this raise as Agency spreads at the time of the raise were attractive, and we see good opportunities in CSLs and MSRs. We will provide full details on our updated portfolio after deployment is completed.

As we turn to slide 11, let's discuss a few metrics from the portfolio. The overall profile of our portfolio remained fairly consistent with prior quarters. Our Agency prepayment rate for the quarter including inverse IOs ticked somewhat higher to 7% from 6.6% previously, while prepay speeds generally remained fast across the overall market due to the low interest rate environment and the continued success of the HARP program. We believe that our Agency prepayment rate relative to the faster prepayments experienced in the broader market is a result of our dedication to a stringent security selection approach when purchasing assets. About 98% of our Agency portfolio had 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. Consistent with past quarters, our non-Agency holdings are predominantly weighted towards low dollar price subprime bonds. More information on our non-Agency portfolio is available in the appendix on slide 21.

Next let's talk about leverage. Our overall debt-to-equity ratio is 3.1 times. Lower than 3.4 times at the end of the fourth quarter due largely to our recent capital raise. While we have increased the leverage on our Agency strategy recently due to more attractive spreads, overall leverage at quarter end remains impacted by the timing of the capital raise. It is also important to note that our stated leverage does not include implied leverage from being long TBAs. Broadly speaking, we continue to target a debt to equity ratio of 6 to 7 times for the Agency portfolio including our TBAs, and 1 to 1.5 times for the non-Agency portfolio. We expect overall debt to equity to be around 4 times once our capital is fully deployed.

Let's discuss hedging next, which is another important element in protecting book value. Although interest rates moved a touch higher in the quarter, in an historic context they remain low. Further they have moved back to roughly year-end levels since quarter end. If the macro-economic backdrop continues to improve, we think rates could move higher, so protecting our portfolio against higher rates makes a lot of sense to us, and you can see our duration profile on the right hand side of this slide.

Note that while we typically carry little rate exposure, as of March 31, we were actually slightly net short. That means that rates rise we would expect our book value to increase. Also as you will see in our 10Q, our portfolio is currently positioned such that a parallel increase in rates, including LIBOR, would have a beneficial impact to our interest income, although from an overall portfolio management perspective we continue to enjoy the low rate environment from a funding perspective and expect these conditions to persist. More details on our hedging positions as of March 31 are in the appendix on slide 19.

We are very pleased with our financial performance in the first quarter of 2013 but we are even more excited about the progress we have made in some of our new initiatives.

On slide 12, 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. I like to spend a few minutes updating you on the progress we have made in these areas.

Let's talk about securitization first. Last quarter we noted that the math around creating subordinate bonds and IOs via a securitization had become more attractive recently. We are pleased to note that we participated in a prime jumbo securitization in the first quarter through Credit Suisse. This produced attractive residential mortgage credit and IO bonds for our portfolio.

More importantly, we continue to work on building our own originator network to source loans which will enable us to be an ongoing issuer over time. We anticipate adding several originators in the second quarter who will originate and sell loans directly to Two Harbors with the aim of growing our originator partners throughout the remainder of 2013. We are very constructive regarding the future of non-Agency originations and securitization as the government reduces its footprint over the years to come. We hope to play a meaningful role in this market and will continue to keep you posted as we build out this initiative.

Credit sensitive loans, or CSLs, as we have spoken about before are a nice complement to our non-Agency holdings as they contain similar credit exposure. In short, they are essentially like the performing loans in non-Agency deals. We have had good success adding CSLs so far this year and have purchased or contracted to purchase in total about $600 million in loans or about $450 million in market value, as compared to $123 million in market value as of March 31. Importantly, these loans are potentially securitizable and we intend to consider a securitization if the math allows us to create credit bonds with attractive yields. It is worth noting that while this endeavor capitalizes on our credit expertise and we have been successful in purchasing packages at prices we like, supply is typically limited to what the banks decide to sell, and as such, we have less control over how much we can purchase at any point in time. That said, we are excited about CSLs providing attractive credit opportunities for our portfolio and will keep you posted on continued developments in this initiative.

Another opportunity we are pursuing is MSRs or mortgage servicing rights. MSRs are a nice fit in our portfolio as they provide a natural hedge to our Agency MBS. As Tom mentioned, we recently closed on the purchase of a company which allows us to be involved with Fannie, Freddie and Ginnie MSRs. We have been in discussion with a number of potential sellers of MSRs and will keep you posted as we progress towards adding these to our portfolio.

Finally, as we have discussed before, credit investments from the GSE are still on our radar screen. As mandated in the FHFA score card this past quarter, the GSEs are charged with disseminating credit risk on at least $60 billion notional of Agency RMBS in 2013. We think this could be a very interesting opportunity given our strengths in understanding mortgage credit.

Before wrapping up, I would highlight that we are excited about 2013 for a variety of reasons, funding rates are low, we like what we own in our securities and CSLs portfolios and believe that the new initiatives we just discussed will lead to excellent additions to our holdings over time. Our goal is to continue driving value for our shareholders over the long-term and we look forward to keeping you informed on the opportunities we see across all facets of our business. Thank you again for joining us today. I will now turn the call back over to our operator, Tyrone.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Douglas Harter of Credit Suisse.

Douglas Harter - *Credit Suisse - Analyst*

Thank you. I was just hoping to touch a little bit more on the MSR acquisition. The company that you acquired. First off, I guess were there any MSRs that actually came with that? You said there was little legacy risk. Can you just expand on that a little bit?

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

Yes. Doug, good morning. It's Tom. A very small amount came with it. So small it was really, it would be not of any real note. The thing that we did like about the company was that it hadn't originated loans in many years and therefore we think the legacy liabilities should not be an issue. And it came with a small handful of employees, but came with all of the licenses. It was a very clean acquisition in our mind and something that fits really well within our business model.

Douglas Harter - *Credit Suisse - Analyst*

And just on that, coming with the license, now as you look at larger MSR packages, can you talk about what the approval process would be if you can agree to a price with the seller?

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

Yes, I'm going to let Bill handle that one.

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

Hey, Doug. As you know we just closed on this. We are in a position now to entertain working with sellers or partners. Our best understanding of the approval process in terms of the conversations we've had with the agencies is that, and I think this is true across the board, is that you need to show up with whoever you are partnering with or purchasing from. There is an application that is put in, the GSEs have to review it, understand whether it's a bulk purchase or a flow purchase and then approve it. It's a lot different than buying securities in that it can take a month or two to go through that process.

Douglas Harter - *Credit Suisse - Analyst*

And I guess just finally on this, did the GSEs have to approve your purchase?

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

Yes, they had to approval the transferal of the licenses. That's what we -- so we closed the acquisition and we received all the requisite approvals from the GSEs and from Ginnie.

Douglas Harter - *Credit Suisse - Analyst*

Great. Thank you, guys.

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

Thank you, Doug.

Operator

Mark DeVries of Barclays.

Mark DeVries - *Barclays Capital - Analyst*

Thanks. Bill, could you talk about what the loss adjusted yields are that you expect on your retained interest in the securitization?

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

Yes, it's -- good morning. Thanks for joining us, Mark. Because these are very leveraged structures, if you are retaining the bottom 3% or 5%, right, a very small move in either the price of the loans or the price of the AAAs or AAs, et cetera that you sell actually is very impactful. So we send the path that we think the ROE from this kind of strategy is in the double digits. But I'm a little bit reluctant to give you a number to hang your hat on because you can imagine if you have that much implied leverage, which is 20 to 1, or more, a small move in any one of the components can actually make a big change. So we expect it to bounce around as the inputs change. But we are only going to focus on doing securitizations where what we retain is attractive to us.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Got it. From an accounting perspective, I think you guys mentioned you elected fair value. Will this contribute much to core earnings in the near term? Will there actually be cash flows initially? Or will it have a bigger impact just on fair value marks out of the gate?

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

Mark, it's Tom. I am going to hand that one over to Brad.

Mark DeVries - *Barclays Capital - Analyst*

Okay.

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

Yes, thank you. Obviously these loans are, the entire loan structure and the AAA debt structure is on our balance sheet. This will obviously generate both yield and cash flow. So there will be an impact on core earnings. The objective of the fair value, and this is how we think about a lot of things, is core earnings is obviously a metric that is used in the industry. We look at economic return in total. So the ability to mark these at fair value, which is largely going to mirror the actual economics, which is really just the subordinates and IOs we hold is really kind of the objective of what we are trying to do there. Core earnings, yes, an impact, but we are looking at this more around the fair value of these instruments and the impact to the economic return.

Mark DeVries - *Barclays Capital - Analyst*

Okay, great. And then, Bill, how much of a pickup would you expect to generate on returns from the strategy once you are able to move to the loans you have kind of directly sourced through these originator partners?

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

Are you talking about the prime jumbo securitization?

Mark DeVries - *Barclays Capital - Analyst*

Yes, exactly.

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

Yes, the originating, working with originators yourself generates the inputs at a better valuation than buying them in bulk, as you can imagine. And that also varies over time. But more importantly, we feel it's more important to control the process. Have loans underwritten to our guidelines. And basically create a sustainable business model as opposed to just relying on purchasing in bulk. So it's -- while the economics are better, it's really more about creating a sustainable business model than it is just the math.

Mark DeVries - *Barclays Capital - Analyst*

Okay, that's helpful. And then just one last house cleaning thing. Brad, I think you mentioned there was at least one $1.4 million contra expense that reduced the management fee related to the Silver Bay spend. Was there anything else in there that brought that number down on a Q over Q basis?

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

The direct impact of the management fee was the $4.3 million.

Mark DeVries - *Barclays Capital - Analyst*

Oh.

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

That's the contractual discount that was negotiated through the contribution agreement. The $1.4 million came through a separate line, the discontinued ops, and largely that's the allocation we received from Silver Bay in the management fee that they paid to the managers. There is nothing else other than those two items I noted.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Great, thanks.

Operator

Trevor Cranston of JMP Securities.

Trevor Cranston - *JMP Securities - Analyst*

On the credit sensitive loan portfolio, you talked a little bit about potentially securitizing some of that and retaining the subordinate pieces. I think there have been a few other securitizations of reperforming loans that we have seen over the last few months. Can you maybe just comment on whether or not you think the economics of securitizing those is attractive where we sit today? Or is it something that is likely to be more far out in the future for you guys?

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

Hey, good morning, Trevor. Look forward to seeing you out on the west coast in a few weeks.

Trevor Cranston - *JMP Securities - Analyst*

Likewise.

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

So to answer your question, there have been a number of deals done. It really depends on the collateral so we have seen deals done that have been unrated private deals that had what I will call higher LTV loans in it, and then we have seen rated deals with even some of the tranches getting AAA from better quality collateral. The answer to your question is that it is likely that the economics will be attractive, but how attractive they are really depends on what kind of pool you put together. So we've, as I mentioned, we've purchased about $600 million in face amount. Once those all close, and we settle those, what we are going to do is stratify that and see if we can optimize the math regarding a securitization. So that's really what it will come down to. So it's not something that you can expect to see out of us immediately because some of these things have to settle and we have to go through that process. I think that market is -- there have been a number of deals done. I think there is more and more investor interest as more deals will come to market and so I think that's a developing asset class. Like any developing asset class, typically the more acceptance it gets, the better pricing you get as an issuer.

Trevor Cranston - *JMP Securities - Analyst*

Okay. That's helpful. And then one more thing on the MSRs, as you start adding assets in that bucket, would you envision taking off some of your swaps and swaptions, or can you maybe just talk about how you will be thinking about hedging your portfolio as you start adding MSRs to the book.

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

Good question, Trevor.

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

That's a great question. And I would say first because we don't really run much interest rate exposure at all and I mentioned as of the end of the quarter we were slightly net short. The addition of new, particularly new issue, low coupon MSR obviously adds negative duration which would make us more short. Unless we decided that we wanted to be even more short, we would therefore be able to either add positive duration by buying more pools or by unwinding swaps. So one of the benefits to adding MSR to the extended underlying swaps is it obviously not only produces an asset on our books with positive yield, but also saves us money on unwinding our swap position. In a bigger picture since we would look at adding MSR, likely would adding IO, and we would have that hedged in the portfolio as we would hedge IO.

Trevor Cranston - *JMP Securities - Analyst*

Okay, that makes sense. And the last thing, if you look at some indications like some of the ABX indexes, it looks like prices of that are more so far in the second quarter than they were in the first quarter. Can you just comment on what you are seeing in the market and maybe the general trend in book values since quarter end.

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

Yes. Trevor, it's Tom. I said my prepared remarks the non-agencies continue to rally into the second quarter. I want to caution that a month doesn't make a quarter, right? The Company did have a nice April.

Trevor Cranston - *JMP Securities - Analyst*

Okay. That's good enough. Thanks, guys.

Operator

Jason Stewart of Compass Point.

Jackie Earle - *Compass Point - Analyst*

Good morning, guys. This is actually Jackie Earle on for Jason. I just have a quick question on MSRs. I know historically you haven't really discussed the expected returns but with the acquisition and GSE approval it seems more relevant today. I was just wondering if you could provide more color on what range you expect to see IRRs on new production to trade within?

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

Yes, I mean, they are attractive otherwise we wouldn't have gone through this, but we are in the game now which is, as they say ain't nothing because this has been a difficult process to get to this point. And our team did a great job to affect this acquisition. We would feel more comfortable talking about MSR yield when they become a meaningful part of the portfolio. Today they are attractive. They are honestly a little less attractive than they have been but still nonetheless very attractive relative to an absolute and relative expected return. So we are very excited about being in a position to acquire MSR.

Jackie Earle - *Compass Point - Analyst*

And do you see this attractive versus IOs or versus levered MBS investing?

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

The short answer is yes.

Jackie Earle - *Compass Point - Analyst*

Okay. Thank you.

Operator

Dan Altscher, FBR.

Dan Altscher - *FBR Capital Markets - Analyst*

Thanks, good morning. I was wondering if you could give us the relative breakout of the book value contribution between the Agency book and non-Agency book and then the swap and swaptions, kind of on an either per share basis or dollar amount how much that individually contributed, since the other components of Silver Bay and the dividends are pretty clear.

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

Sure we are going to let Brad tackle that.

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

Yes, I think maybe I will just kind of feed a couple of points that we mentioned in our stated comments. Bill noted that the return on the non-Agency portfolio was $274 million in the quarter. I also noted that we had a small gain on Silver Bay of $8 million. And so you largely can take the delta to kind of back in to where the Agency fell out, in rough numbers is how I would look at it. We don't provide necessarily the break down between kind of the hedging instruments and the cash bonds. We look at that in kind of a total return perspective. But that kind of gives you the three buckets that might address your question.

Dan Altscher - *FBR Capital Markets - Analyst*

Okay. That's fair. And then sorry, one more question on the MSRs. How big I guess do you envision this book getting, I guess maybe in the near term or longer terms in terms of maybe the unpaid principle balance or an actual MSR value. And then also, since the press release stated that you plan on managing the MSRs, do you actually plan on servicing them or off shoring them or shipping them out to a sub servicer?

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

It's Tom. We do not anticipate servicing them ourselves. So we are in discussions with a number of servicers. Obviously we are concentrated on ones that the agencies like the best because that speeds the comfort that they would have around those servicers, speeds the path to actually acquiring the MSR and receiving the necessary approval from the agencies. I'm sorry, you had another question. What was your first question?

Dan Altscher - *FBR Capital Markets - Analyst*

It was just I guess the relative size of how much you envisioned the MSR book becoming on a, whether it's an unpaid principal balance or the actual value of the MSR.

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

Yes, that's difficult for us to say. It's frankly, it's going to be a function of two things. Supply and the relative attractiveness to other options within the portfolio. So it could be significant but we love all of our children equally. It's going to have to compete with our alternative investment opportunities.

Dan Altscher - *FBR Capital Markets - Analyst*

That's a great line, loving your children. That's great. Thanks so much.

Operator

Joel Houck of Wells Fargo.

Joel Houck - *Wells Fargo Securities - Analyst*

Thanks. Just hoping to go back to the disclosure on page 11 regarding the sensitivity changes in rates. You provided some color. I'm more interested in how you guys think about the tradeoff in kind of current yield versus protecting book value. Because we normally, at least in recent history haven't seen REITs, everyone seems to take a little bit of exposure to rising rates. This is -- could be a fundamental shift and I'm just interested in Management's thoughts in terms of how you are going to manage or your thought process around this going forward. Are we going to continue to see you guys be net short on balance given where rates are now? Or is this more of a transitory thing in Q1?

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

Hey Joel. Just one remark and then I will hand it over to Bill. In respect of comparing us to other REITs, we really don't aspire, and I say this with all humility, we don't aspire to be anyone other than ourselves and how we think about managing our shareholders' money. Bill, do you want to opine upon our current --

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

Yes, Joel, we said in the past we are not -- we don't view ourselves as in the business of producing a dividend because if we want to do that we could use a lot more leverage or take a lot more interest rate risk. We're really frankly thinking about total shareholder value. Which is obviously a combination of the dividend and then book value change. So the way -- as you know, we rarely in at least the last few years, have taken much interest rate risk, primarily just because rates are so darn low and while they might go lower, if they go higher, they can go a lot higher. We view it's our job to protect our shareholders' investment by being very cautious given where rates are at this point in time.

Additionally, if you see what's going on in the economy, yes, some numbers are bad some months and some numbers are a little better. We've seen consistent slow growth. We've seen the US become more competitive, the private sectors adding more jobs at the expense of the government. So to the extent that that changes and the Fed decides that they want to be less involved, let's just say that, we could see a reasonable move in rates and we just think that it's a very prudent time to be very cautious. So we are not -- we are not as concerned with eeking out the last $0.01 or $0.02 of dividend vis-a-vis having an issue with book value.

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

Yes, I think it's important to note, Joel, how we think about this and in a global context. The economy is improving, right? Housing is rebounding, unemployment is falling. That's going to lead at some point to a reduction of QE and where would rates be without QE? I don't know but definitely higher than they are today and we want to be prepared for that.

Joel Houck - *Wells Fargo Securities - Analyst*

That's a good commentary. You guys have executed extremely well and this quarter illustrates that. Very -- always curious to see how companies think about potential rate changes and I think your comments were very good. Thank you.

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

Thanks a lot for those kind words.

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

Thanks, Joel.

Operator

Thank you. There are no further questions at this time. I would like to turn the call over to Management for any closing remarks.

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

Great, a lot of good questions today. Thank you for joining our call. Thanks for your interest in and support of Two Harbors. Have a great day. We look forward to speaking to you again soon.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect and have a wonderful day.