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TWO - Q3 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 third-quarter 2013 financial results conference call.

(Operator Instructions)

As a reminder, this conference is being recorded.

I'd now like to turn the call over to your host for today, Ms. July Hugen, Director of Investor Relations. Please go ahead.

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

Thank you, Ben, and good morning.

Welcome to our third-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, who will discuss our third-quarter results.

The press release and financial tables associated with today's conference were filed yesterday with the SEC. If you do not have a copy, you may find them on our website and the SEC's website. This call is 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. We would encourage you to reference the accompanying presentation to this call, which can also be found on our website.

We wish to remind you that remarks made by 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 our recently released webinar titled Fundamental Concepts in Hedging. The webinar is focused on hedging for mortgage REITs, with a focus on interest rate hedging, and can be found on our website in the investors section.

I'll 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*

Thanks, July.

Good morning and thank you for joining our third-quarter earnings conference call. During the quarter, due to uncertainty around interest rates, Fed actions and budget ceiling issues, our portfolio positioning remained defensive in respect to spread and interest rate risk. The times seem to warrant this. We also have been husbanding liquidity to fund some of our new investment initiatives.

Both Agencies and non-Agencies moved slightly higher in the quarter following the Fed's announcement to forego tapering their RMBS purchases, which came as a surprise to the market. As a result, both our rates and credit portfolios were up nominally, although, as we were positioned with a low leverage profile, we didn't see dramatic movement in our portfolio.

Let me recap our third-quarter and year-to-date financial results. Our book value was $10.35 per share as of September 30, representing a quarterly total return of 1.5% when combined with our third-quarter dividend of $0.28. In the quarter, we recorded comprehensive income of $54 million, or $0.15 per weighted average diluted share. During the first nine months of the year, we generated $156 million in comprehensive income, representing a return on average equity of 5.4%.

We were happy with this performance in the context of the macro backdrop and sector performance through September 30. On a book value basis, Two Harbors had a total return of 6.3% through September 30, while 10-year treasuries had a negative 5.1% total return in the same period. We incurred a GAAP loss of $0.53 per share for the quarter ended September 30, and core earnings of $0.19 per share. All these metrics are consistent with our expectations when we set the third-quarter dividend.

We continued to repurchase stock under our share repurchase program during the third quarter. As you may recall, in the second quarter we repurchased 1 million shares, and during the third quarter we repurchased an additional 1.45 million shares at an average price of $9.23 per share, bringing our purchases year-to-date to approximately 2.5 million shares.

As a reminder, our total authorization is for 25 million shares, so we have capacity to continue to repurchase stock. As always, we evaluate this program through the lens of the investment opportunities available to us in an effort to optimize value for our shareholders. Because the stock was trading below book value, the repurchases were accretive.

Next, let's touch upon our warrants. In the third quarter, approximately 65,000 of our warrants were exercised. We recently announced we intend to delist the warrants from the New York Stock Exchange upon their expiration tomorrow.

Now I would like to provide a brief update regarding the MSRs and our mortgage loan conduit and securitization program, as outlined on slide 4. MSRs remain the best use of capital in the current investment environment and we are very excited about the progress we have made related to our MSR initiative.

We announced Monday that we have entered into a two-year flow agreement with PHH Mortgage Corporation, subject to Agency approvals and pricing terms. Additionally, we are in advanced negotiations with other MSR sellers that are likely to result in substantial additional investments in the near term.

Importantly, we are making progress in our mortgage loan conduit and securitization program. We closed on our first securitization using our own depositor Agate Bay Mortgage. We believe this business represents an excellent long-term opportunity for Two Harbors. Our goal is to develop an industry-leading prime jumbo mortgage conduit, and while not material to our financial performance in 2013, the completion of the securitization represents progress toward that goal.

Please turn to slide 5. Interest rates experienced significant volatility during the quarter, but were ultimately relatively unchanged on a quarter-over-quarter basis. Mortgage rates are higher than earlier this year, which may dampen refis and mortgage origination. Unemployment metrics have generally shown signs of improvement over the course of the year, although some recent reports have been more mixed.

Improving employment data has largely been reflective of demographic vagaries rather than robust job creation. On a national level, home prices increased 12.4% as of August 31 on a rolling 12-month basis, according to CoreLogic. Consensus forecasts predict a continuation of home price appreciation during the next several years, creating a nice tailwind for our credit strategies.

From a policy standpoint, there was no shortage of headlines during the quarter. Janet Yellen was nominated as Federal Reserve chairperson. While senate approval is still needed, the market is generally expecting that her nomination will be confirmed, and that she will follow retiring Chairman Bernanke's policies rather consistently.

This is a good segue into a discussion about Fed tapering. Uncertainty reins around the future of the Federal Reserve's RMBS purchases, another topic that dominated headlines in the third quarter. However, assuming Ms. Yellen is installed as the new Fed chair, she won't take over until January 2014, which may mean tapering is hold off until the new year.

Now I will turn the call over to Brad for a discussion of our financial results.

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

Thank you, Tom. And good morning, everyone.

Please turn to slide 6. Core earnings of $0.19 per weighted share represented a 7.1% annualized return on average equity. The $0.19 per share earnings aligned with our core earnings expectations for the quarter as we defensively positioned our portfolio, and what we considered when establishing our third-quarter dividend of $0.28 per share. Our debt to equity ratio was 3.0 times and 3.6 times at September 30 and June 30, respectively.

While this appears to be a reduction in leverage, our implied debt to equity was 2.9 times at June 30, after accounting for a short TBA position. As Bill discussed on our second-quarter call, we believed a reduced leverage profile was prudent given the risk profile in the market, and it also frees up capital for us to allocate to our new investment initiatives. Today, it is most important for us to have capital available to put to work in our MSR strategy.

Our operating expense ratio as a percent of average equity moved modestly higher on a quarter-over-quarter basis to 1.0%. Similar to last quarter, the rise in operating expense was largely driven by MSR and loan activities and a lower equity base. I would note that our operating expense does exclude the deal cost associated with the Agate Bay transaction, as it is nonrecurring and is a cost that we view as part of our target yield in creating the subordinate securities we hold.

As noted in other past earnings discussions, GAAP earnings are not as meaningful as core earnings and comprehensive income when assessing the performance of the quarter. Similar to the second quarter, this quarter was a good illustration of that, as we incurred a GAAP loss of $0.53 per weighted share. I would note that we did choose to realize $262 million of capital losses as we sold about $3 billion of Agency pools.

I would now like to briefly touch upon a few accounting topics. First, we did complete a securitization in the quarter which is now consolidated on our balance sheet. Consistent with our overall accounting philosophy, we elected fair value option for the accounting of the mortgage loans held for investment and collateralized debt to best reflect the economics of our retained interests.

Second, while I would note our MSR assets increased to $16 million as of September 30 due to a few small pools settled early in the quarter, the forward purchase commitment of any bulk or flow MSR is not recognized in the financials under GAAP until settled. And last, I would briefly note that we did not recognize any other-than-temporary impairments in the quarter, nor did we release a meaningful amount of credit reserves.

Now please turn to slide 7 which contains our quarterly book value roll-forward. Our book value per diluted share was $10.35 this quarter. Let's discuss a couple highlights. First, we are pleased with our comprehensive income this quarter and the year, given the ongoing turbulence in the mortgage market.

Comprehensive income is one of the key ways we judge our performance over the long term. Year to date, we have declared dividends of $676 million through the combination of three cash dividends and our special dividend of Silver Bay stock. As it is our previously stated intention for the Silver Bay dividend distribution to be treated as a return of capital to Two Harbors' stockholders, it is our goal to distribute 100% of our taxable income and any prior-year carryover through our cash dividends. Excluding the special dividend of Silver Bay stock, we have distributed $332 million, which equates to approximately 97% of our taxable income as of September 30, when combined with a carryover from last year of $10.7 million. We are pleased with this metric, as we are well positioned moving into year end from a dividend distribution standpoint.

Please turn to slide 8. I would next like to spend some time discussing the repo markets and financing profile, both in the third quarter and how we are positioning ourselves for the long term given our new business initiatives. The repo markets are generally continuing to function in a normal manner and we have not experienced any sizable shifts in financing haircuts or repo rates. We continue to maintain a lengthy maturity profile with an average of 76 days to maturity at September 30. As we approach year end, we have extended our repo terms, consistent with our past practice, in order to avoid any choppy trading around that time. Importantly, as of today, we have a de minimis amount of repo maturing prior to year end.

Slide 8 provides an update to our counterparty exposure at September 30. We spend a significant amount of time analyzing our balance sheet and liquidity profile. Our lower leverage, cash-funded collateral, and available capacity with counterparties provide us with both the flexibility to manage through market volatility, as in the second quarter, and also the opportunity to deploy capital to investment opportunities such as MSR, as we anticipate doing in the near term.

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.

Please turn to slide 9. In the third quarter we generated a total return on book value of 1.5%. For the first nine months of the year our total return is 6.3%. This is a result we are pleased with, given our overall defensive position and low leverage. Both our rate strategy and our credit strategy posted positive results for the quarter. Please note that we are now including Agencies and MSRs in the rate strategy, and non-Agencies, securitizations and loans in the credit strategy.

As we have communicated at a few recent conferences, we find the returns for our new initiatives, particularly MSR, to be superior to the returns available in the securities market, especially in the Agency space. As such, we are focused on maintaining a low leverage and risk profile and high liquidity to be able to fund increased investment in these new opportunities. Agency securities sold off hard early in the third quarter with rising rates as the 10-year hit 3%, then rallied late in the quarter when the Fed announced it was delaying its tapering of MBS purchases. With our lower risk profile in place since early in the second quarter, we neither suffered much in July nor profited that much in September. As a result of this defensive posture, our Agency returns this quarter, while positive, were generally modest.

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The credit strategy was also up nominally in the third quarter, net of hedges, as fundamentals generally continue to improve. The improving housing market has led to lower delinquencies and improved prepayment speeds. Continued improvement in housing metrics and job growth are good for the future performance of these portfolios. During the quarter, we sold some high dollar priced non-Agency bonds that had largely realized their upside potential, and replaced these with lower-priced bonds with more upside optionality.

Regarding CSLs, supply has been somewhat sporadic and yield levels uninspiring. We neither increased nor decreased our position in CSLs this quarter. So far in the fourth quarter, rates and Agency MBS are roughly unchanged. If you look at the non-Agency market you would see that prices are modestly higher. Our book value is generally reflective of these trends.

On the bottom left of this slide, you can see our book value performance relative to weighted average 50/50 Agency/non-Agency portfolio. As you would expect given our defensive positioning and lower leverage profile, we posted a more modest total return than the 50/50 portfolio. That said, for the first nine months we have outperformed the index by over 500 basis points. As we have articulated many times in the past, we think book value protection is of the utmost importance, especially during times of uncertainty and turbulence in the market, and our results this year speak to that.

Going forward, as we continue to invest in MSRs and build out our mortgage loan conduit and securitization business, measuring our performance versus the security strategies such as shown here will be less relevant. On the bottom right you will see that our yields and spreads for the third quarter were slightly improved as compared to second quarter, due to a slight increase in our RMBS asset allocation towards non-Agency RMBS.

Turning to slide 10, let's take a brief look at our portfolio. Our portfolio as at September 30 was $13.6 billion in total size, including $9.9 billion in rates and $3.7 billion in credit. This reduction from last quarter reflects the sale of several billion Fannie 3 pools which were previously fully hedged with a short TBA position. We unwound the short TBA position at the time of sale. Our portfolio composition reflects a 54% capital allocation to rates, which is currently predominantly comprised of securities. You can expect MSR to become a larger component of this strategy going forward.

We continue to like our exposure to credit, especially the deeply discounted bonds, given improving fundamentals. Increasing housing prices and declining delinquencies create a good tailwind for our credit strategy. One bright spot during the quarter was finding some Agency ARMs that we liked, and we boosted our holdings by about $1 billion. As a result of our prudent hedging and thoughtful portfolio management during volatile markets, we were able to be on offense when others were defensively liquidating positions. This enabled us to pick up these securities at attractive prices.

Please go to slide 11 for some key portfolio metrics during the third quarter. Our implied debt to equity ratio for RMBS, Agency derivatives and mortgage loans held for sale, net of TBAs, is 3.2, up modestly from 2.9 times at the end of the second quarter. This represents a slightly increased exposure to Agencies through our ARMs purchases. While we believe that opportunities at the Agency market will improve as the Fed becomes less involved in the market, currently it's challenging to find much value in the Agency space. As a result, we are carrying fairly low leverage, as well as Agency basis risk exposure for the time being.

Our non-Agency CPR continues to climb. While a CPR in the 4% to 5% range does not sound exciting, on very low dollar priced bonds where we assumed only 1 or 2% CPR, it can be quite impactful. That bodes well for our non-Agency holdings. For a deeper dive into our rates and credit holdings you can also find more details in the appendix on slides 21 through 23.

Next, let's talk about rate exposure. As you may recall, this spring we have positioned the portfolio with a net short position, and by late spring and early summer we had a more significant short exposure to rates, including a sizable net short position in TBAs. This had the effect of greatly reducing our exposure to wider mortgage spreads in a rate selloff. As we have noted in several conferences, we greatly curtailed our short position this quarter and are close to neutral now. We have reduced our swap, swaptions and short TBA positions as we think the risk of a large move higher in rates from quarter end levels is somewhat diminished. You can find details on our financing and hedging strategy in the appendix on slide 20.

Please turn to slide 12. We were excited to announce on Monday a two-year MSR flow sale agreement with PHH. Under our flow sale agreement, we will purchase 50% or more of PHH's MSR on new origination production, subject to pricing terms and Agency approvals, with PHH providing subservicing. We believe this agreement will allow us to accumulate current production MSRs in decent size over the two-year term. We're very excited about this partnership, as PHH has both high-quality production and servicing capabilities.

During the quarter we also closed on two MSR mini bulk purchases. Both of these were Fannie Mae deals with mid-sized originators, and there may be flow arrangements to follow with either of these. Further, we continue to be engaged in advanced negotiations with other MSR sellers that could result in significant additional investments in the near term. In addition to providing attractive yields, MSRs are a natural hedge to our Agency MBS, hedging both interest rates, as well as mortgage spreads. The progress we have made on our MSR initiative has positioned us well to generate franchise value for our stockholders in the years to come.

Please turn to slide 13. Let's talk about the prime jumbo conduit and securitization business, which is another area we've been working hard to develop. You may recall that we participated in a securitization in the first quarter with Credit Suisse, but our most recent transaction was unique in that we used our own depositor, representing good headway on this initiative. In the third quarter we closed Agate Bay Mortgage Trust 2013-1, a $434 million securitization, which was an exciting and important step.

This deal, which was backed by roughly 550 prime jumbo mortgage loans, allowed us to create attractive investments for our portfolio. In the two deals we have done this year, we've been able to invest in attractively yielding credit and IO bonds. As we are able to scale this program, this bodes well for our credit strategy going forward.

This year we have made good progress developing our originator network. We currently have approximately 30 originators in various stages of approval and are excited about the ability going forward to source not only prime jumbo loans, which will enable us to be an ongoing issuer, but also other products including MSR. We are constructive about the long-term opportunity in the private label securitization market and hope to play a meaningful role in helping to finance housing as the government reduces its involvement in the mortgage space over time. Similar to our MSR initiative, we look at this opportunity as creating franchise value for our stockholders.

While the MSR, loans and conduit businesses are exciting, and we believe can be quite additive to stockholder value, it is very important to have the infrastructure in place to support them. This year we have added expertise in servicing oversight, underwriting, transaction and documentation management, as well as in compliance. Further, we have enhanced our systems to accommodate the quantity of loans that involve large-scale investments in MSR in the loan space.

This year we have executed on several MSR deals and are continuously involved in discussions around potential MSR transactions. We have completed two securitizations, including a first using our own depositor, and have a good pipeline of potential originator partners. Developing these initiatives has us well positioned to take advantage of the changing landscape in mortgage finance in the years to come.

Finally, it is worth mentioning that the progress made by the GSEs around disseminating credit risk we believe is also very exciting for our business. The development of a market for mortgage credit risk we believe plays well to our strengths. Whether it is the GSEs that distribute credit risk, which could be sizable, the expansion of the private label market, or more likely both, Two Harbors is well positioned to take advantage of our credit risk expertise and deploy capital to opportunities that can benefit our stockholders.

Thank you again for joining us today. I will now turn the call back over to our operator, Ben.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Mark DeVries of Barclays.

Mark DeVries - *Barclays Capital - Analyst*

Thanks. Good morning. Could you give us a little bit of color on, given the size of your current MBS portfolio, ideally how you would look to size your servicing book against that if supply's not really an issue?

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

Sure. Thanks, Mark. I'll give that to Bill.

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

Hi, Mark. Good morning. Thanks for joining us. I've said a couple times in some of these conferences that if you look at our total capital base and our holdings in the security space that we could have easily $1 billion of MSR market value without really too much trouble. Obviously, we're a long ways from that. But I think that if you think about capital allocation, you could see the rates allocation stay in the 60% range, plus or minus, with a substantial amount of that going to MSR. So I think before we even think about moving things around, we have plenty of runway to go.

Mark DeVries - *Barclays Capital - Analyst*

Okay. And how should we think about, as you build up that MSR, how much your swaps portfolio might shrink over time?

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

Yes, I think the best way to think about it, if you want to noodle with some numbers, is current production MSR - and it depends what kind of product it is, whether it's Ginnie Mae, GSE or fixed or ARM -- roughly has a duration that's about somewhere around 3 to 4 times that of a five-year. So if a five year, call it a five-year duration, then MSR would be 15 or 20 negative. So I think you could do the math and figure out what our hedges could go down to. The way we like to think about it is if you think about what that does, it probably adds anywhere from 150 to 250 basis points in ROE by adding MSR and reducing hedges.

Mark DeVries - *Barclays Capital - Analyst*

Okay, great. And finally, Tom, could you just comment a little on how aggressively you might look to buy back more stock if the shares continue to trade around this level of 0.9 times book or below it?

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

Yes, thanks, Mark, it's a great question. In the current context, given where the shares are trading, and given the relative opportunity set within our legacy portfolios, we view it through the lens of what's best for the shareholders. And in the current paradigm that's an interesting opportunity set. So I can't obviously speak to numbers but I will assure you we'll always do what we think is right for our shareholders.

Mark DeVries - *Barclays Capital - Analyst*

Got it. All right. Thanks for the comments.

Operator

Douglas Harter of Credit Suisse.

Douglas Harter - *Credit Suisse - Analyst*

Thanks and good morning. I was wondering if you could talk about the capacity given your low leverage to add, whether it be the MSR opportunity or other assets, just by increasing leverage to a more normalized level.

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

Thanks, Doug. How are you? Good morning. Bill, do you want to handle that one?

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

Yes, sure. I think the way we think about it is we look at what we think the expected ROE is on any given product, using what we think is an appropriate amount of leverage there. So Agencies today, as we've said, are not that interesting. We think when the Fed gets out of the way, if you will, that that will be potentially more interesting. In the meantime, MSR is the best dollar we can spend in terms of acquiring assets. And that we would not intend to use any leverage on. So, if Agencies become interesting again, you can expect that we would increase our leverage there. But in the meantime, we're happy to have the excess liquidity deployed into MSR. And the same goes with non-Agencies, as well. Right now our leverage reflects the fact that we don't see great value except in, as I mentioned, MSR. But that takes some time to put to work.

Douglas Harter - *Credit Suisse - Analyst*

Just to try to understand that, so if the MSR, the larger MSR opportunity that you reference came to fruition, is that something where you would look to sell Agencies to fund that or you could use extra leverage against that book to fund that?

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

One of the great things, Doug, is that we can use the portfolio to effectively leverage MSRs. So our liquidity position is great right now. So there's no issues around that.

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

This is Brad. I'd comment on one thing. It will even become more transparent in the 10-Q, which we intend to file later today. Especially as at September 30 we are cash funding a reasonable amount of our balance sheet, specifically the non-Agency and some of our loan products, which we do have available financing if we choose. And so that's just a very illustrative example of being able to put those out, seed capital from that and then apply those to MSRs. That's probably a good example for your question.

Douglas Harter - *Credit Suisse - Analyst*

Thanks, Brad. And then you've referenced a couple times the best dollar of return available would be in the MSRs. Could you just frame what you see the return opportunity today?

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

Yes, sure. So, just to give you an idea, and like I said, it depends on the product, but new issue MSR are anywhere from very high single digits into the low double digits on an unhedged basis, just outright with no leverage. As I said before, once you either add a long position to offset the negative duration or remove swaps and swaptions, that actually becomes additive to that. I would say that securitization is very interesting from an ROE perspective. As you probably know, the securitization math today is very challenging based on where the big banks are posting rates for jumbos. So we think that that is not a long-term issue but rather just a function of the current market. And if you look back at earlier this year, there have been a decent amount of securitizations done. And the math on the subs and IOs there is also attractive. So those are the two best in terms of buying assets. But I think the latter will hopefully revert back to the opportunities we saw earlier this year.

Douglas Harter - *Credit Suisse - Analyst*

Great. Thank you, Bill and Brad.

Operator

Trevor Cranston of JMP Securities.

Trevor Cranston - *JMP Securities - Analyst*

Thanks. Just to follow up a little bit on the last questions on the MSR investment opportunities. Can you comment at all on if you're seeing much in the way of bulk purchase opportunities? You made some comments about keeping your liquidity level high for investments. And it seems like flow purchases wouldn't require a very large amount of capital, at least in the near term. So could you maybe comment on how you view the attractiveness of any bulk opportunities you're seeing versus flow, and if you would include that in that near-term opportunities that you mentioned?

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

Good morning, Trevor. It's early where you are. Bill, would you take that one, please?

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

Sure. The nice thing about the flow deals, you're getting current coupon, and from a cash standpoint it's very easy to deploy a month at a time. On the other hand, we're involved in pretty much every discussion that we can be, now that we've announced this initiative where we're in the deal flow. And so we absolutely are seeing opportunities and hearing of opportunities. And we're certainly open to bulk purchases and we'll evaluate those just as we would any other investment alternative.

Trevor Cranston - *JMP Securities - Analyst*

Okay, that's helpful. One detail thing, I saw on slide 9, it looks like you were allocating some interest rate swaps and swaptions to the non-Agency book this quarter. Is that something you expect to maintain going forward, that you need a rate hedge on the non-Agency book given the correlation we've seen over the last couple quarters?

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

I'm taking a look at slide 9. Where are you referring to, Trevor?

Trevor Cranston - *JMP Securities - Analyst*

The bottom right table for the September 30 side, there's a 0.6% swap and swaption cost on the non-Agency column.

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

Yes, we do think that some of the non-Agencies -- look, when you have bonds that were $50 or $40 or $30, and they're all credit, it's hard to see how there's any real rate component. But as the market has rallied substantially, and some of these bonds have -- we mentioned on the call that we sold some of these higher dollar priced bonds because they run out of room. To the extent that we still have some of those, we do believe that they have accumulated some duration. Not very much. But we think the purest way to think about it is that bonds that have duration you should appropriately either hedge or decide not to hedge. So that's where that comes from.

Trevor Cranston - *JMP Securities - Analyst*

Okay. Understood.

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

And just a reminder, too, that non-Agency is a wider view, as well. We obviously have prime jumbo loans. We had a larger bucket of prime jumbo loans prior to the securitization. So some of that is also mixed into that number.

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

Trevor, one thing I want to add. We don't want to be too cute here. Given that we said we've been husbanding liquidity, you might reasonably expect that we're anticipating some bulk purchases in the near term. Now, that's subject to a lot of ifs, including, not insignificantly, GSE approval. But we're not trying to be cute around our language here. That's what we're anticipating. It might not come to fruition, but that's how we position ourselves.

Trevor Cranston - *JMP Securities - Analyst*

Okay. I appreciate that clarity. And then last thing on the dividend, you made the comment that the results this quarter were in line with what you were expecting when you set the dividend level. Can you comment at all on if there was a meaningful gap between where core EPS and taxable EPS was, just for the third quarter? And how you're thinking about the dividend level for the fourth quarter, if taxable EPS was somewhat closer to where core EPS was in the third quarter?

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

Yes, thanks, Trevor. I will say that Brad and the team have done a marvelous job of doing financial projections for the year. And, as we said, our results in respect to both core EPS and book value were almost spot-on where they ended up. And with that, I'll give it to Brad to talk about the dividend a bit.

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

Yes, there's a lot to this and I'll try to hit a few key points. First, we obviously don't provide projections on where Q4 or even 2014 might land. That's just not in our current views of -- we just don't do forward-looking statements. But a couple things to note there. First, given the Silver Bay stock distribution and our intent, which we've noted several times, to distribute 100% of our taxable income, that is a large driver of our dividend, and any dividend this year that we've projected. And so conveying the 97% mark where we are as of September 30 is an important message, both from a comfort that we're very comfortable with where we've forecasted ourselves, and, two, it gives you a sense of the taxable income measure.

Second, again, we've commented a lot on comprehensive income and book value protection is our number one, number two, number three focus internally. Core earnings, while I do understand it presents some sort of run rate estimate that the market can digest, it's just not how we manage the portfolio or how Bill and Tom and team manage the portfolio. Core earnings has a lot of weakness in measure. An example of that is where we took our short TBA position on Agency pools, really we derisked our mortgage exposure on $3 billion of our mortgage pools. So really, whether we held those mortgage pools or sold those mortgage pools, it really did not have an impact on our overall return. But if we held those pools obviously it would have generated a higher core earning. But that inflation would not really have been the best decision for us to hold those positions. Again, there is a gap between taxable income and core earnings. It's made up of a lot of factors. But we're looking at taxable income first, book value and comprehensive income second, and then third we obviously are reinvesting capital as principal and interest comes in. Obviously if we are investing in lower yields over time that will cause pressure or downward pressure on the dividend naturally. But taxable income and book value preservation are the first two drivers that we focused on this year.

Trevor Cranston - *JMP Securities - Analyst*

Okay. Thanks. I appreciate all the comments.

Operator

Bose George of KBW.

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

Hi, guys. Good morning. Going back to the MSRs, is distressed MSRs part of the opportunity or do you guys really -- is it really going to be more on the prime side?

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

Yes, great question, Bose. I'll give it to Bill.

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

Hi Bose, good morning. We're obviously, as you know, we're an opportunistic approach to investing. But the reality is that the distressed MSR really relies on having a servicing operation that can more efficiently capture and process those loans. So, we think that our competitive advantage is in managing IO risk, which relates to newer issue prime part of the market. We're certainly not averse to considering the other, but we don't think that we have a comparative advantage there. So I think from your standpoint you should assume that most, if not all, of what we do will be related to new issue.

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

Okay. Great. Thanks. And then actually just in terms of the mechanics of the agreement, how is the price determined? Is it the market price at that time? Just curious how the structure is going to work.

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

Yes, sure. So, what we do is we agree on a pricing matrix for all products -- fixed, adjustable, all the different products -- once a quarter. And on a multiple basis. And then that's in effect for three months. And then at the end of three months we reprice, if necessary, and then that would be good for the next three months.

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

Okay. Great. That makes sense. And actually then just switching over to the jumbo securitization side, I'm curious what the ROEs, the implied ROEs are right now if you securitize, just based on where banks are pricing their product, et cetera. I'm curious where the economics stand and what happens to get back to where it makes more sense.

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

Today, Bose, they aren't inspiring, I would say. But there's a lot on the horizon that we're quite excited about. GSE reform is at the top of that list. So we believe over the long term this is going to be a very interesting, very compelling, very accretive business. But today ROE is where the big bangs are because of their lack of opportunity set away from mortgages. It's just not good and it's not our focus. Our focus right now today is on MSRs.

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

But if we had to think about what needs to happen, like if I look at Wells Fargo's pricing, if they take their jumbos in line with conforming, is that enough? Or does it have to go above conforming? Because right now it looks like they're 30 basis points inside of conforming. Does that have to fully go the other way to make the economics work?

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

That's obviously abnormal. But I'll let Bill give you some more color.

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

I think if you look at the 25, roughly, deals that were done this year, and you looked at the math, the bonds, the retained bonds with a small bit of leverage gets you into the 10% to 15% ROE range. And that's obviously worthwhile for us to be involved in. If you price the jumbo loans 1 point higher, or 1.5 points or 2 points, whatever the math is on a given day, you can see how the numbers fall apart pretty quickly. So, I think from a long-term perspective you have to think about the government reducing its footprint, rates not necessarily being -- the rate market being where it is today, and banks not necessarily taking the quantity or the percentage of production that's out there. And if you do that, we think that that becomes very worthwhile. But, look, it's the mortgage market, right? Things change very quickly and without necessarily notice. So what we're trying to do is have an originator network in place so that we can take advantage of the opportunities. And it may not be in prime jumbo in the short run. But there's MSR that we can source from this network. And presumably at some point there will be other products, although that's what we're focused on today.

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

Okay. Thanks a lot.

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

The originator network is really important, both in respect of prime jumbo and MSRs. So those things go hand in glove pretty nicely for our business.

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

Okay. Thank you.

Operator

Rick Shane of JPMorgan.

Rick Shane - *JPMorgan - Analyst*

Hi, guys. Thanks for taking my question. First, on the MSR business, I'm assuming that this is going to be a strategic business that you're going to retain permanently. But there is precedent in the market for standalone servicing businesses, and there's precedent within your history of incubating businesses and then spinning them out. Am I correct in seeing this as a long-term strategic business or is it something you would contemplate as ultimately a separate vehicle?

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

That's a darn good question. We're always going to do what's right for our shareholders. Today, we're just interested in building out this platform, this business. It's very compelling. And we really can't speak to the future. Today, we contemplate that this would be all housed within Two Harbors. But we don't know what the future brings. But today our focus is on building out this platform. It's a very compelling opportunity for us today and that's really our only thought. Bill, I don't know if there's anything you want to add to that.

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

The one thing is it's right, it's very complementary to our core business. So we think it makes sense within our structure. And we're not really thinking about any other solution at this point except for executing on what we have.

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

Yes, there is precedent that the market likes this as a standalone business, but we're not that far down the road yet.

Rick Shane - *JPMorgan - Analyst*

Got it. Okay. Second question, obviously there was a pretty significant shift during the quarter in terms of your hedging strategy. And you explained that a little bit. But I'd love to understand two things. One is the timing of the shift. And maybe that will help us understand the second part of the question which is really the outlook. Because I think the consensus view is still that rates are going higher. It's just that that has been pushed out in terms of when it will occur. And maybe over the next 12 months the expectations of, for example, where the 10-year will move have been dampened, but the expectation is that it still will be higher. Why, given just the temporal shift, make a pretty significant strategic shift on that?

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

Yes, sure. I'll give it to Bill in a second. But we really felt in the spring that there was going to be a jail break in respect of interest rates. And, not to be self-congratulatory, but Bill and the team got that about right. Rates moved a lot higher. And then we became worried about some of the shenanigans in Washington, about very muted job creation, that sort of thing, so we brought it much closer to home. So, from a rates perspective, we got it about right. And as we look forward, there's a lot of uncertainty out there. We really think that the Fed's super metric is employment data. And as I said in my earlier comments, if you look at employment data it's not really job creation that's going on, it's really vagaries of demographics. In other words, people falling out of the workforce, America's getting older, people just retiring, that sort of thing. So, while the Administration may pound their chest that the nominal unemployment rate is lower, that's really a tickle misleading. Bill, would you add something there?

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

Yes, sure. The thing is, Rick, when the 10-year was at 1.60% or 1.90% or 2.10%, it just seemed to us that, as Tom mentioned, there was this great asymmetry. In the third quarter, when you see the Fed pretty insistent that the short rates are going to be very low for a long period of time and the 10 year's 3% or 2.75%, the risk, the parameters have changed. And so we just felt that it made a lot more sense to be closer to home. Now, the other thing is, there's two other things that are extenuating circumstances. First of all, with the PHH arrangement we're going to be buying negative duration MSR every month. So, we're going to add a negative duration every month which we may or may not choose to hedge. Second of all, as Tom mentioned, some of these discussions that we're involved in may lead to decent-sized MSR coming our way in the near term. Which also has negative duration. So we're not afraid, as you can tell we're not afraid to change our positioning if we believe that that's appropriate. But we just thought that the market was in a much more balanced situation with the 10-year in the 2.60% to 3% range than it was in the 1.60% to 2% range.

Rick Shane - *JPMorgan - Analyst*

Great. That asymmetry characterization really helps me get there. Thank you.

Operator

Dan Altscher of FBR.

Dan Altscher - *FBR Capital Markets & Co. - Analyst*

Hi, good morning and thanks for taking my question here. I was wondering if you could give us a little bit of a sense in terms of the progression of the PHH flow that's going to come in. How much in size of maybe UPB or related MSR do you think we're going to see on a monthly or quarterly basis on a go-forward basis?

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

Hi, Dan. Good morning. I'll give that to Bill.

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

Hi, Dan. Thanks for joining us. As you may have seen, and maybe for those who didn't, under our agreement with PHH, we would be looking to purchase 50% or more of their newly originated mortgage loan MSR where the MSR's eligible for sale. So I think what I would point you to is if you look at PHH volumes in terms of their production, you can make some reasonable assumptions about quantities. A lot of it obviously depends on how much is produced going forward. But we think that over the two-year term this will be a pretty decent size for us.

Dan Altscher - *FBR Capital Markets & Co. - Analyst*

Okay. And maybe just sticking with the MSR also, I think it's pretty clear why a lot of the large banks are looking to off-load MSR portfolios with Basel III and capital treatment. But we've seen a little bit more of a move for the non banks to do this, as well. Could you talk maybe just conceptually why you think the non banks are now looking to off-load, as well, here?

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

Sure. Great question, Dan. And, by the way, thanks for the kind words last night in your note and your research report. What happened is there's just been this torrent of refinancings within the mortgage space. So a lot of these standalone guys have wound up -- business has been great for them and they wound up with a lot of MSR on their balance sheet. And I think they're just looking to derisk a little bit. And I think we're a great capital partner for them. We're not going to compete with them in origination. We're not going to compete with them in the ultimate servicing. And so it's a great marriage and we're quite excited about PHH. We think they'll be a great financial partner. They're great people and so we're very excited about that. So it's really a very natural marriage, I think, for us.

Dan Altscher - *FBR Capital Markets & Co. - Analyst*

That's a really interesting point when you said you won't compete with them on origination. That's leading to my third question. As you're building up this origination network of, it looks like, 30 folks already can you talk a little bit about, or describe, who those originators might be? Not names, necessarily, but geographies and products or however you want to think about it that way.

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

Sure. I'll give that one to Bill.

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

As we mentioned, we have about 30 originators in some part of the approval process. And so our view is that we want to align ourselves with high quality organizations that have demonstrated good performance in the past and are involved in the kind of products that we're looking at. There are a lot of entities out there, some are national and larger, some are regional. You can imagine, if you look at any of the securitizations, you need to have a good diversification of geographies and so we're obviously mindful of that. But it's a mix. But the biggest thing is that we want to be aligned with what we think are high-quality organizations that produce a high-quality product.

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

Additionally, we do a lot of diligence on our counterparties. They do a lot of diligence on us. It's a whole new world out there where people want good counterparties. And that's what we are working toward and we're very confident that we'll get there.

Dan Altscher - *FBR Capital Markets & Co. - Analyst*

Okay. Thanks for the time everyone.

Operator

Joel Houck of Wells Fargo Securities.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Good morning. Thanks for taking my questions. A couple technical questions on the PHH transaction. Are all of these MSRs REIT-eligible assets? I'm assuming the bulk purchases are. Just if you could confirm that.

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

Sure, Joel. I'll give that to Brad.

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

We discussed that at a high level in the past. So, Matrix Financial Services is the seller servicer that we acquired a few quarters ago. That is the entity that acquires the MSR. We also noted that we received a private letter ruling from the IRS that allows us to structure what we call an excess servicing strip, and taking a portion of that asset and putting it into the REIT. And that excess piece is structured, as we've outlined with the IRS, a good REIT asset. So that's probably the technical answer to your more technical question. Hopefully that addressed it.

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

Yes, bottom line, it's a good REIT asset.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

I just wanted to confirm that because, obviously, given the size that you talked about earlier, that has huge implications for lowering the basis risk in Two Harbors.

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

Yes, that's a perfect summary.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

So, the second technical question, PHH itself has been in the news with respect to possible sale. Who knows what's true, what's not. But I'm wondering just in terms of your agreement if you have protection. I'm assuming you do, with respect to any change of control with PHH.

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

We really can't comment on PHH's business. So I think that's probably best directed to them rather than us. But we're quite comfortable in our arrangement with them. But we really can't comment on their business. And, frankly, we have little or zero insight into those issues. So I think it's best directed to them.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Okay. I was just wondering more what if, as opposed to having you guys predict what they were going to do. Anyway, I'll take it offline. More on the last point here, the more strategic development, which I think the market investors are perhaps not fully appreciating, is this notion of adding these negatively convex MSRs and replacing swaps. I think Bill made the comment that it's 250 basis points of ROE added. I'm assuming that's more current income from the reduction of having to use swaps. But, more importantly, swaps as hedges, still, they do nothing really to mitigate the basis risk that's inherent in any mortgage REIT. So if you guys look out in terms of the build-out of strategy in a couple years, what does it do or at least how are you guys thinking about this in terms of how much basis risk will be eliminated once this kind of strategy is fully up and running?

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

I want to congratulate you. That's a very nuanced question. I can see that Bill's putting on his math nerd hat right now so I'll give it to Bill to answer that.

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

Basically one of the key benefits of owning MSR is -- there's three key benefits, frankly. First of all, it has an attractive yield. But it's not just the yield because there's a number of things that have yield in them. It's got negative duration. And, as you noted, it hedges mortgage basis risk. Which is to say that if the mortgage rate goes up and the swap rate doesn't -- IE, mortgages widen, like we saw in the third quarter -- that can be very damaging to a portfolio and it's just mortgages and swaps. So if you have mortgages and MSR, as the mortgage rate changes, the MSR obviously changes in value, as well. So it's a much better hedge. July's going to be happy that I'm going to refer you to the webinar that we just did, because we have a discussion on, and we actually have a little discussion, some slides on the impact of that.

So, going forward, I think if I could predict out several years, I might be trolling on a beach somewhere already by now. But I would say that generally having mortgage assets, such as Agency securities or loans, that have positive duration, and having MSR which is an IO product that has negative duration and hedges basis risk, that can be a core component of our strategy. Now, that doesn't mean that you don't include swaptions or swaps. It's just that we can replace a substantial amount of those hedges and have a much better risk profile. We have higher ROE. We have less basis risk. Now, there's still other risks that are involved, and there's probably beyond the scope of this conversation. But we think that that's a very powerful combination. So you can expect to see that to become a more pre-eminent part of our portfolio going forward.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

And does it also, if I'm thinking of this correctly, does it lower the need to delta hedge because your duration wouldn't move as much for given rate increases?

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

It depends upon the construction of the portfolio. So, you shouldn't anticipate that swaps and swaptions will never be absent within our portfolio, because we need to mitigate interest rate risk along the curve. And so there will never be a perfect coupling, likely, of our Agency book versus our MSR book. But it's a very elegant and a very creative hedge to our book. So there will have to be a union of MSR swaps and swaptions as we look forward. But we're quite excited about it because it has a very positive OAS and it mitigates spread risk. And so your question or questions are really great ones, and something that obviously we're quite excited about.

Joel Houck - *Wells Fargo Securities, LLC - Analyst*

Again, congratulations on the deal, as well as the progress you've made in getting to this point in a quick time frame. Thank you very much.

Operator

Jason Stewart of Compass Point.

Jason Stewart - *Compass Point Research & Trading - Analyst*

Hi. Good morning. If you could give us just generically an idea of where MSRs for this type of product are trading relative to, say, perhaps, trust IOs, and if that's a good benchmark to gauge relative movements.

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

Sure, Jason. Good morning. I'll give it to Bill.

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

Hi, Jason. Good morning. New issue MSR, you're buying brand-new zero WALA current production. There's not necessarily a perfect comparable in the trust market. Most of these are fairly seasoned so they might be a year season, two year season. And so there's not really a direct comparable. I think if you want to take a stab at it, you'll go back to my remarks about the high, very high single digits into the low double digits for yields. So if you run -- you can run a variety of different trusts that you think might be comparable. But if you look on Bloomberg and try and find something that's perfectly comparable there's nothing really that lines up exactly. So it does make it a little challenging. But I will say they do trade at a substantial OAS and yield pickup, as you would imagine. And so obviously that's very worthwhile from our standpoint.

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

Yes, if you look at the market generally, Jason, there's been really a sea change in the relative valuations between IO and MSR. And MSR historically have been rich relative to IO. Today the market's completely different than that. And that's why we're so excited about this opportunity.

Jason Stewart - *Compass Point Research & Trading - Analyst*

Okay. It's fair to say that there's a significant barrier to investing in excess MSRs, or MSRs relative to buying a trust IO, just as a security. There's a significant difference in the operations and access to that market. That's fair, right?

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

Absolutely. It took us a long time to build this platform. Yes. The GSEs rightfully are very concerned about who the counterparties are in the space because what they're really concerned about is the person that has the mortgage. Are they being properly serviced and served? And, therefore, they're quite mindful of who can get into the space. So, while a lot of people want to get into this space, it's very difficult. It took us a long time to get here. And the progress has not been as great as we would have liked internally, but we finally feel like we're there. We have all the approvals. We have the platform. We have the counterparties. We have the opportunity. That's why we're excited.

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

And I would note, too, and I think you merged two different elements, and there's a significant distinction between buying the MSR and buying the excess. The barriers to entry to buy just the excess are lower. To buy the MSR and have all the rights to terminate and to manage servicers and to make different decisions around the MSR and the performance of the MSR, provides greater value to us. And there's a lot higher barriers to entry to achieve that.

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

Yes, we could have bought the excess -- Brad's point is a great one -- we could have bought the excess a long time ago, but we didn't feel that that served our shareholders particularly well. And the reasons for that are long and nuanced and we would be glad to have a discussion around that, if you choose to. But essentially the rights to the excess holder are not the same as the person who directly owns the servicing rights. And we think in the interest of our shareholders the route we've taken is absolutely the proper one and is good for a long-term business initiative.

Jason Stewart - *Compass Point Research & Trading - Analyst*

And I think you've discussed some of those before, and down the road at some point you'll get credit for managing your counterparty relationships the right way. But when you think about your counterparties and who's originating this, are there products -- I'm assuming there's products, maybe hybrid ARMs or ARMs, that you would exclude from the agreement to buy the MSR on?

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

I'll give that one to Bill.

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

There's an old saying, old bond trader saying -- there's no such thing as a bad bond, just a bad bond price. And I think that would hold true for MSR, as well. Obviously let's just take a simple example, a 5/1 ARM. It's a lot shorter. Speeds are typically much faster. That's going to trade at a different price. That's something that you need to do the work on and model it. But we've spent a substantial amount of time analyzing the pricing and potential prepayment path for all these products. And so we build the differences into our model. So, I would say certainly at the wrong price we don't really want anything, and at the right price we're happy to take any of the products that make sense for us.

Jason Stewart - *Compass Point Research & Trading - Analyst*

Okay. Thanks for taking the questions. Appreciate it.

Operator

Jim Young of West Family Investments.

Jim Young - *West Family Investments - Analyst*

Hi. Could you talk about your typical non-Agency portfolio in which you recognize the discount accretion of $37.2 million for the quarter, yet you still have a net debt accounts remaining of $2.5 billion with a $1.4 billion credit reserve still as of September 30. How do you see this developing over the next couple of quarters, given the underlying improvements in the housing fundamentals? Thank you.

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

Jim, good morning. I'll give that one to Brad.

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

I think I'll answer it from more of an accounting. I think Bill can probably give more of the future view of prepayment speeds and other things. We look at our credit reserves on a quarterly basis. There are signs of improvement, prepayment speeds, even though a small change in prepayment speeds is very valuable to us. But there's been a lot of mixed results in the market. Unemployment's been a little bit inconsistent, as we mentioned, so we have not taken an aggressive stance on releasing credit reserves today. If the path continues, that will likely occur over time. And, Bill, maybe you can comment more on your view of how that portfolio performance might play out.

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

Yes, sure. Mathematically it's fairly simple, right? If every loan in every deal were prepaid tomorrow, at par, then the credit reserve would just go into income. Now, we know that's not going to happen. But, as Brad mentioned, we've been fortunate to be able to release reserves because performance has been good. And we do look at that every quarter. Certainly if performance exceeds our expectation, there's the opportunity to see more of that going forward. We're very pleased with the way the performance has been. Prepays have picked up. Part of that's been because rates are low and some of the guys can re-fi. Part of it is, frankly, because housing prices are higher. If a guy was under water and he couldn't re-fi and now he's got some equity in the house, that's driving prepays. So, we're certainly optimistic that that could happen in the future, where we see more releases, but we can't make any promises, obviously.

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

And Jim, I'll just tell you how we feel about that philosophically. We don't want to get into the business of taking OTTI one quarter and then releasing credit reserves and vice versa, quarter over quarter. So, we take a very conservative approach to. And we release credit reserves where it's abundantly clear, where it just hits us over the head that our assumptions were too conservative. But we want to take a very level approach to that. Obviously the fact that OTTI in our book has been de minimis over time speaks to the fact that the portfolio is really performing well and, frankly, in excess of our original assumptions. But we just want to take a very level approach to the accounting treatment around that.

Jim Young - *West Family Investments - Analyst*

Thank you.

Operator

Thank you. And this does conclude our Q&A session. I'd like to turn the conference back over to Mr. Tom Siering for any closing remarks.

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

Thanks, Ben. I'd like to thank everyone for joining our third-quarter conference call. We had a lot of great questions. We really did. And we appreciate your interest in Two Harbors and we look forward to, genuinely, speaking to you again soon. Have a great day, everyone.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program and you may all disconnect. Have a great rest of your day.
